

The Russian “Agrocompany Krasnodar”:

To win in times of sanctions?

Teaching case

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This case study was prepared by Associate Professor Vera Kononova, Lomonosov Moscow State University School of Business, and Assistant Professor Svetlana Ledyeva, Aalto University School of Business. It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was compiled from an interview with a top manager of a Russian company.

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1. INTRODUCTION

October 2017 seemed to be a challenging time for Andrey Ivanov, the Chairman of the Board of Directors of “Agrocompany Krasnodar” – an agricultural company based in the Krasnodar region of Russia. 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.

Mr. Ivanov started his career in the agri-food business in Russia in 1994, in the midst of the many reforms that were aimed at transforming the country into a market economy. At that time, he was involved in the sale of frozen chicken meat from the USA on the Russian market – a very profitable business in times of a sharp decline in local food production. At the beginning of the 2000s, when the 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 several 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 divisions involved in agricultural, agri-food and related production, almost all of them located in the Krasnodar region. Within a decade, the “Agrocompany Krasnodar” secured its position on the Russian market as one of the largest wheat producers. What is more, the company became one of the top-20 livestock farmers and milk producers in Russia.

Mr. Ivanov has put much time and effort into the development and implementation of the strategy of “Agrocompany Krasnodar” over the last few years. The key direction of this strategy was to improve productivity. That was the aim of the majority of investments the company has made. “Agrocompany Krasnodar” was among the first Russian companies to implement “smart farming” technologies. In 2017 this included weather sensors, detailed land maps based on satellite data, quadcopters for field diagnostics and a 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 agri-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 a wheat yield of more than 65 quintals per hectare – among the highest results in Russia. The pace of crop harvest was ahead of the previous year’s results, and close to the country’s highest records. The monitoring of land and optimization of agricultural machinery workload allowed for economizing 30% on fuels. The livestock productivity for milk production was improving substantially.

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

2. THE STRATEGIC CHALLENGE

Andrey Ivanov knew that the previous paradigm of development had worked well at a time when agri-food companies increased their capacity and attracted new inputs – acquired new farmland, brought modern equipment and technologies in from abroad, and had better opportunities to finance all these things. Frankly speaking, finance in Russia has always been 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 began, the expectations for the future in the agricultural sector were quite diverse. Much attention was paid to the opportunities for import substitution in agri-food products, especially after Russian import food ban and the collapse of ruble at the end of 2014. The Ministry of Agriculture of Russia announced new programs, aimed at supporting the agri-food sector and their partner industries, and the Ministry of Economic Development announced additional measures to ensure export support.

Mr. Ivanov himself, his colleagues and partners were convinced that now, in the fall of 2017, things were being viewed differently. First and foremost, it became obvious that sanctions were a long-term issue that was going to go deeper and deeper and was far from seeing an end. The foreign partners seemed to be cautious of entering into new contracts with a Russian company that could potentially have sanctions imposed on it at any given moment. Second, the internal market had reached its limits. The economic downturn in

2016 and (as everyone expected) in 2017 was followed by the drop in people's disposable income and resulted in "total saving" – even on foods. And, finally, the instruments and incentives provided by the Ministries of Agriculture and Economic Development were not so easy to use, and, apart from anything else, could not help the agri-food companies to solve all the problems they had. Import substitution started, but "Agrocompany Krasnodar" could still not find the locally-produced harvesters, seeds and additives of appropriate quality.

The Board of Directors meeting that was held at the time showed that the members had some promising ideas in mind, where to go and how to find new strategic directions for company development. One idea that appealed to Ivanov was to expand the export activities of the company. The "Agrocompany Krasnodar" was already exporting wheat (actually it was grade-4 wheat with a small share of grade-3 wheat) to Egypt and Iran. The most likely new directions could be former USSR countries such as Uzbekistan and Tajikistan, as well as others. The main risk here was financial – partly originating from the economic instability of these countries, and partly from the situation that "Krasnodar" would have to deal with on engaging with new partners. At the same time, the new export support policies in Russia might prove to be helpful. Ivanov needed to investigate this.

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

The Director responsible for soybean production called the attention to the project that had already been discussed at a board meeting several years before. That was the project for the deep processing of organic soybean to produce cardio-protectors and antioxidants. Several years before the crisis, this project was quite exotic for the Russian market – it was easier to import the ready-made products from abroad than to spend time, effort and money to organize the new production inside the country. However, at that time, after all these calls for import substitution, this idea could be now perceived differently.

What was really challenging was that in those times “Agrocompany Krasnodar” could not attract owners’ financing for all these things. The company had to apply for market financing, where possible, and the issue of profitability was more important than ever before.

In this regard, 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 by cooperating with small farmers that surrounded the company’s farms. If these farmers would agree to work according the “Agrocompany Krasnodar” orders, and sell the crops for the reasonable price (costs plus 10% to 15%), they would have 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 from using subsidies or accessible loans for machinery and equipment. Ivanov was somewhat skeptical about that, but it was still worth thinking about.

3. BACKGROUND

3.1. Western sanctions on Russia and their general impact on the Russian economy



In 2014 the United States, the 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 were 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 were imposed. In July 2014, economic sanctions were adopted. There were three types of economic sanctions. The first type restricted access to Western financial markets and services for designated Russian state-owned enterprises in the banking, energy, and defense sectors. The second type placed an embargo on exports to Russia of designated high-technology oil exploration and production equipment. Finally, the third type was an embargo on exports to Russia of designated military and dual-use goods (Christie 2015). Up to the present time, all of these sanctions have been continuously renewed and expanded several times.

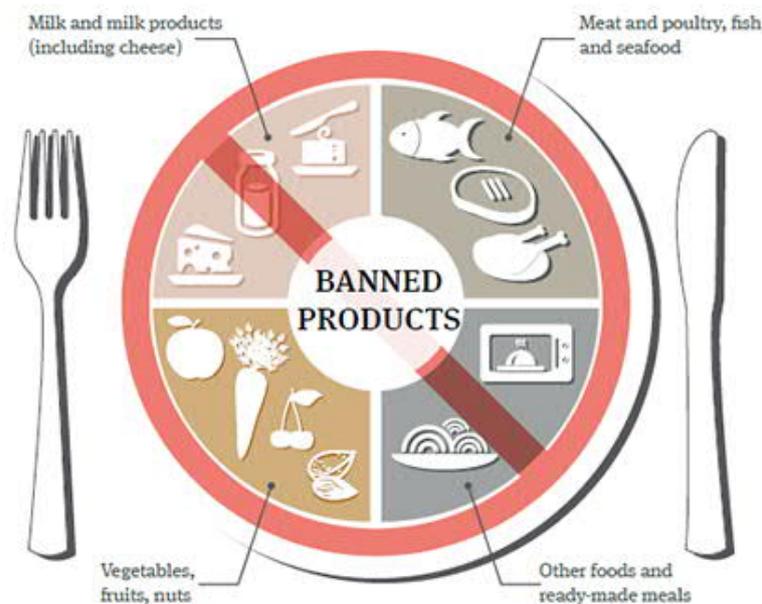
The sanctions exacerbated the macroeconomic challenges that the Russian economy was already facing, and which deepened notably with the rapid and significant fall in oil prices that started in the last months of 2014 (see Figure A1 in Appendix A). The combined effect of these sanctions and of the fall in oil prices caused significant downward pressure on the value of the ruble and increased capital flight (see Figures A2 and A3 in Appendix A). At the same time, the sanctions on access to financing forced the Russian state to use part of its foreign exchange reserves to support the sanctioned entities. These developments forced the Central Bank of Russia to abruptly cease defending the value of the ruble and hike interest rates in December 2014 (Christie 2015). The dynamics of interest rates in Russia in recent years is represented in Figure A4 in Appendix A.

Though 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 (see Figure B1 in Appendix B). However, sanctions also had some impact. Since early 2016, a modest recovery in oil prices has helped Russia return to growth (Russel 2018).

3.2. Russian food counter-sanctions



In response to the Western sanctions, on August 6 2014, President Vladimir Putin signed the decree which aimed to prohibit or limit the import of a broad range of agricultural products from countries which had initiated or joined sanctions against Russia. An agro embargo was implemented in three stages: from 2014 - for the USA, member states of the European Union, Australia, Canada and Norway, from 2015 – for Iceland, Lichtenstein, Albania and Montenegro, and from 2016 – for Ukraine. The Russian embargo has been continuously renewed until the 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 specified types of banned products, which included: meat and poultry, fish and seafood, milk and dairy 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 was reported that some suppliers had to recall deliveries which were already on their way to Russia. Some EU agricultural businesses sought to import their goods through Switzerland, but the Swiss authorities did not allow 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).

As a result of the Russian product ban, agri-food imports shrunk by about 40% in 2013-2016 as shown on Figure 1 (see also Liefert and Liefert 2019).

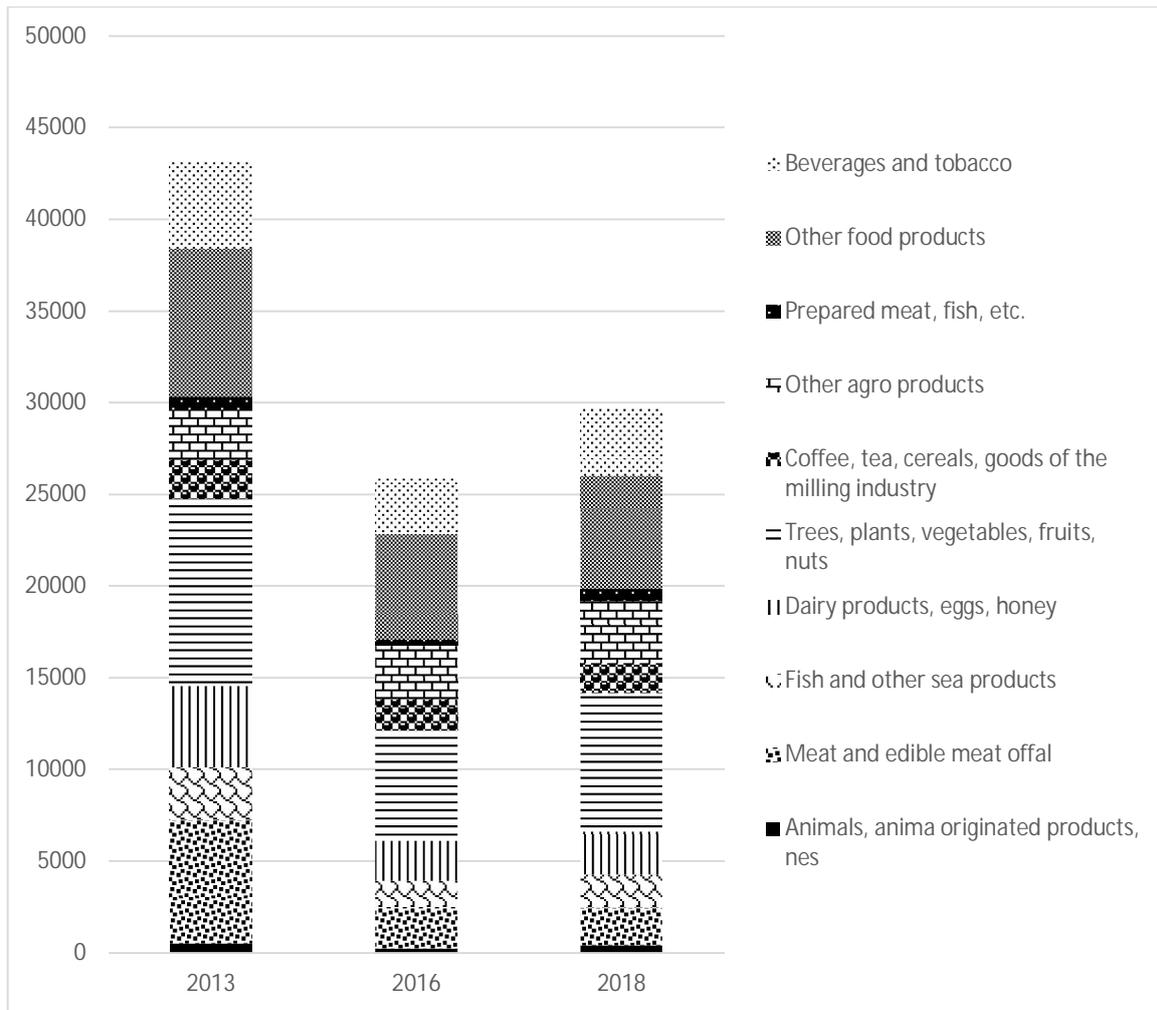


Figure 1: Russian agricultural imports, billions USD

Source: Authors' calculations based on UN COMTRADE data.

3.3. Sanctions and Russian agri-food sector

Russia's agri-food sector has benefited from reduced competition, partly as a result of the agri-food embargo on many agri-food goods from the EU and partly as a result of ruble devaluation, which pushed up the price of food imports. 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 the import ban. In particular, they faced higher prices (though food inflation has since slowed down and now is below average; see Table C1 in Appendix C). In addition, Russians are also having to do without favorites such as Parmesan cheese – although the country's farmers are working on domestic substitutes (Russel 2016).

According to Forbes “in few years, state support, counter-sanctions (the agro embargo) and ruble devaluation turned the 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 frozen and defrosted	142%
Cheese and cheese-based products	139%
Frozen fish filet	131%
Meat and food sub-products of fowl	123%
Cream	121%
Shellfish non-frozen, oyster, other water invertebrates, alive, fresh or chilled	121%
Seafood	117,5%
Cream and 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 grain (Russia Today, 2018). Though the increased grain export was mainly due to bumper harvests, supportive state policies for the agro sector, which followed the Russian food embargo, could have played a positive role as well. The turnaround is impressive since in the last 15 years and for a couple of decades before during the Soviet era, Russia was a net importer. Though agriculture remains far below oil and gas, the sector has overtaken arms sales to become Russia’s second-biggest exporter (Buckley 2017).

3.4. State policies to develop agri-food production in Russia

In recent years, the Ministry of Agriculture of the 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 a federal level was 212.5 billion RUB (at that time it was about 3.6 billion 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 lower than 5%. The system started operating in February 2017, when the average short-term loan rate (for non-financial companies) was 11.5%. At first, 10 banks were authorized to provide the loans, and by the end of 2017 the number of authorized banks had increased to more than 40. These banks agreed to provide the preferential loans at less than 5% interest within 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% at the beginning of 2017).

The demand for preferential loans was very high. In 2017, the authorized banks provided more than 630 billion RUB (about 11 billion USD) as preferential loans for about 8000 agricultural companies and farmers. The total amount of subsidies for the authorized banks exceeded 50 billion RUB (about 0.9 billion USD). However, in some regions the small agricultural businesses complained that the quotas for preferential loans were full very quickly, 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 agricultural production was **a set of subsidies**. The subsidies provided 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 a 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 billion RUB (0.24 billion USD).

In addition, the Ministry expanded its **grant program for farmers** that had been in effect since 2012 (in 2017 the maximum size of a grant increased from 1 to 3 million RUB (from 0.02 to 0.05 million USD). According to the Ministry's estimation, one farmer in five in Russia received 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).

4. CONCLUDING REMARKS

Due to a serious political conflict between Russia and the West that started in 2014 and continues until the present time, the business environment in Russia has changed drastically. Though for most economic agents inside Russia business conditions have become worse, the impact on the agrarian sector is ambiguous. On the one hand, as is the case with all economic agents in Russia, market players in the agrarian sector have experienced difficulties with obtaining financing due to Western sanctions and the overall worsening of economic conditions inside Russia. On the other hand, the Russian embargo on the import of a number of agri-food products from Western countries and state support for import substitution activities have opened up new opportunities for agricultural businesses' development. Thus, owners and top managers of agricultural companies in Russia have faced new challenges in configuring their future business strategies. This case study provides a real example of such a strategic challenge and gives students a unique possibility to find themselves at the crossroads of new business opportunities, though also with many hazards.

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APPENDICES

Appendix A

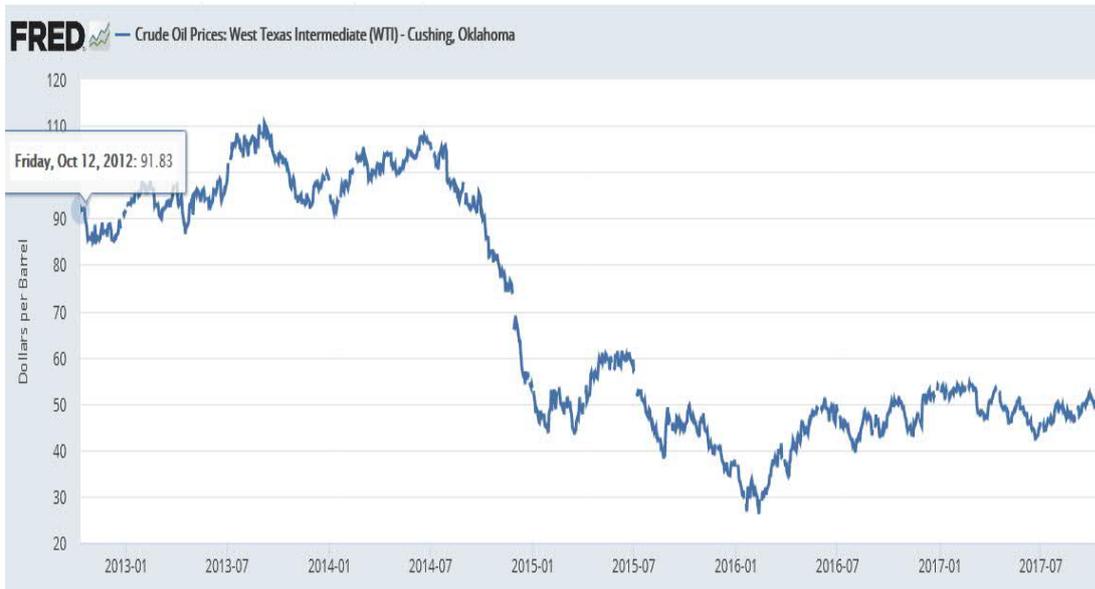


Figure A1: Oil price dynamics in 2013-2017

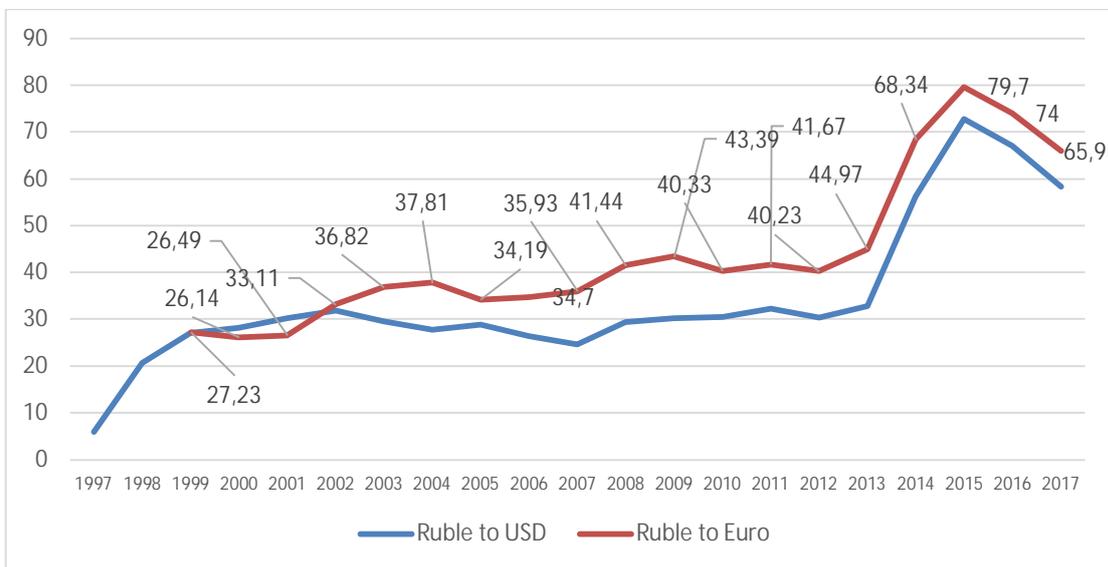


Figure A2: Russian ruble-Euro/USD exchange rate dynamics in 1997-2017

Source: Central Bank of Russia

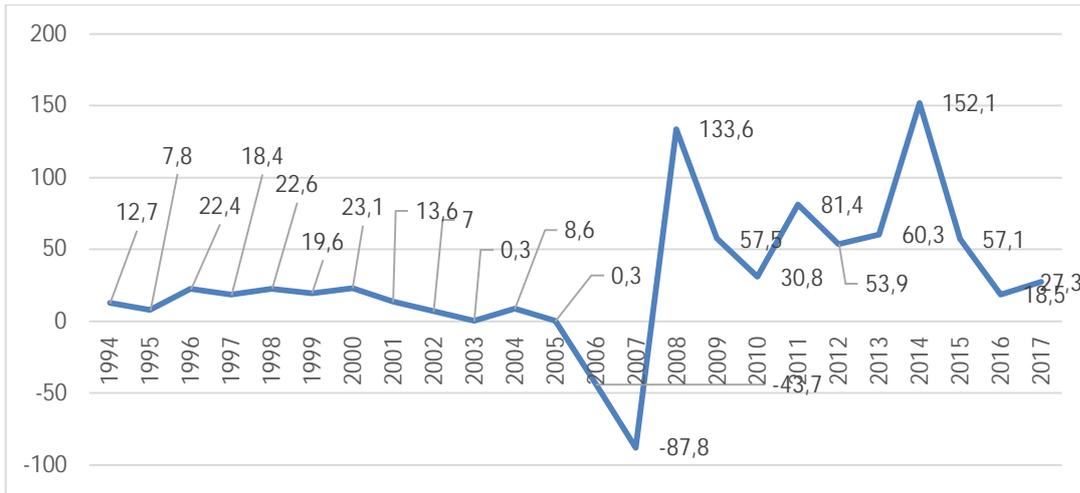


Figure A3: Capital flight from Russia in 1994-2017, billion USD

Source: Central Bank of Russia

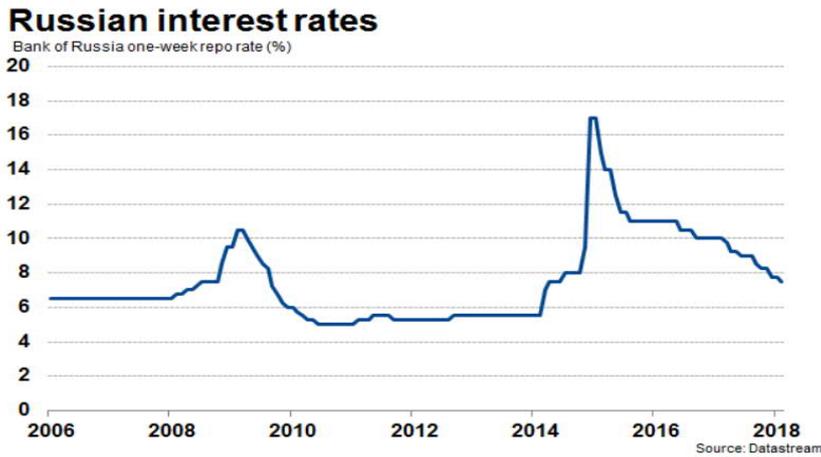


Figure A4: Interest rates in Russia in 2006-2018

Source: Screenshot from Jones 2018.

Appendix B

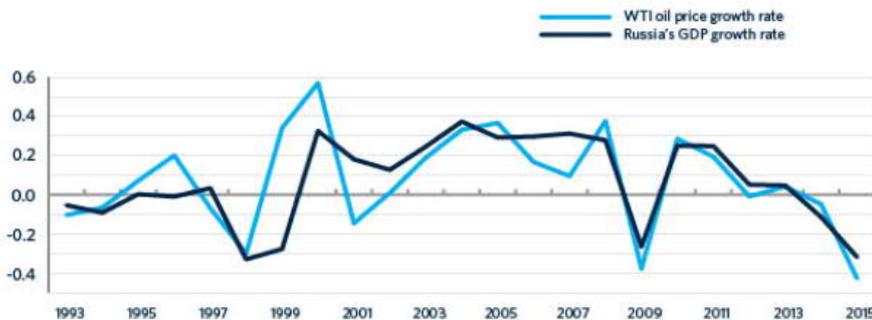


Figure B1: Changes in Russian GDP growth versus changes in WTI (West Texas Intermediate) oil prices (current USD)

Source: Screenshot from Movchan (2015)

Appendix C

Table C1: CPI inflation in Russia in 2013-2019

	<i>CPI</i>	<i>CPI for food items</i>	<i>CPI for non-food items</i>	<i>CPI for services</i>
<i>Inflation rate in 2013 (Dec2013 to Dec2012), %</i>	6.3	7.3	4.5	8
<i>Inflation rate in 2014 (Dec2014 to Dec2013), %</i>	11.4	15.4	8.1	10.5
<i>Inflation rate in 2015 (Dec2015 to Dec2014), %</i>	12.9	14	13.7	10.2
<i>Inflation rate in 2016 (Dec2016 to Dec2015), %</i>	5.4	4.6	6.5	4.9
<i>Inflation rate in 2017 (Dec2017 to Dec2016), %</i>	2.5	0.8	2.8	4.5
<i>Inflation rate in 2018 (Dec2018 to Dec2017), %</i>	4.3	5.1	4.1	3.9
<i>Inflation rate in 2019 (Dec2019 to Dec2018), %</i>	3.4	3.77	3.04	3.78

Source: Authors' calculation based on ROSSTAT (Russian State Statistical Agency) data.