

Editors:

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Cases in Management

(Strategy and General Management)

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ENABLING DECISIONS


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GRADUATE TO PROFESSIONAL

AN INITIATIVE BY

TIMES OF INDIA GROUP

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THE ELECTRODE GAMBLE (A, B)

Michail V. Plotnikov, Professor, National Research University - Higher School of Economics,
Nizhny Novgorod, Russia

The Electrode Gamble (A)

'...are fired!' – the executives' meeting on May 7th 2007 ended up on an almost hysterical note as the CEO of Kislorod Group struck his hand on the table expressing his rage towards a 34-year-old executive of a subsidiary company Kislorod Plus. This man's unprofessional actions led the company into a dramatic crisis and he had just written an account of his failure. There was much despair in the CEO's voice for the greatest strategic initiative of the year had been utterly ruined despite the profound investment and a splendid market opportunity. To make matters worse, only an hour was left before a scheduled Board meeting and the CEO had no idea what to say to the people who need neither excuses nor explanations but wait for proofs and action plans.

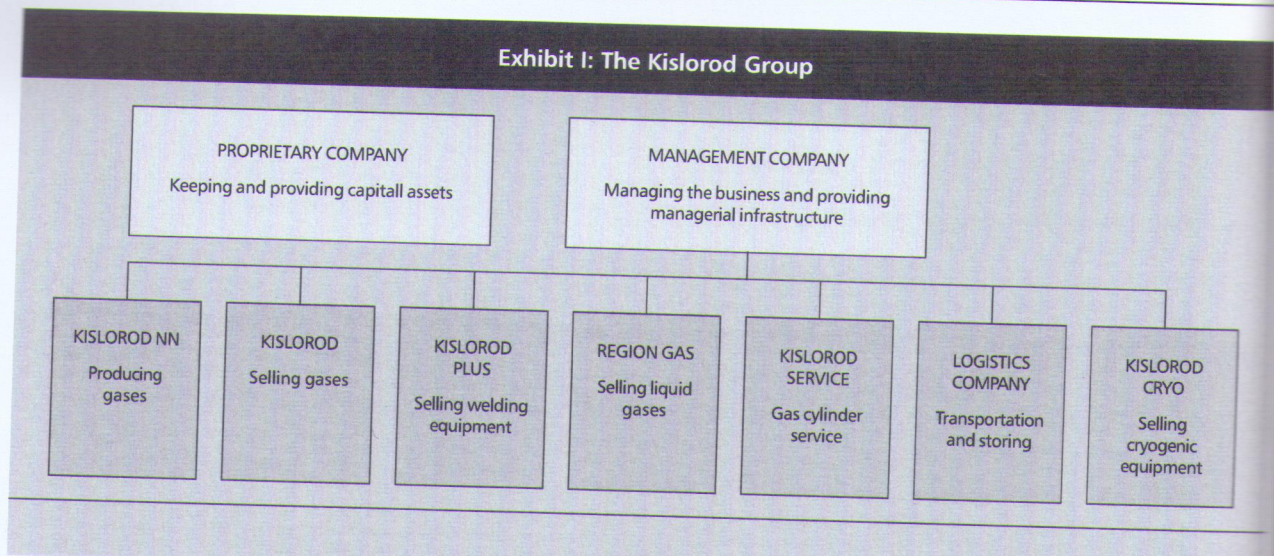
Kislorod Group

Founded in 1999 Kislorod Group is a local holding company situated in Nizhny Novgorod. It consists of nine legal entities including the Proprietary Company and the Management Company that owned seven subsidiary business units (Exhibit I). The group had been formed recently as the result of the restructuring of a single limited liability company. The change started in November 2006 as a part of a broad-scale strategy that presumed aggressive diversified growth in all the major activities of the holding company and was supposed to provide the necessary level of decentralization together with clear budgeting and managerial control.

One of the essential aspects of the change was promoting division supervisors to be TOP executives of separate legal entities, each representing a major business unit namely: producing technical gases, selling gases in cylinders, selling liquid gases, selling cryogenic equipment, providing technical service for gas cylinders and transporting technical gases.

The first few months appeared to be very busy though promising. Due to the seasonal decline in sales the executive team was involved in developing strategies and drawing up plans and budgets for the upcoming season. As Kislorod Group CEO put it:

Exhibit I: The Kislorod Group



"We were all overcome by a glorious feeling of omnipotence. We carried out what nobody had ever performed in that business field as we applied professional management approach to a completely messy environment. We analyzed markets, recognized opportunities, worked out plans, and calculated budgets; we generated business models and created financial schemas – everything seemed possible, everything seemed easy".

Kislorod Plus

At that time Kislorod Plus sold two types of welding equipment: welders and electrodes. Set up as a complementary activity to the main gas business, it finally grew into a solid business unit that contributed greatly to the overall profit (Exhibit II (a) and II (b)).

Exhibit II (a): The Average Monthly Financial Figures of Kislorod Group*

Business Unit	Total Revenue	Fixed Costs	Variable Costs	Fixed Dividend Payment
Kislorod	6 200	1 400	4 400	400
Kislorod Plus	3 600	600	2 480	500
Region Gas	4 000	100	3 500	400
Kislorod Service	400	100	200	100
Kislorod Cryo	3 100	400	1 700	800
TOTAL	17 300	2 600	12 280	2 200

* Kislorod NN, Logistics company, Proprietary Company and Management Company do not generate revenues from outside markets

Exhibit II (b): Kislorod Plus Records at the Beginning of April 2007

Balance sheet (thousands of RUR)

Assets

Current assets

Cash	900	
Short-term investments	0	
Accounts receivable	2 900	
Inventories	900	4 700

Fixed assets

Land	0	
Buildings and equipment	0	0
Total assets		4 700

Inventory stock

Item	Price (RUR)	Quantity	Stock Value (RUR)
Welder	4 000	50	200 000
Electrodes	160	4 375	700 000
			900 000

Liabilities

Current liabilities

Accounts payable	2 000	
Interest payable	0	

Long-term liabilities

Bank loan	0	2 000
-----------	---	-------

Stakeholder's equity

Capital stock	2 700	
Retained earnings	0	2 700
Total liabilities and equity		4 700

The company had no capital assets (renting the necessary from the Proprietary Company) and only four employees: three sales managers and a director. The sales were organized in two ways: The first way comprised direct sales to corporate clients, the second one constituted retail sales through six Kislod outlets – three in Nizhny Novgorod, one in Dzerzhinsk, one in Bor and one in Arzamas.

The two products, though complementary, were very different. The welders were sold at average RUR10 000 per unit, had 3–4 months of turnover period, low seasonal sales volatility, and were provided by a number of suppliers. The electrodes were sold at RUR200 per box, had 2 weeks of turnover period, high seasonal sales volatility and were actually provided by a single Supplier in the central part of Russia that had a very strict dealing policy (Exhibit III).

The company was obliged to pay 500 000 RUR monthly of fixed dividend payment to the owner (the Management Company). The overall fixed costs of *Kislod Plus* were about 600 000 RUR per month. This included the fixed part of the wages and all internal corporate payments: the services of the Management Company, rental fees to the Proprietary Company and contracts with the other business units to provide necessary logistics and retail sales.

Exhibit III: The Dealing Policy of the Electrode Supplier

To obtain the status of an authorized dealer the buyer should meet the following conditions:

- Minimal contract volume – 12 500 boxes per week
- Allowed payment delay – no more than two weeks

The status of an authorized dealer provides the following privileges:

- Special dealer's price – 150 RUR per box
- Priority stock reservation and shipping

The Electrode Market

The electrode market primarily constituted of firms of different sizes: from private brigades to state-wide corporations. High seasonal sales volatility resulted in one half of annual sales done in four months: from June to September and only 20% was done from January to April (Exhibit IV).

Kislod Plus sustainably held about 1/5 share of the regional electrode market, competing with a large number of other companies, none of which though was part of a greater corporation (Exhibit V). Being relatively small companies each market player had certain restrictions in turnover assets, logistics capacities and manpower.

Each year during the high season there was a traditional supply deficiency which was estimated to be up to 30000 boxes a month of pent up demand during the 2007 high season. This gap was caused by the quoting policy of the supplier. The policy was supposed to ensure equal cross-regional distribution for the limited volume of electrodes being produced, while keeping production capacity at its average level.

The Strategy

The strategy accepted by the Board of Directors on March 10th 2007 presupposed rapid growth during the upcoming season by attracting the construction firms which had seasonal pent up demand and consequent signing long-term supply agreements.

Exhibit IV: Estimated Electrode Market Volume in Nizhny Novgorod Region (2007)

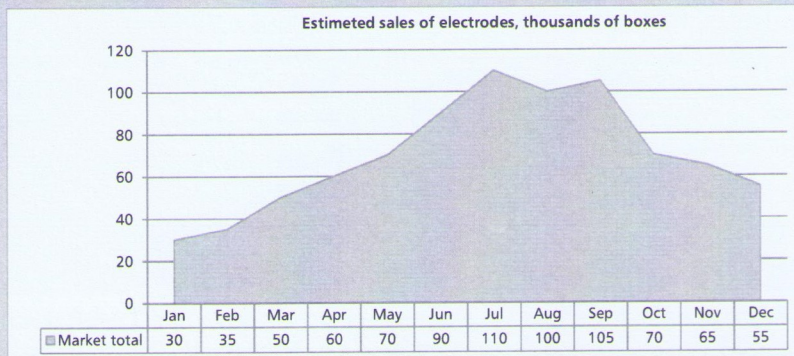
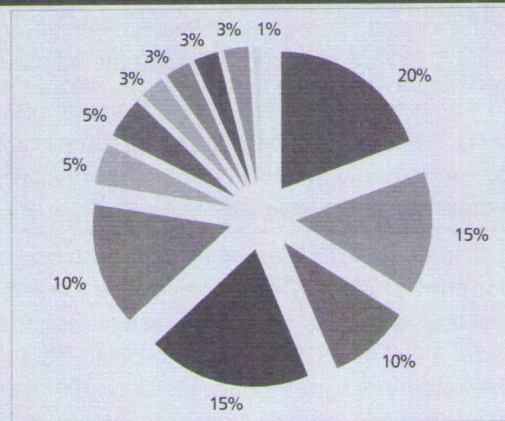


Exhibit V: The Main Players of Electrode Market in Nizhny Novgorod Region (2007)



The planned implementation depended on the successful performance of the two key tasks. The first one was to raise turnover assets by receiving a bank loan of 4 000 000 RUR, and the second – to provide the earliest supplies of electrodes in the region through more frequent ordering and decreasing the amount of payables to zero.

This should have resulted in selling additional 50 000 boxes of electrodes during the high season and reaching 35% of sustainable market share after it ended.

The Failure

During the executives' meeting on May 7th the Director of *Kislorod Plus* reported on the current situation which was clearly far from what had been planned and looked like a complete failure of the strategy (Exhibit VI).

Exhibit VI: Kislorod Plus Records at the Beginning of May 2007

Balance sheet (thousands of RUR)			
Assets			
Current assets			
Cash	450		
Short-term investments	0		
Accounts receivable	3 200		
Inventories	1 200	4 850	
Fixed assets			
Land	0		
Buildings and equipment	0	0	
Total assets		4 850	
Inventory stock			
Item	Price (RUR)	Quantity	Stock Value (RUR)
Welder	4 000	250	1 000 000
Electrodes	160	1 250	200 000
			1 200 000

Liabilities		
Current liabilities		
Accounts payable	0	
Interest payable	0	
Long-term liabilities		
Bank loan	4 000	4 000
Stakeholder's equity		
Capital stock	850	
Retained earnings	0	850
Total liabilities and equity		4 850

April 2007 started with great news that the Partner Bank approved the necessary loan for three years at 16.5% interest rate, and the money was transferred to the company account. On April 16 in accordance with the strategy 210000 RUR were paid to the Supplier in order to dispense off the debt and buy the first batch of 500 electrode boxes. It appeared impossible to buy more due to the late order (caused by the delays in payment and transport allocation from the Logistics Company) The Supplier could provide only the rest of the stock by the earmarked date though promising delivery of the remaining quantity of electrodes within week. As the money was not spent on purchasing electrodes, the executive decided to transfer the dividend payment two weeks earlier than usual and the sum of 500 000 RUR was transferred to the Management Company on April 17th.

April 20 witnessed an accident. The main compressor of Kislorod's producing company broke down and required immediate repairing. As the producing company did not have enough money in its bank account, the CEO of Kislorod Group had to insist on taking an extra out-of-turn dividend payment of 800 000 RUR from each business unit to cover repairing expenses.

Having yielded to the CEO's demand, the Kislorod Plus executive realized later that there were not enough funds left to perform the strategy. Desperately trying to reach the planned level of sales, on April 23rd he decided to make a risky deal that seemed extremely attractive. He ordered 200 welders for 800000 RUR payable in a week in order to raise about 1 000 000 RUR of marginal profit from selling them to a wholesale client. The delivery was done in two days, the welders were not sold as the potential client rejected had only a verbal contract and rejected the purchase. But that was not enough. The company's freight crashed on its way to the electrode Supplier and arrived with a three days delay. At the appointed time only 125 boxes of electrodes were left available for Nizhny Novgorod region.

The April sales of electrodes were extremely poor due to the lack of stock. On the whole only 3750 boxes to the total sum of 750000 RUR were sold. 2/3 of it constituted accounts receivable in a period of 2 to 6 weeks. Besides, not a single welder was sold during the whole month. By the beginning of May the situation became disastrous. The implementation of the strategy now seemed totally impossible. After the executives' meeting the CEO tried to calm down and think of what could be done in such unfavorable circumstances.

Should he abandon the strategy and develop an alternative action plan? Or is there any possibility of reaching the previously set objectives despite the circumstances? What proposition should he make to the Board?

The Electrode Gamble (B)

Dmitry Beloff, the newly appointed Director of *Kislrod Plus* suggested an anti-crisis program. He understood that regardless of all the mistakes and difficulties, the entrepreneurial opportunity for growth – the seasonal increase in demand – was still the same and worth struggling.

He understood that pursuing the opportunity would require a sustainable competitive advantage of having enough electrodes in stock all the time, so that the clients (primarily construction companies) could receive them on time in order to prevent the losses caused by the delays in shipment.

To provide this competitive advantage *Kislrod Plus* should have enough turnover assets and guarantee the necessary payment from the suppliers.

Dmitry suggested meeting the requirements of the dealing policy of the electrode suppliers to obtain 'priority stock reservation and shipment' option. Considering the quota set by the supplier for the region was 90 000 boxes per month, and the demand was 90000 to 110 000 during the summer, the amount of 50000 boxes per month (obliged by the dealing agreement) seemed more than realistic to be fulfilled as all the competitors could receive no more than 40 000 boxes per month altogether.

Performing the strategy required raising the necessary amount of turnover assets. Dmitry decided to sell the accounts receivable of 3.2 million RUR to the partner bank for 70%. Dmitry raised 1.2 million RUR from the regular clients as pre-payment for guaranteed summer supplies. He understood that the strategy could be successful only if the competitors would have insufficient stock. The dealer status obtained, he used the assistance of a trusted client to buy the bulk of the electrodes from the four major competitors, delayed payment for a short while and then suggested as an alternative payment mode for his stock of welding equipment at a discounted price of 3700 RUR per unit, which seemed a good deal.

Dmitry also negotiated with the management company to postpone the regular payments to the end of October, thus keeping the funds within the turnover assets all through the high season.

In order to cover possible gaps in the cash flow, Dmitry used a bank overdraft, supported by the proprietary company of the *Kislrod* Group.

The strategy proved to be successful. By the middle of June *Kislrod Plus* became dominant in the regional electrode market, as the other players combined together could not equal it in the stock and the actual supply. This allowed raising the selling price of a box up to 300 RUR, which along with the special dealer's price of 150 RUR resulted in raising the margin up to 100%.

The total amount of *Kislrod Plus* sales during June-September 2007 was more than 52 million RUR. The strategy let the company cover all its debts and generate a solid volume of profit. The October sales were moderate and did not allow supporting the terms of the dealing agreement with the supplier. The company still retains more than 50% of market share of electrodes today.

Ashish Kumar Garg

Ashish Kumar Garg was an Assistant Professor, Finance & Accounting at IIM Raipur. Presently he is working as an Assistant Professor, Finance and Accounting at IIM Kashipur. He has published and presented research papers in many national and international journals and conferences.

K K Ray

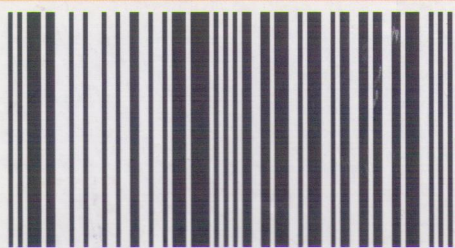
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