Choice of Economic Strategies by Food Complex Enterprises in Conditions of Market Uncertainties

Olga Yermolova, Natalia Kireyeva, Natalja Fisenko
Institute of Agrarian Problems of the Russian Academy of Sciences,
Moskovskaya st., 94, Saratov, 410012, Russia,
apk@mail.saratov.ru

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Abstract

The paper presents the results of the sociological survey and expertise describing the factors of risk reduction and increase of the level of trust in contract relations in food networks. The level of contract discipline is analyzed. It is shown that the insufficient rate of development of the institution of trust restricts the liberty of action for companies operating in a food network, deprives them of the opportunity to achieve the local optima and provides no grounds for setting their economic behavior sure-footed standards.

Following the sociological survey the dynamics and structure of the transaction costs in food networks are displayed along with the specific features of their accounting in the company's operations.

An expertise of the most important risk factors encountered at the current stage of development of the food networks is presented.

Case studies for a number of companies enabled to reveal the advantages and contradictions of pursuing the strategies of diversification and integration as a means to reduce the external risks and uncertainties and overcome the negative impact of the asymmetric market information and underdeveloped institutional trust.

A quantitative analysis of the synergetic effects from implementing the diversification strategy was made for a number of food companies to find out that the risks get reduced almost twice. At the same time, it is discovered that the transition of diversified companies from the zone of critical risks to that of minimum risks bears both positive and negative consequences. One the one hand, these are lower operational costs, more efficient distribution of the resources, greater market value of the company. But on the other hand, the above gains are offset by the excessively complicated organizational structure, dissipation of the resources, impediments to restructuring and etc.

Keywords: *food complex, economic strategies, risks*

In order to assess the efficiency of economic strategies for food complex enterprises, an inquiry was carried out among the leadership and specialists of 35 companies operating in the food industry of the Saratov and Volgograd oblasts of Russia, in which 48 respondents took part. The inquiry form included questions concerning the level of competition on individual food markets, objectives of development of the food complex enterprises, factors of their competitive power, and about the role of investments and innovations in the economic growth of a company. In addition to that, the inquiry had the aim to assess the efficiency of the competitive strategies pursued.

When developing an economic strategy for an enterprise, it is important to understand clearly the basic objectives the leadership sets for it. Figure 1 shows that enterprises disperse their resources seeking to achieve numerous minor goals, which prevents them from focusing on what is of the major significance. Nevertheless, we can single out the principal objectives mentioned by the respondents. These are increase of the profitability of production and expansion of the sales markets.

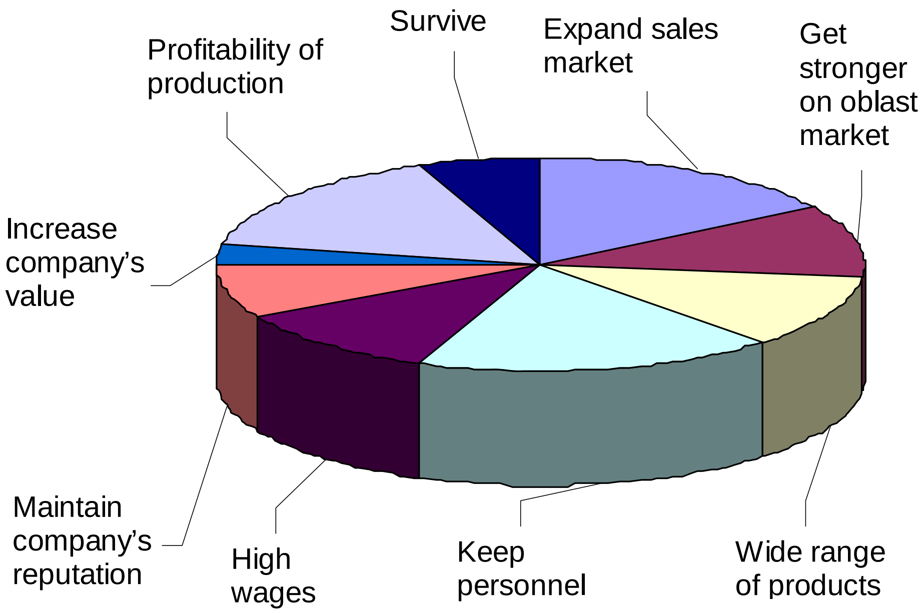

Figure 1. Principal goals of food complex enterprises in 2004-2005

Most strategies developed for enterprises today in the conditions of uncertainty, organizational difficulties and contradictory goals do not strictly have hypothetical maximization of profits as their major objective. The task of maximization of short-term profits often appears in conflict with the task for the enterprise to survive in the short-term. Often enterprises rather have concern in increasing the volume of sales. There are examples when enterprises occupy a small segment of the market, but have a high level of profits. In these cases the strategic factors fire, i.e. efficient competitive strategies.

The respondents put adequate supply of raw materials in the first place as a competitive power factor. The inquiry reveals that the raw-material component of the competitiveness growth is acquiring more and more importance, which especially manifests itself in the meat and the dairy sectors. In the meat industry, for instance, as the raw material production has declined and meat quotas were introduced, the domestic producers experience greater demand for domestic raw materials. Therefore, attempting to stand the competition, a number of enterprises are in for setting up their own agricultural production units, which can lead to a greater concentration of production as a result of creation of vertically integrated holdings. Dearness of and more severe competition for raw materials and suppliers (that have grown in the number) is a feature of the competitive environment of the today's food market.

Availability of a well thought-out and tuned raw material supply system is of an utmost importance. One of the powers affecting the competition on the raw material market is the suppliers' ability to bargain. In the present-day Russian conditions this component has undergone a certain transformation and, to our opinion, should now rather be put as "the suppliers' ability to survive and only then to bargain". The problem of getting supplied with quality domestic raw materials in due time and regularly has come to the forefront, which is proved by the results of the inquiry. For instance, on the meat market which is experiencing raw material shortages, any reduction of the purchase prices by processing companies can lead to immediate loss of the most part of their suppliers from among the domestic agricultural producers.

Domestic commodity producers tend to have long-standing inter-branch partner relations with their suppliers. That is what 80% of the respondents – leaders of enterprises manage to do. It should be noted that most successful enterprises offer various kinds of support to agricultural producers. Most of them (67%) provide loans to agricultural producers, finance sowing campaigns in advance, render commodity credits and issue guarantees for them to obtain loans, fuel or machinery. Believing that their competitive status much depends on the availability of raw material supplies, the processing enterprises themselves, even showing some 5-8% profitability (like dairy enterprises, for instance), see subsidizing of weak farms and state support of agricultural production the most importance factor.

The inquiry shows that most enterprises obtain raw materials from large companies – intermediaries basically. Their proportion in the total volume of the raw materials supplied varies from 40 to 98% constituting about 70% on average, the larger the enterprise the bigger the figure. It should be mentioned that the major part of these raw materials is imported semi-finished products, which is particularly a feature of the meat processing industry.

The respondents think that the regional support policies should be made more flexible. For instance, in Mordovia, to encourage the processing activities the local agricultural producers are paid subsidies for delivering their milk to dairy factories. As a result, producers in this region supply cheaper products to the local market and benefit from the inter-regional exchange.

Partially raw materials are purchased from agricultural producers, including both small independent farms and large agricultural enterprises - former kolkhozes or sovkhozes, as an instance. This sort of cooperation can either be based on contracts or not. The latter form prevails depending on the habits and traditions of the partner enterprises as well as on the extent to which the informal relations between the suppliers and the processing enterprises are developed. It should be noted, however, that according to the results of the inquiry, most enterprises do not feel convenient cooperating with small suppliers because of the small amounts and instability of supplies and seasonal fluctuations (the amounts supplied are bigger in summer, almost coming to zero in winter months).

On the other hand, about 50% of the respondents think that cooperation with large companies has certain shortcomings as well. The principal one is the instability of large companies resulting from the instability of the state support, on which they depend. About 50% of the failures to meet contract obligations were caused by the bankruptcy of suppliers, which most frequently were large enterprises. Small farms, many leaders and specialists of food companies believe, are on the contrary more stable and less exposed to ruin. An additional factor of their stability is that they perform “shadow” operations, which cannot be adequately controlled by the state.

Weak payment discipline on the part of processing companies is a negative feature the producers have to face. The major problem here is the long duration of cashless transfers for the products supplied. It often happens that the producers receive their money only a few weeks after their products have been sold.

Imperfect legal framework in relation to the ownership rights produces impact on the contractual practices of enterprises. The lack of long-term contracts increases the uncertainty for companies, which negatively affects the decision-making process and the companies’ readiness to restructure. One of the factors much influencing the economic strategies of enterprises is the atmosphere of trust. Trust can neither be negotiated nor stipulated by a contract. It is an informal institution developing by experience. Creation of the atmosphere of trust in inter-firm relations is a long process influenced by some certain factors.

Among the factors restricting business activity, the most important the respondents think to be the insufficiency of own funds and poor consumer demand on the market (Figure 2).

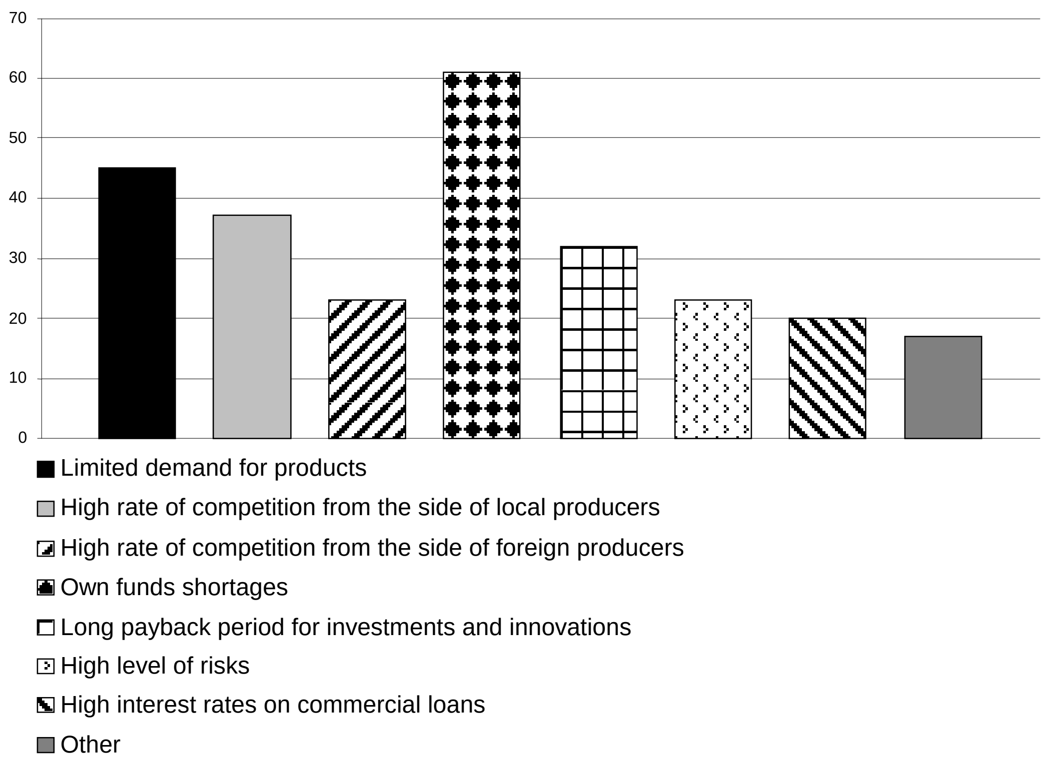

Figure 2. Factors restricting economic activity

Price, innovation and investment policies, as well as the opportunities for medium and small food enterprises to survive, are governed by their diversification strategies. Active vertical and horizontal integration and diversification of food businesses into the allied spheres of the food complex are taking place. Diversification is progressing differently for sectors having a bent for regions – sources of raw materials (sugar beet, canning, primary winemaking and etc.) and for that gravitating towards regions-consumers (baking, alcoholic and nonalcoholic beverage and etc.). Diversification strategies of the kind are being pursued by both large food companies of the regional and national levels and medium and small enterprises of the local level.

Analysis of the diversification processes going on the food market shows that many operators of this market today are having their eyes fixed on the food industry. Furthermore, the food industry became attractive in terms of investing for many companies of the oil, metallurgic, gas, motorcar and other sectors of the economy. Capitals are penetrating not only in the processing industry, but in the agriculture as well.

Enterprises following non-allied diversification strategies often acquire businesses offering quick financial return opportunities. It is for this very reason that large companies belonging to non-food sectors started to acquire agricultural and food processing enterprises, as the assets of the latter are often undervalued, they usually have difficulties with financing, and their capital investment inflows are far from being sufficient.

The inquiry shows that investments in the food complex are made in order to distribute the risks from production operations and market transactions. Non-allied diversification on the side of non-food sectors of the economy has the aim to recover the losses from some certain lines of activity by carrying out other kinds of activities. A special feature here is that the development of the raw material base is invested first, and then – the processing facilities. Alongside the intention to diversify their financial portfolios and production risks, diversification on the part of non-food operators is caused by the intertwining of interests of the private capital and the state authorities in the person of regional government authorities. Motives here are not restricted to economic benefits alone, but there exist other, non-economic reasons as well. Later on this can cause an outflow of investments from the food complex. Diversification allows a company to get insured from the instability and non-transparency of the Russian market. It can also serve a company a means to bring down the tax burden.

The most common reason for diversification is to gain benefit from the synergy stemming between different lines of business or between a separate business and its corporate parent structure. A synergetic effect is generated when individual businesses operate within the framework of a single company. In this case, owing to lower costs, availability of common resources, qualification and other, the enterprise acquires certain competitive advantages. As it was mentioned already, diversification brings about synergetic effects. In particular, some additional value can result from a merger allowing cut down the costs of entering new markets. Synergism is possible in the cases of both horizontal (entering new food markets within an existing company) and vertical integration as a result of expansion of the basic functional lines of activity. This effect emerges from the unused compatible production and technological resources and marketing opportunities the enterprise can make avail of. This in turn helps reduce the production costs, enlarge the scope of operations and allows for greater mobility in respect of the distribution of financial resources. A synergetic effect may arise when the value of a company undergoing a merger or benefits from its acquisition are undervalued on the market, and also due to an excess of cash – a merging enterprise might have great reserves of cash, which it can use through the incorporated company.

Taking one of the typical midsize diversified food enterprises of the Saratov oblast as an example, we have calculated the synergetic effect from the allied diversification of its activity. The principal results of its operations were viewed for two periods of time: before and after 1998. In light of the general recovery of the food industry, beginning with 1998 and up to 2005 the enterprise experienced active diversification processes. Later on the diversification effects have decreased owing to the loss in the relative quality parameters, lack of investment resources required to enhance the technical level of production and due to the increasing accessibility of the regional markets.

The production diversification effect manifested itself with expansion of the range of products. Sources of the synergy were classified into four main kinds, that being increase of revenues, reduction of costs, reduction of additional investments and reduction of tax payments. Effects from the diversification constituted 9,8% of the company's profits.

An increase in profits can be achieved both through expansion of the company's activity and as a result of reduction of risks from its operations. Assessment of the effects required that the augmentation of profits be broken down into two components, that is the one resulting from the expansion of activity and that from the reduction of risks following diversification. Increase in profits due to the risk reduction resulting from production of additional kinds of products is assessed to equal 24,6% of the total growth of the profits. For this the proportion of the products gained as a result of diversification was taken into account.

The reduction of risks owing to diversification in the case of this enterprise takes place because of expansion of its market opportunities, production and distribution of its products on various segments of the market, more comprehensive consideration of consumer preferences and consolidation of the enterprise's financial soundness.

The synergetic effect for the diversified enterprise with taking into account the risks we assessed by making an expertise, which shows that the most important risk factors are the utilization of facilities, the technological effectiveness of production, its quality and the inflow of money revenues. Paying due respect to the specific features of the enterprise's products, its material and technical base, financial position, the risk factors were classified according to a ten-point system (see Table 1).

The expertise also indicates that before the diversification the most important risk factors for the enterprise were its financial soundness and the capacity of the market. The latter factor determines the production and marketing opportunities, as overstocking considerably affects the financial soundness and leads to underutilization of the production reserves. A significant factor determining the possibility of risk is the quality of products, and this factor is acquiring more and more importance, as non-price methods of competition are being used wider in the branches of the food industry. As a result of diversification, the risk of loosing the financial soundness gets reduced and the market capacity gets expanded, but such factors like the quality of products and access to raw materials gain additional importance. Expansion of operations brings along higher product quality requirements, which are difficult for the enterprise to match by using the existing technologies and material and technical base. Calculations show that the average risk level has decreased almost twice. Before the diversification the enterprise was in the critical risk zone, while after it has been diversified it found itself in the minimum risk zone. However, the expertise rather demonstrates the potential opportunities and advantages diversification offers. Making the diversification effect reveal itself takes development of the enterprise's marketing policy, including careful segmentation of the market and positioning of the goods, and consolidation of its competitive advantages based on differentiation of the goods.

Table 1 . Risk assessment for enterprise before and after diversification

Factors	Before diversification			After diversification		
	Points	Weight	Grade	Points	Weight	Grade
Market capacity	5	0,25	1,25	2	0,2	0,4
Increase of competitiveness owing to:						
Lower prices;	3	0,05	0,15	3	0,10	0,3
Quality of products;	5	0,20	1,0	5	0,30	0,15
Closeness to consumers;	2	0, 01	0,02	2	0,01	0,02
Closeness to sources of raw materials.	3	0,02	0,06	2	0,03	0,06
Consolidation of financial soundness	7	0,30	2,10	4	0,25	1,0
Saving on raw materials and inputs	6	0,02	0,12	3	0,01	0,03
Utilization of facilities	7	0,15	1,05	3	0,10	0,3
Total risk grade			5,75			2,26

A specific feature of the food complex, especially of the market for meat and meat products, is more intense consolidation in the form of changing the production chain by means of horizontal integration. An enterprise occupying a strong position on the market acquires a weaker competitor that is still attractive for this or that reason, as its ownership. This process of changing the production chain is principally based on two premises. The first one is enlargement of the share of the market by attaching the merged competitor's share. And the second premise is enhancement of the production by drawing in additional production facilities.

Sometimes the process of consolidation is conjugated with two manifestations that are diametrically opposite in terms of their direction and form. In the first case the potential object of consolidation possesses a good raw material base, and the consolidation is indirectly accompanied by integration with the supplier of raw materials. The second case is when the potential object of consolidation has a well-established dealer network, and the consolidation goes along with the process of integration with the intermediary. However, making these processes progress requires considerable financial spendings and due coordination of managerial decisions. Moreover, enlargement of the market share this way is hardly a solution to the marketing problem.

It is not only trust between partners, but also confidence in legal institutions like the government, judicial agencies, contracts, the Central Bank, etc. that is important for pursuing efficient economic strategies. Any fall of trust in these institutions undermines the business activity and deprives one of the opportunities to have an adequate strategic vision. In such conditions the enterprises' operations rather acquire the form of short-term temporary actions, which negatively affects their ability and willingness to stick to intensive and long-term investment projects. This in turn produces impact on the level of economic development of the enterprises and on their financial soundness.

Imperfection of the food complex's institutional structure, as well as its certain specific features, is a cause of excessive transaction costs. The transitional inefficient transaction structure of the market can be characterized as far from being perfect and having too many transaction elements in the food chain. The latter feature can be most clearly observed on the grain market, where multi-layer intermediary structures very often appear on the primary market. Within these structures grain is sold to processing companies in 3 or 4 consecutive stages, which makes the overall trade and intermediary margin rise considerably. The inquiry shows that about 70% of agricultural enterprises use intermediaries' services. The largest proportion of the total transaction costs (about 30%) falls on the costs of looking for market information, which proves the urgency of developing a civilized information services market. The costs of testing the quality of products are also rather high and reach 25% of the total costs. Negotiation costs make 18% and the costs of specification and protection of the ownership rights constitute 14%. The costs of opportunistic behavior of partners in a deal form the smallest part of the transaction costs, that is 13%. The greater the intensity of exchange in the economy, the higher the transaction costs, other conditions being equal.

The analysis of the economic strategies shows that many enterprises have adapted to the external market environment. This adaptation, however, is not always just a passive accommodation. Already now it becomes clear and understood that there must be a strategic vision of the way the agribusiness should follow in the long run.