

# Motivation for Holdings in Russia's Agri-Food Sector

I. Khramova, Eu.Serova. AFE, Moscow

## 1. Introduction

The integration processes in Russian agriculture, when non-agricultural companies begin to produce agricultural production independently, creating the specialized agricultural structures, have been always marked during the transition period. Nevertheless, the end of the 1990s is considered to some degree to be the boom of the investment activity in the agrarian sector.

The motives why non-agricultural companies began to be occupied with agricultural production are weakly studied. Most likely, the motive of integration in agriculture determines the type of activity and terms of the investment activity of a company in the branch.

In this article, written following the results of the investigation of agroholding companies only some problems will be examined: the motives by which non-agricultural companies began to invest in the branch and were actively occupied with agricultural production and the forms in which these companies organize agricultural production, i.e., the attitude of companies to the factors of production — land, assets, labor, as well as how an agrarian sub-division blends with the structure of agroholding companies and how it is managed.

## 2. The motives of the organization of agrarian production by non-agricultural companies

One of the most important questions that arise when analyzing the activity of agrifood holding companies is the explanation of the motives of their investing in agriculture. To answer the question it was suggested to examine the following hypothesis: the motive to organize its own production can be *the vertical integration* or *diversification of business*. In the first case, we supposed that the high degree of the market imperfection induced the company to organize its own agricultural production. High costs and risks of the market operations implementation, technical barriers on the way of production movement to the market, absence of the state guarantees, and finally, opportunistic behaviour of counteragents especially typical for transition economy make the organization of its own production less hang-the-expense for companies as compared to operations in the free market. Such motive is typical for companies being occupied with processing of raw agricultural materials.

In the second case, the organization of agricultural production by non-agricultural companies can be connected with diversification of business. By such strategy possible losses from investments in one type of activity are compensated by returns from investments in other type of activity. Subsequently, risks are reduced if the components of integration differ to a considerable degree, i.e., we speak about investing in weakly functionally connected branches of business

We connected the apportionment of two motives why companies began to invest in agricultural production with the time of companies' presence in the branch and with the character of the organization of production. If the reason of the organization of its own agricultural production is the attempt to overcome imperfection of the market, most likely, the company orients toward the long-term presence in the branch. If investing in the agrarian sector was connected with diversification of business, most likely, the presence of the company in the branch would be short-term.

In 2002, the Centre of Agrifood Economics investigated the activity of agroholding companies. There were interrogated fourteen agroholding companies: twelve of them worked

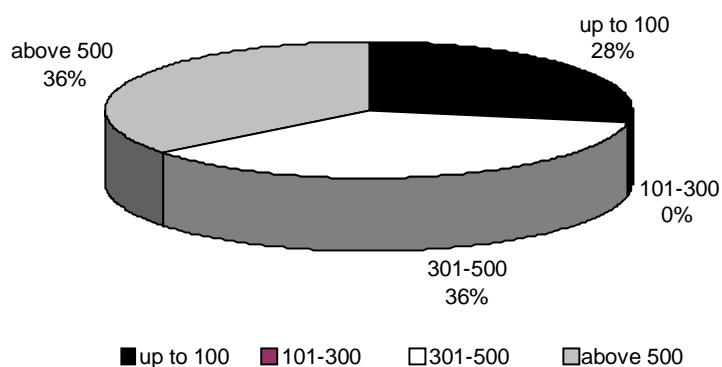
in the regions of Rostov and two of them — in the region of the Stavropolskiy kray bordered on the region of Rostov. The data of the interrogation related to 2001.

The brief characteristic of the interrogated companies:

According to the results of the investigation, 31% of the companies were related to small, their annual turnover was up to 100 million rubles; 38% of the companies were considered to be very large — with annual turnover above 500 million rubles, 31% of the companies had middle annual turnover that fluctuated from 300 to 500 million rubles (*Figure1*).

According to the survey, the average number of employed in agricultural production was equal to 72,5% of the total number of employed in agroholding companies.

**Figure1. Distribution of companies by volume of the turnover, million rubles**



Source: data of the investigation

The survey included all companies related to the category of private companies or companies with mixed participation: 31% of the companies turned to be private (with the individual capital), the same number of the companies was private with the state participation, and 38% — private joint-stock companies.

The main part of the investigated companies (77%) began to be occupied with agricultural production in the second part of the 1990s. It confirms our supposition that namely in that period of time, and especially after the financial crisis of 1998, there were created the most favorable conditions for investing in agriculture used by many non-agricultural companies.

Finally, from the standpoint of the productive potential in 2001 twelve companies produced about 30% of the total volume of wheat production in the region of Rostov and 10% of sunflower; the area of land in the turnover of those companies constituted 6,7% of the total sown area in the region.

When answering the question about the motives of investing in agricultural production we received the following responds.

The most popular answer was given by 58% of the companies — the need in raw materials for their production. On this basis we can make the conclusion that the most companies processed agricultural production and their decision to invest in agricultural production was caused by bad provision with raw materials.

The second by frequency answer (50% of the total number of answers) — the recommendations of the regional (local) authorities — confirms that the latter continue to exert informal pressure on the productive decisions of companies that work in the region.

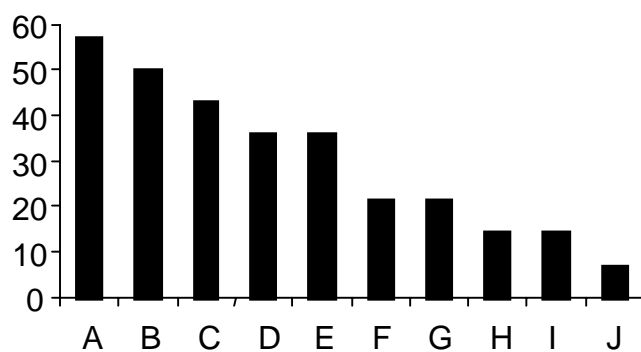
For the regional authorities, control of the activity of companies may be connected with the extraction of both political and economic rent. Non-agricultural companies are also interested to a considerable degree in cooperation with the authorities. It can be the access to subsidies for the organization of agricultural production. The interests of private business and the

authorities cross in other spheres. Private companies get other advantages, such as, for example, indulgences in the case of prohibitions on export of the production, as well as the lowering of other transaction costs.

The motive of the organization of its own agricultural production for 42% of the companies was the necessity to control the productive process for repayment of earlier given credits. This answer seems to be convincing because during many years non-agricultural companies, as a rule, advance money to agricultural producers and the problem of repayment of debts is not trivial: it includes both opportunistic behaviour of agricultural producers (the availability of contract does not guarantee its execution) and the low efficiency of the branch.

36% of the companies recognized that agriculture was profitable business. This answer confirms the second hypothesis about the motives of investments in the agrarian sector. Risks connected with agricultural production remain to be high but in the end of the 1990s the possibility to receive high returns from investments increased.

**Figure2. Ranging of the reasons for investing in the agrarian sector, frequency of answers to the total number of respondents, %**

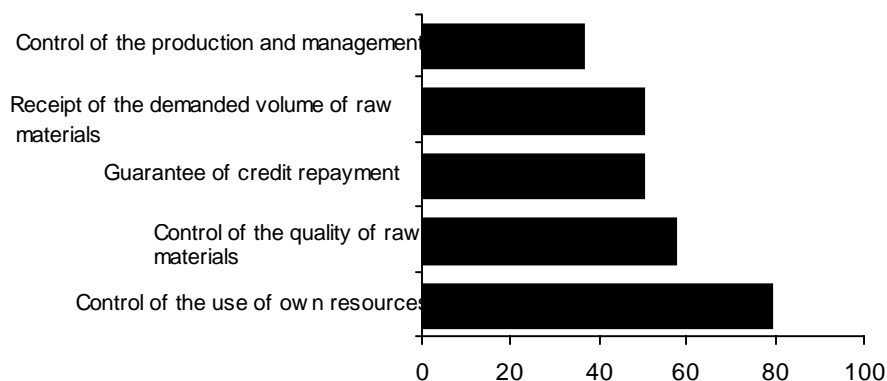


A – The need in raw materials for its main production; B – Recommendation of the regional/local authorities; C – The necessity to control the process of agricultural production for repayment of earlier given credits; D – Profitable business for investments; E – The need in widening of their production sale; F – The widening of scope of activity in order to reduce the financial risks; G – One of not numerous branches where the secondary redistribution of property did not take place; H – Quick payback of investments; I – Favourable taxation; J – The necessity of the food supply of employees of the company included in the group.

Source: data of the interrogation

The second question of the form was connected with the clarification why companies invested in the agrarian sector in the form of the organization of agricultural production. The primary word of answers is “control” (Figure 3). Companies aspire to control the production, use of resources, and repayment of given credits.

**Figure 3. The reasons why companies began to be independently occupied with agriculture (frequency of answers, % to the total number of respondents)**



Source: data of the interrogation

### 3. Organization Structure of Agroholding Companies

In this survey, we were interested in the question about organization structure of agroholding companies from the two points of view. Firstly, we supposed to examine the hypothesis about motives. Secondly, we tried to understand how private business solved the problem of management inefficiency in agriculture.

Let us remind that we examine the hypothesis about the motives of integration in the following way:

a) if the volume of production received by the channels of inter-trade supplies constitutes above 50% and the leading company demands the obligatory inter-trade supplies, there is the case of the vertical integration;

b) if the volume of production received by the channels of inter-trade supplies constitutes 50% and less, and the leading company demands the obligatory centralization of the share of profit, while there is no term of obligatory inter-trade supplies, there is the case of diversification of business.

**Table 1. Forms of inter-holding management according to the results of the survey**

|   | 1* | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 |
|---|----|---|---|---|---|---|---|---|---|----|----|----|----|----|
| Centralization of profit (from 75 to 100%)                          | +  | + | + | + | + | + | + | + | + | +  | +  | +  |    | +  |
| Centralized sale of agricultural production                         | +  | + | + | + | + | + | + | + | + | +  | +  | +  | +  | +  |
| Establishment of the single prices for production                   | +  | + | + | + | + | + | + | + | + | +  | +  | +  | +  | +  |
| Establishment of volumes of supplies inside the group               | +  |   | + | + | + |   |   |   |   | +  | +  | +  | +  | +  |
| Obligatory supplies inside the group                                | +  | + | + | + | + | + |   |   | + | +  | +  | +  | +  | +  |
| Regulation of resources purchase                                    | +  | + | + |   | + | + | + | + | + | +  | +  | +  |    |    |
| Assignment of the manager of a joint-venture by the leading company | +  | + | + | + |   | + | + | + |   |    | +  |    | +  | +  |

\* figures mean the companies of the survey

\*\* - % to the total number of answers

Source: data of the interrogation

The examination of the hypothesis revealed that for two companies (number 5 and 7, Table 1), the motive of the organization of agricultural production by the formal features laid by us in the hypothesis was diversification of business. For those companies, the requirement of obligatory centralization of profit was fulfilled; subsequently, the volumes of agricultural production supplies inside the holding company were not established, moreover, there was no demand for sale production inside the holding company. The fact that one of the companies began to be occupied with agricultural production in 2000, i.e., on the peak of the investment activity in agriculture, also confirms this hypothesis. The second company was created in 1992. For that company, the main motive of the organization of agricultural production was the recommendation of the regional authorities, as well as the necessity to manage the state share holding in the agricultural enterprise. Most likely, there is the private case of diversification of business with the purpose of the lowering of high costs for conduct of a business in the region.

We suppose that for other companies, the main motive of the organization of agricultural production was the vertical integration.

Thus, the data of the investigation confirmed the accuracy of the supposition about two different motives of the organization of agricultural production. If the organization of agricultural production represents the vertical integration for non-agricultural company, the gradual overcoming of the problems connected with market imperfections should not cause the outflow of investments for the middle-time period: only the motivation of the vertical integration can pass from the market imperfections to assets specification. For example, there are always companies (firstly, processing enterprises, food companies) interested in the receipt of production (raw material) with certain qualitative features. In other words, the company vertically integrated with agriculture, most likely, is interested in the long-term presence in agriculture.

If the organization of agricultural production represents diversification of business for non-agricultural company, the change of the external terms, for example, the lowering of attractiveness of agriculture as a branch for investing should cause the outflow of investments from the branch. First of all, agriculture should lose the capital invested with the sole purpose of speculation.

To improve this statement it is possible to say that during last two years the outflow of investments from the agrarian sector began. Most companies that directly began to be occupied with agricultural production on the peak of the high investment activity caused by the financial crisis are gradually leaving agrarian business. First of all, we speak about business connected with the organization of production on land; the industrial production (battery farms, pig farms) continues to remain profitable.

There are no quantitative estimates of these processes. We can only cite as an example the titles of some companies. For instance, the company *OGO* is a large grain trader. In 1999, the company began to be directly occupied with agriculture: the company leased 8,000 ha of arable land and organized its own grain production. In 2000, the area of arable land constituted 12,000-15,000 ha (including about 3,000 – 4,000 ha in Saratov); the company was going to widen the area under grain up to 30,000 ha. Already in 2003, *OGO* ceased to cultivate land.

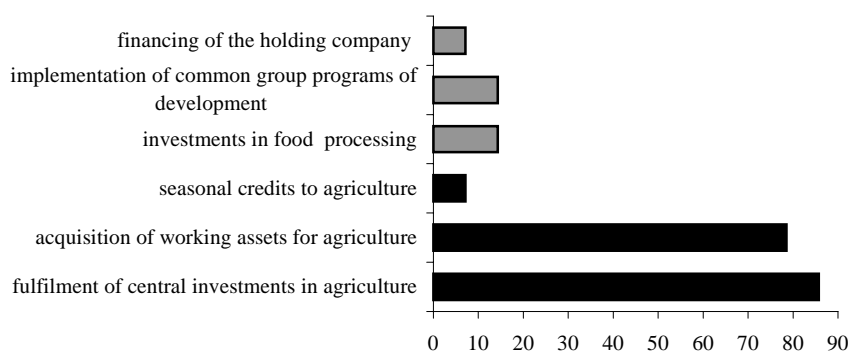
The company Limited Partnership *Efko*, one of the largest operators in the market of vegetable oil, that managed 26 joint-ventures, also refused to cultivate land. The company *Unidell* sold agricultural assets, the company *Stoylinskaya Niva* ceased to invest in agricultural production; the *Agriholding* company also ceased its activity in grain production.

#### 4. Management of the agricultural activity of a sub-division.

The investigation revealed rather strict internal control of the agrarian subdivision within an agroholding company (Table 1). The control of the leading company spread on the most top positions of agricultural business, including sale of production, purchase of inputs, establishment of the volume of purchase and prices; in some cases the leading company assigned the manager of an agricultural enterprise. For example, 85% of the companies answered that the leading company assigned the manager of the agrarian department. 36% of respondents answered that the leading company or the Committee of directors of the company solved the problem of hiring of manpower for agricultural production and the establishment of the level of payment for them (i.e., the range of problems that directly related to the operative management).

In most cases, the leading company confiscated 100% of profit from the agricultural subdivision. In the overwhelming majority of cases, accumulated in the centralized way profit returned in the agrarian sector: in the form of centralized investments — 86% of answers, for replenishment of circulating assets of agricultural enterprises — 79% of answers, for seasonal crediting of agriculture — 3% of answers.

**Figure 4. The structure of use of profit withdrawn from agriculture, % to the total number of respondents**



Source: data of the interrogation

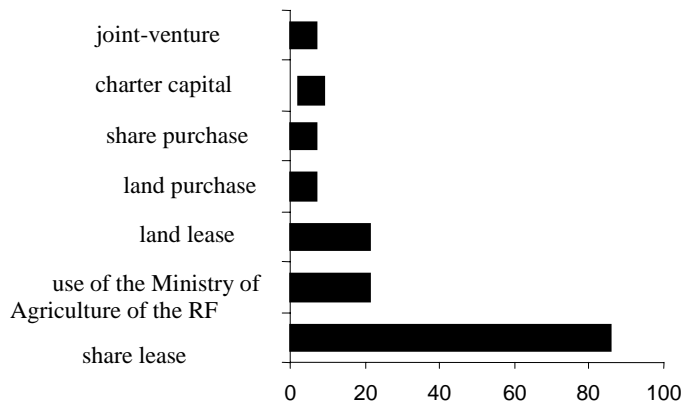
Only in 17% of the cases, according to the strategic and tactical aims the share of profit obtained from agricultural production did not return to agriculture, but it was sent for the maintenance of the leading company, implementation of the general programs of the group development, investing in processing of produced agricultural production.

#### 5. Acquisition of land and assets

When beginning the agricultural activity non-agricultural companies acquire land and assets for use. In the course of the investigation, we tried to elucidate the methods of land and assets acquisition by companies and the methods of the organization of production that also helped to understand the intentions of companies regarding their presence in the branch.

Only 10% of the total number of methods of land acquisition was represented by its purchase in the form of a share or land plot; in this case, land was purchased either directly from the owner of a share or municipality. In the majority of cases, land was rent — 68% of answers; and the most preferable method of rent turned to be rent of shares from their owners.

**Figure 5. The methods of land acquisition for agricultural production, frequency of answers, % to the total number of respondents**

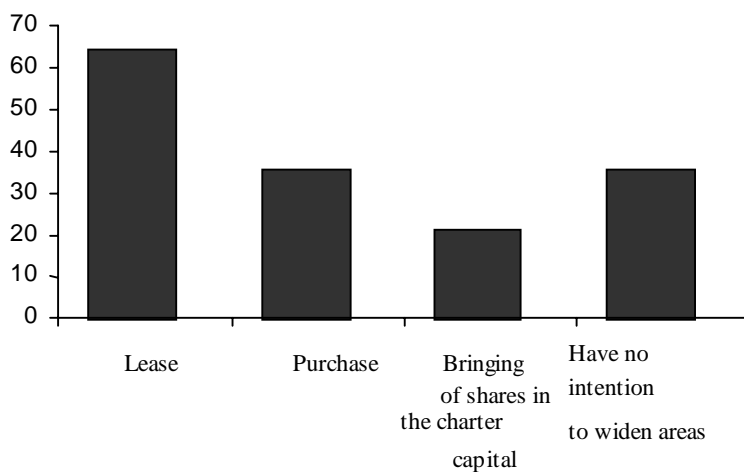


Source: data of the investigation

During last years land lease is implemented in rather civilized form. In 2001, the data of the interrogation showed that in all cases acquisition of land for use was accompanied by the registration of written contract. The contract was concluded with all land lessors independently of their legal form, both with agricultural enterprises, municipality and individual owners of shares. The preference was given to the middle-term contracts: 84% of the companies rent land for the term from 4 to 10 years and 16% — for the term above 10 years. Middle terms of rent permit leaseholders to plan the production, implement corresponding investing and receive profit from their capital. Middle terms of rent also confirm the long-term productive intentions of the company. These answers coincide with the answers about intentions (64% of answers) to widen the area of cultivated land in the future.

The companies that intend to increase the area of cultivated land suppose to do it by different methods, including rent, purchase, and bringing of land shares in the charter capital. At the same time, rent remains the most preferable method to widen cultivated land — 100% of the companies of the survey chose the method as the primary one; but they did not exclude the possibility to widen the area of cultivated land owing to its purchase and bringing as a share in the charter capital.

**Figure 6. The supposed method of widening of the area of cultivated land (frequency of answers), % to the total number of respondents**



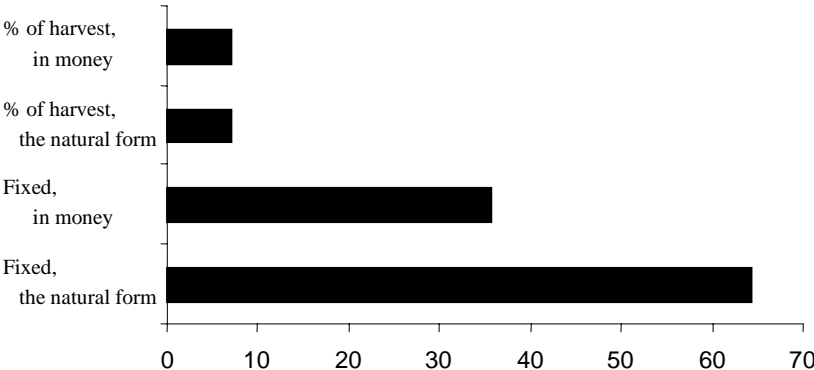
Source: data of the interrogation

The fixed form of rent for land (both in money and the natural form) turned to be the most spread — 88% of answers. Subsequently, share cropping lease was less spread — only 12% of answers.

On the other hand, in the overwhelming majority of cases, rent was paid in the natural form, even it was established as the fixed one. This specificity is explained firstly by the fact that for a long period of time during the 1990s the natural forms of payment prevailed in agriculture. Land owners mainly represented by individual owners of shares psychologically “lost the habit” of money; for most of them, especially for pensioners, doing services is the most attractive form of payment for a share. Secondly, of course, high risks in agriculture also make the natural form of payment more preferable. Payment in money by the middle-term contract for lease seems to be rather risky because contracts scarcely likely include the point about the corresponding indexation by depreciation of ruble. In all cases, when land lessors were owners of shares, rent was implemented in the fixed natural form. Payment in money was used only by rent from the municipality or an agricultural enterprise.

The average rate of rent in those farms constituted 3,560 rubles<sup>1</sup> per share (or 296-300 rubles per ha or approximately about \$10 per ha). There were marked considerable fluctuations in particular companies, from 960 rubles per share a year to the highest — 6,190 rubles per share. In that case, the rate of rent was weakly positively correlated with the area of land rent by companies (correlation coefficient =+ 0,1463). This fact confirms that companies did not put the rate of rent into dependence on the need in land, but oriented toward the rates established in the region.

**Figure7. Forms of rent for land, % to the total number of respondents**



Source: data of the investigation

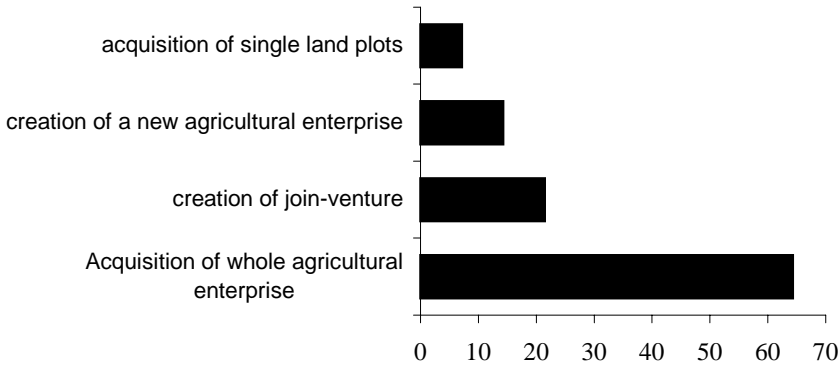
Estimating working contracts for land lease, 62% of the companies admitted them to be stable. We connected the stability of the lease contract with impossibility to annual a contract in the unilateral order or to infringe its other conditions. In spite of rather high percentage of the positive answers, the share of companies that considered contracts unsteady was also high and constituted 38% of answers. The latter reflects remaining rather high risks of infringement of the contracts in agriculture, i.e., the availability of written lease contract does not guarantee its execution.

<sup>1</sup> Converting of rent from the natural form into money was made on the basis of actual prices for production at that moment in the region.



The purchase of the whole farm assumes that for the organization of agricultural production companies buy, besides land, its non-land assets. The results of the interrogation reveal the preferences of companies that organize independent agricultural production. The *Figure 8* shows that the most preferable form of the organization of agricultural production for interrogated group of companies was the acquisition of the whole existing agricultural enterprise as a productive unit. Besides land, non-agricultural companies acquired assets of agricultural enterprises: buildings, agricultural machinery, and equipment. The agricultural activity on the “naked land”, only with the receipt of land for use is rare.

**Figure 8. Method of land and assets acquisition for the organization of agricultural production, % to the total number of respondents**



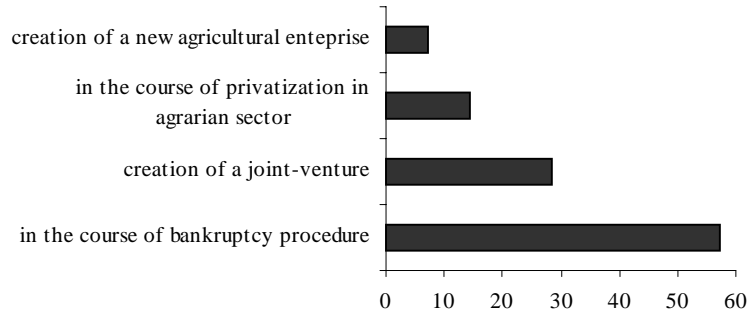
Source: data of the interrogation

The investigation reveals the most typical methods of agricultural enterprises acquisition. The most popular method of agricultural enterprises’ assets acquisition turned to be its purchase in the course of the procedure of bankruptcy (Figure 9). This example confirms that acquisition of the whole farm is included in the sphere of interests of investor because the costs for acquisition of a farm by parts, most likely, turn to be considerably higher. The less spread method was the purchase of an agricultural enterprise in the course of the initial privatization.

The second by popularity method of the organization of production turned to be the creation of joint-ventures. In our opinion, this fact is also explained by relative cheapness of this procedure. Joint-venture was created on the basis of the contract regarding the voluntary entry into the company with the corresponding transference of the share in the charter capital.

In other cases, the acquisition of agricultural business was implemented through the creation of a new agricultural enterprise. The agricultural enterprises were not acquired in the secondary market or from other private owner. The same practice widely used among non-agricultural enterprises was not popular in agriculture, but it does not exclude its spreading in the future.

**Figure 9. Procedure of purchase of an agricultural enterprise, % to the total number of respondents**



Source: data of the interrogation

## 6. Conclusion

The activity of non-agricultural companies (agroholding companies) in Russian agriculture became an outstanding phenomenon in the end of the 1990s. The phenomenon received a great impulse for development after the financial crisis of 1998 that made agricultural production profitable.

The examination of the hypothesis about the motives of the organization of agricultural production by non-agricultural companies confirmed the accuracy of both cases: for some companies — it is the vertical integration, and correspondingly, rather long-term presence in business; for other companies — it is diversification of business, and correspondingly, the probability of the outflow of investments from the agrarian sector for the middle-time prospects. The lowering during last years of the profit from investments in the agrarian sector leads to the fact that most non-agricultural companies begin to refuse from agrarian business, firstly, connected with the organization of production on land. Companies aimed at the long-term presence in the agrarian sector stay in the branch.