OTIS RUSSIA

Teaching Note Developed by

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OTIS RUSSIA

I. Teaching Note

This case has been designed for use in a capstone course in the final year of the undergraduate program or better still at the master's (MBA) level. Because of its strategic decision-making and international focus, this case may not be appropriate for students who have not had solid foundation courses in economics, finance, international business, management and marketing. This case is ideally suited for a course in international business although its major thrust touches free-market economics, international finance and strategic management. Issues such as country and foreign exchange risk as well as entry strategies into foreign markets are issues that should have been discussed in class before this case is tackled. Marketing is also an important component of this case and there is enough room for a marketing professor to emphasize this aspect of Otis Russia's strategy. Because of the relatively complex nature of the case, the authors have decided to pose questions at the end of the case to enable students and the instructors alike to focus their thought in specific areas of international business.

Given the amount of detail available for the student to digest, students should be given adequate time to read and prepare for the case discussion and analysis in class. Ideally, a weekend of preparation should be adequate for the student. To gain the most of this case, it is best that the case be discussed in the class so that everyone in the class gains from the discussion and analysis. Some of the issues to be addressed could be controversial hence it would be most useful to have these divergent views discussed in class. At times there could be no correct solutions to some problems because of the assumptions made by the participants. The question then is –how solid is the theoretical reasoning behind the assumptions. This case discussion could easily take an hour and a half to two hours to complete. While this case could also be assigned as a "take-home" exam, the drawback will be the lack of interactive discussion that a class-room setting would provide. It is therefore suggested strongly that this case be discussed in class.

Although this case is designed for use in Russia as well as in the United States, our hope is that this case will also be utilized in other former Soviet Republics and elsewhere. This is precisely the reason why we have opted to install the case (English as well as the Russian version) on the web for global dissemination.

II. Learning Objectives

1. To familiarize American (for that matter non-Russian) students with the challenges faced by foreign businesses as they seek to enter (through foreign direct investment) the Russian market.

2. To expose non-Russian students to the challenging business environment in a typical transition economy.

3. To expose all students to some basic, but extremely important economic data, and their sources that are useful for country risk analysis.

4. To encourage students to analyze macroeconomic data and identify their relevance to understanding the country's business environment.

5. To introduce to Russian students, the notion of market structure and competition, and the importance of vertical integration and the role of service in a market economy.

6. To expose students to the fundamentals of financial analysis and their crucial role in devising strategies for corporate reform.

7. To expose students to a wealth of economic, financial and business/political environmental data for analysts to sift through and pick the appropriate information to address globalization and strategic management issues.

8. To introduce students to the fundamentals of foreign direct investment and the different entry mode that corporations can take to penetrate foreign markets.

III. Discussion Questions

1. Taking a long-term (10-15 years) view, does Otis's strategy to enter Russia's elevator market make business sense? What was Otis Russia's strategy to begin with? What are the pros and cons of the strategy?

2. Russia is a transition economy. What are the major challenges that foreign investors face while entering Russia? What is country risk in the Russian context?

3. Given Otis's corporate and historical background, what are the chances for Otis Russia's success? What are the reasons for this conclusion?

4. For businesses to be successful in a free-market democratic system, rule of law, transparency, and disclosure are fundamental requirements. How does Russia fare in this context? What is the direction in which Russia is moving? Given the global opportunities available to Otis, is Russia a good choice?

5. What is Otis Russia's competitive advantage in Russia's elevator market? Has the structure of Russia's elevator industry changed for the better since Soviet times? If so, how? Who are the winners and losers in the present environment? What is the economic impact of developments in this sector on Russia?

6. How does Otis's strategy in Russia differ from those of its competitors? Who are Otis's major competitors, and why are they following strategies different from those of Otis Russia?

7. A close look at Otis Russia's financial statements (Income Statement and Balance Sheet) for the 1997-2000 period provides interesting information. How has Otis Russia performed over that period? Why? How did Otis Russia react to economic developments in 1998?

8. What is the outlook for Otis Russia? Should Otis Russia shut its operations? If not, why? Based on a detailed analysis of Otis Russia's income statement and balance sheet, devise a corporate strategy for the company's management that would strengthen Otis Russia's financials.

IV. Key Issues to Remember

1. "Otis Russia" deals with the issue of entry strategy into Russian market for elevators.

2. Russia is a transition economy and as such is burdened with as a host of problems that industrialized or free-market, democratic economies do not generally face. Attention should be brought to the fact that the transition process started only a decade ago and that too without a free-market history. The economy is still weak with a lack of functioning institutions.

3. Russia's elevator industry has gone through a major structural change since Soviet times. It is far more integrated and the level of competition has increased significantly.

4. Otis Russia's major strength is that it manufactures major elevator parts and components (adapted to meet Russia's environment) domestically thereby reducing foreign exchange risk. Furthermore, Otis Russia is fully integrated and also provides installation and maintenance service for all types (brands) of elevators.

5. The ruble crash of 1998 caused by unsustainable budget and current account deficits and the consequent Russian default on external debt and non-payment for goods and services provided by Otis Russia to the government, was a major cause for Otis Russia's poor financial performance since 1998.

V. <u>Responses to Discussion Questions</u>

Responses to questions are given in a summarized manner so that the instructor could work out the details. The answers are meant to lead the instructor to the correct way of analyzing the case and it is not aimed at providing the complete solution to the issue on hand. At times, several possible answers are likely based on assumptions made. These teaching notes are meant as a guide to case analysis.

1. *Taking a long-term (10-15 years) view, does Otis's strategy to enter Russia's elevator market make business sense? What was Otis Russia's strategy to begin with? What are the pros and cons of the strategy?*

Otis's strategy in Russia is to manufacture as many elevator components as possible locally and then to assemble, install and service all types (including non-Otis brands) of elevators in the six Russian regions. Otis was essentially planning to develop and implement an integrated, full service elevator business in Russia, unlike in the past (Soviet period) when different functions of the business were fragmented and handled by different agencies. In addition, Otis Russia's plans called for servicing of all elevators, Otis or others, as the need arose. This implies that Otis Russia was not only in the elevator manufacturing and sales business, but it was also in the elevator maintenance and service business as well.

Does this strategy make sense? Sure, it does. First, when elevators are manufactured locally, it uses local inputs such as land, labor, steel, electricity, etc. The advantage of this approach is that Otis Russia's foreign exchange risk will be minimized to imported inputs like semi-conductor control panels and also the amount of foreign currency borrowing will be lower. Second, since elevators are bulky items, transportation costs will be smaller if the Otis elevators are manufactured locally instead of being shipped from abroad. Third, since Otis elevators will be manufactured locally, it would be much easier and quicker to adapt and design the elevators to meet domestic needs. Fourth, because of local production, the response and shipping time to meet customer needs will be considerably reduced, thereby gaining customer loyalty and faster service. Finally, since Otis Russia maintains and services elevators manufactured by competitors and given the fact that there are a large number of old elevators in Russia, maintenance service will be a large and recurring business contributing to steady cash flow.

The draw back of Otis Russia's strategy is the huge foreign investment that will initially have to be made in Russia not knowing the precarious outlook for the economy. Unless Otis Russia has committed itself to remaining in the country for the long run, the company would have been better of importing Otis elevators from abroad and providing maintenance service using domestic labor and resources. Otis's approach shows a commitment to stay in Russia for the long run.

2. *Russia is a transition economy. What are the major challenges that foreign investors face while entering Russia? What is country risk in the Russian context?*

Russia is an economy that is moving from a centralized command economic system to one based on free market principles. This is an extremely difficult transition especially for Russia, which did not have any history of free-enterprise system. Prior to the communist regime of some seventy years, Russia was ruled by the Czars, who did not believe in the free-enterprise system either. Because of the lack of experience in the market system, the new Russian leaders were largely inept at understanding, let alone managing a free market economy. Institutions, economic, social and political were not in place. Those that did exist, we dysfunctional at best and rule of law, transparency and disclosure were issues that were unheard of. Russia's country risk, i.e., economic risk and political risk were great. The risk of default on government debt due to economic mismanagement and a lack of clear political succession resulting in potential economic policy reversal was great. In a nutshell, Russia was a risky country to invest in.
Russia's default on foreign debt and consequent financial crash in August 1998 clearly increased foreigners' awareness of the country's risks. Foreign investors seemed to have lost their illusions about Russia. Practices previously dismissed as mere teething troubles, such as grotesque standards of corporate governance, and abuse of minority shareholders, and disregard for creditors, suddenly became glaring, ingrained flaws. The crisis devastated portfolio investors, destroyed most of the country's banking system and cut real wages by a third. Yet, may Russians still hanker for the certainties, real or imagined, of the past: tradition, authority and unity, rather than experiment with competition and pluralism.

3. *Given Otis's corporate and historical background, what are the chances for Otis Russia's success? What are the reasons for this conclusion?*

As the world's largest elevator manufacturer with an excellent track record in the manufacture, sales and service of vertical and horizontal passenger/freight movers, Otis is known to be an innovator that adapts to needs of the domestic market. With its presence in tens of markets world wide, Otis is truly a global company. In fact, if there is one global elevator company that could succeed in Russia, it is Otis. Having said that, one must remember that Otis has not operated so deeply in a post communist country except for China. China, however, had a history of capitalism prior to 1949 when the communists took over the country. One could say that Otis underestimated country risk – the risk of default on foreign borrowing in Russia. Otis Russia is a victim of Russia's economic environment. With much of Russia's public housing owned by the state, payment for elevator service and maintenance was to be made by local governments. With the crash of the ruble in 1998, local governments faced a massive cash crunch resulting in non-payment for services rendered by Otis Russia to the local government. The accounts receivable piled up resulting in huge write offs as indicated in the allowance for bad debt. With infusion of funds from the parent, and significant operational changes, Otis Russia is bound to turnaround and show profits. While this is unlikely within the next year or two, in the medium term the company should be well positioned to succeed.

4. *For businesses to be successful in a free-market democratic system, rule of law, transparency, and disclosure are fundamental requirements. How does Russia fare in this context? What is the direction in which Russia is moving? Given the global opportunities available to Otis, is Russia a good choice?*

Russia in many ways is still a developing economy that has a significant way to go before it has a fully functioning, free-market democratic system that emphasizes rule of law, transparence and disclosure. The level of economic and political chaos has somewhat subsided since President Vladimir Putin took office, and the country seems to be progressing the right direction albeit slowly. Given the generally cautious optimism on Russia's economy, its sizable elevator market for sales, maintenance and service is difficult to ignore. A major player like Otis has to tap Russia's market, but the question is how.

Russia's August 1998 financial crisis was in some ways a deliverance. It made real assets cheap and available for committed investors like Otis who understood what could be done with them --especially when a four-fold depreciation of the ruble was pricing imported goods out of Russia. After the initial shock, the new mood in the real economy was more sober. It mixed a tiny bit of optimism with a lot of grim determination. Russia was marked by consolidation within and across industries, as firms with cash and confidence cherry-picked their competitors. The change did not, however, translate into sustained industrial growth. Standards of corporate governance remain generally low in Russia but an understanding of their value is gaining ground. Newly humbled firs have become more willing to recognize transparency and the fair treatment of outside shareholders both as an incentive to better management and as a prerequisite for raising external finance. The big Russian companies know that if they are to raise market capitalization closer to international levels, they must also raise management quality closer to international levels and generate growth through productive new capital investment. A better investment climate demands a legal system strong enough for contracts to be enforced, the guaranteeing of property rights and the banishing of the "crony capitalism" of the 1990s. Russia is not there yet. However skewed and unfair the rules are today, at least they are not changing continually and unpredictably. If Russia's business is accepting, in principle the arguments for moving in the direction of transparency and for obeying the law, the crash of 1998 has done an invaluable service. In the 1990s business basics such as contracts, proper book keeping and customer satisfaction were largely ignored. Company bosses now worry about weaknesses in previously neglected disciplines such as finance (budgeting and profits) and marketing. Most large companies are trying to publish financial statements drawn up on the western model. The missing ingredient is usually good management skills.

What is emerging in Russia is a new kind of economic system with its own rules and its own criteria for success and failure. Russian companies, especially in the manufacturing sector, have indeed changed the way they operate, but to protect themselves against the market rather than join it. The new system can be called Russia's virtual economy ("*Russia's Virtual Economy", Clifford Gaddy and Barry Ickes, Foreign Affairs, September/October 1998*), because it is based on an illusion about almost every important parameter: prices, sales, wages, taxes, and budgets.

5. *What is Otis Russia's competitive advantage in Russia's elevator market? Has the structure of Russia's elevator industry changed for the better since Soviet times? If so, how? Who are the winners and losers in the present environment? What is the economic impact of developments in this sector on Russia?*

Otis is the only fully integrated (see Exhibit 8: Otis Facilities in Russia) elevator company in Russia and it also services all brands of elevators, domestic and foreign, in all of Russia. Otis Russia now provides maintenance service for over 80,000 units and has some 5000 employees. With an initial investment of $50 million, Otis set up its operations (see Exhibit 9: Otis Russia – Operations) in Russia by dividing the country into six operating areas (see Exhibit 10: Russian Regions). Each regional branch offers fully integrated elevator installation and service.

Otis Russia – H.Q. Moscow

6 OPERATING AREAS/ REGIONS

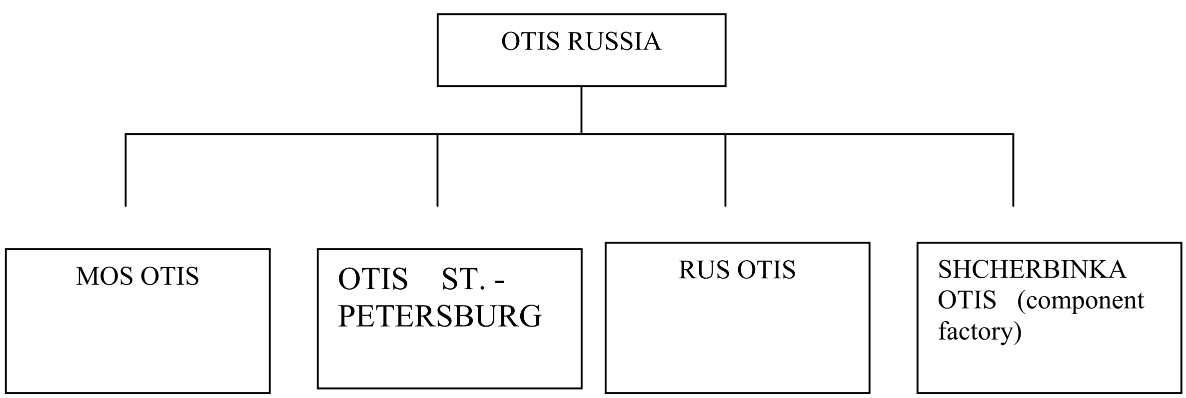
MOSCOW | N.- WEST | CENTRAL | SOUTHERN | URAL | SIBERIA & FAR EAST

Otis' approach is to manufacture most elevator parts locally and to import key technical components like semiconductor control panels from abroad and assemble, install and service the elevators in Russia. Otis in Russia and Ukraine (one of the largest former Soviet republics) combined has over 14,000 employees. The plants in Russia and the one in Ukraine are integrated and manufacture major components for elevators such as winches and door systems. Otis Russia started in 1993 by manufacturing eight models of passenger elevators each capable of carrying a passenger weight of 1000 kg. primarily for Russian apartments. These models are similar to those built by Otis in Europe, but adapted for installation on standard Russian shafts. The elevator doors and cabins are made of steel, which is fire resistant and meets European safety standards. The elevators are designed to provide smooth and silent rides contributing to passenger comfort. From a technical standpoint, Otis' elevators are 10-15 years ahead of the competition. Today, over a hundred models are offered with different car linings, e.g., Standard, Business and Deluxe as well as elevator cars with dual entrances and hydraulic systems. As the first modern elevator manufacturer in Russia, Otis introduced “vandal-proof” elevators along with microprocessors unlike the bulky Russian systems. With a speed of 1.6 meters/sec. and telescopic doors, Otis elevators are “state of the art” in Russia. Otis elevators are capable of operating over 17 floors and the company is the recognized leader in elevator technology in Russia. Among Otis’ major customers (see Exhibit 11: Otis Russia –Major Customers) are the Construction Departments of Moscow and St. Petersburg, Russia’s Central Bank, and major construction companies such as Skanska Oy, Alarko, Lemminkainen, Puolimatka, Soyak, Gasprom and Lukoil.

Otis’ relationship with Russia goes back over a hundred years (see Exhibit 7: Otis Russia – Milestones) to 1893 when it first installed elevators in St. Petersburg during the Alexander III period. Now, some 100 years later, the company has again returned to Russia by establishing four joint ventures for the manufacture, installation, and maintenance of elevators. During the 1991-1993 period, Otis built three factories in Russia: one in St. Petersburg for manufacturing modern “Europe 2000” passenger elevators and two in Moscow for manufacturing components and spare parts. The three factories began operations in 1993.

Otis Russia has its headquarters in Moscow and has four companies with 34 branches (divisions) to serve Russia which is divided into six geographical regions:

1) Mos Otis (with 5 branches),
2) Otis St. Petersburg (with 4 branches),
3) Rus Otis (with 25 branches),
4) Shcherbinka Otis (an elevator component manufacturing factory)



Because of regional differences (population, buildings, economic activity, ect.), Otis Russia segmented the Russian market into six distinct operating regions. These include: (1) Moscow city, (2) North-West Russia (including St. Petersburg), (3) Central Russia, (4) Southern Russia, (5) Ural-Volga region, and (6) Siberia- Far East (see Exhibit). In addition, all operations – engineering, manufacturing, sales, installation, maintenance and modernization –are provided by three divisions of Otis Russia, viz., (1) Mos Otis, (2) Otis St. Petersburg, and (3) Rus Otis. Shcherbinka Otis is essentially an elevator components supplier.

In total, Otis Russia services some 80,000 elevators in the whole country. In August 15, 2000, Shcherbinka Otis and Mos Otis were certified to have met Russian Standard of Quality similar to ISO 9002. Thus Otis became the first elevator company in Russia to be certified for quality. It is Otis Russia's hope that the certification will help promote sales. All branches of Otis Russia generate a lion's share of their revenue and from technical maintenance. Otis Russia's goal is customer satisfaction. To fulfill this objective Otis Russia is dedicated to building quality elevators and escalators that can be delivered at the building site, on time, for installation to the customer's total satisfaction.

Otis St. Petersburg (see Exhibit 12: Otis St. Petersburg), which services Russia's Northwest region, is one of Otis Russia's four divisions that offers strong competition to the local elevator manufacturers. Otis services every fourth elevator in St. Petersburg, although it installed only 475 of the city's 55,910 elevators. Vladimir Marov, director general of Otis- St Petersburg, who has worked in the elevator industry since Soviet times, believes that Otis' success in the Russian market it primarily due to the fact that Otis Russia is the first and only Western-style, full service elevator company in the country. Otis St. Petersburg has completely integrated operations and it offers the customers delivery, installation, and preventive maintenance service on a "turn-key" basis.

During the Soviet period (pre-1991 period), several government institutions handled each aspect of the elevator business from manufacturing and installation to service. However, different government agencies handled each of these functions independently. In a nutshell, the industry was fragmented and inefficient. The Soviet elevator industry consisted of several hierarchically functional levels (1) elevator production, (2) elevator installation, and (3) elevator service. Since the fall of communism and break up of the Soviet Union starting in 1991, there has been significant consolidation in Russia's elevator industry. Several Russian elevator manufacturing companies have either collapsed or merged or acquired by others. Also, in the service sector there has been some vertical integration. Instead of having firms that dealt with installation or maintenance alone, several elevator service companies have combined their installation and maintenance functions together. Still others have fully integrated their operations to include elevator manufacturing, installation and service. With the entry of foreign companies into Russia, the level of competition has also increased. The ultimate beneficiary has been the Russian consumer who now has access to quality, working elevators that are properly maintained thereby increasing economic efficiency. The level of competition has also put downward pressure on prices.

6. *How does Otis's strategy in Russia differ from those of its competitors? Who are Otis's major competitors, and why are they following strategies different from those of Otis Russia?*

As mentioned above, Otis Russia's strategy is to "think global and act local", i.e., Otis uses its global experience and resources to run a fully integrated operation in Russia with local production by adapting Europe 2000 elevators to meet Russia's demanding

environment. Otis Russia is the only foreign company with domestic manufacturing facilities and fully integrated operations.
There are only two domestic elevator manufacturers who could be considered as significant players in Russia's market. These local elevator manufacturers are Shcherbinsky and Karacharovsky. Shcherbinsky has about 20% of Russia's elevator market compared with Otis's 15%. The key to Shcherbinsky's success is price competitiveness (company's product costs half that of Otis elevator). Shcherbinsky produces some 1800 elevators per year and has numerous customers in the CIS (Commonwealth of Independent States). The Shcherbinsky factory also serves as a supplier of Otis spare parts and components.

The other significant domestic player in Russia's elevator market is Karacharovsky Elevator Factory, which produces around 2000 elevators annually and has a very strong position in the Moscow market (around 80% of the buildings are equipped with these elevators). Moslift, a Russian company, restructured since 1991, is responsible for installation and maintenance of those elevators. Liftremont currently provides a complete range of service (maintenance, modernization, replacement, installation, and commissioning) for Russia made elevators.

Liftremont is a competitor of Otis in the maintenance and repair sector of the elevator business. Liftremont does not manufacture elevators, but it provides maintenance, and installation service. In 1993 its maintenance portfolio consisted of 1900 elevators of Russian and former Soviet Union origin. Today Liftremont's maintenance portfolio consist of around 9000 elevators and escalators. Liftremont is considered the third largest elevator service company in the Moscow region.

Foreign competitors include Schindler and Kone. Both of them sell their imported elevators in Russia. Schindler (world's largest escalator and second largest elevator manufacturer) of Switzerland supplies imported elevators essentially to banks and offices. Since January 1997, Liftremont became the exclusive distributor for Schindler Group in Moscow and Moscow region. Liftremont also provides service for elevators and escalators built by Schindler. Schindler is striving to become the leading supplier (not of service) of elevators and escalators in Moscow and the Moscow region. Schindler is a serious foreign competitor to Otis in the Russian Market.

Kone of Finland sells its imported elevators to hotels and entertainment complexes. Kone ships elevators from Finland and because of its proximity to Russia it seeks to become a major player in developing Russia's elevator market. Both Schindler and Kone have their representative offices in Russia, and supply imported spare parts to local dealers.

The two domestic elevator manufacturers are Otis Russia's major competitors because of their similar cost structures. They manufacture elevators locally. Otis still imports components like control panels. One could argue that Otis Russia's cost could be higher than its Russian competitors. However, because of modern manufacturing techniques, it is likely that Otis Russia's operations are more productive. Yet, it is possible that the domestic manufacturers may still receive some inputs at subsidized costs. On the other hand, Schindler and Kone are limiting their investment exposure to the Russian market by exporting their elevators from Switzerland and Finland respectively. It is likely that Schindler and Kone are not too confident on the outlook for Russia's economy and are therefore minimizing their risk by exporting elevators. The big difference between Otis on the one hand and Schindler and Kone on the other is that Otis has a long term commitment to Russia whereas Schindler and Kone are not too sure about the prospects for Russia's economy and would rather export their products than commit large sums of money to Russia by investing in local production. Because of Finland's proximity to Russia, Kone could very easily establish operations in Russia if and when economic conditions become palatable.

7. *A close look at Otis Russia's financial statements (Income Statement and Balance Sheet) for the 1997-2000 period provides interesting information. How has Otis Russia performed over that period? Why? How did Otis Russia react to economic developments in 1998?*

To provide an objective assessment of Otis Russia's performance, one needs to analyze the company's income statement and balance sheet within the framework of Russia's economic environment. One cannot analyze Otis Russia in isolation without obtaining a good feel for economic developments in the country. For that reason, the analyst must evaluate the economic indicators shown in Exhibit 5 & 6 to see how the economy was performing and also to analyze its impact on the Russian ruble. The causes of Russia's financial crisis are clear. As can be seen in Exhibit 5 and 6 (Russia: Key Economic Indicators), Russia's consistently large budget deficits were unsustainable. Fiscal deficits increased from 69.5 million rubles in 1995 to 147.6 million rubles in 1996 and to 150.4 million rubles in 1997, which led to the build up of short-term dollar liabilities, which when coupled with capital flight led to falling foreign exchange reserves, debt service problems and eventually to the massive devaluation of the ruble in August 1998. To shore up its finances, Russia was asked to reduce the budget deficit by raising tax revenues and cutting government expenditures. To support the restructuring of short-term debt and the new macroeconomic program, the IMF and Western donors pledged a loan package of $17 billion. While this did help stabilize the value of the ruble and move the country toward greater market reform the economy contracted and it its impact was felt over different market sectors. The housing and construction industry was one of the worse effected and this had a direct and negative impact on Otis Russia's operations.

When analyzing Otis Russia's operations, three major issues need to be scrutinized:

Gross revenue: One needs to take a close look at Otis Russia's revenues. Between 1997 and 1998, Otis Russia's revenues grew by a remarkable 36%. Despite the 1998 financial crisis and its subsequent economic collapse in 1999 revenues rose by some 12% in 1999 and Otis Russia's gross sales jumped from some 500 million rubles in 1999 to 1160 million rubles in 2000. That was impressive. However, allowance for bad debt (see Balance Sheet) has been growing faster (in absolute terms) than ever swelling from 65.1 million rubles in 1997 (20% of gross sales) to 248.8 million rubles in 2000 (21.4% of gross sales) in 2000. When the allowance for bad debt grows faster than revenues, it is a very worrying signal. This implies that the company's sales are to non-creditworthy customers. These customers are delinquent and unless Otis refrains from conducting business with them, they would be a drain on the company's income and cash flow. If the trend reverses, it is good, but how completely is the question. Another area of concern is "trade receivables". It has remained stubbornly high at 30-35% of sales or some four months sales. This has severe impact on cash flow as well as higher working capital needs.

Ratio analysis: One measure to watch is return on equity [ROE: is a product of five components: tax burden, interest burden, EBIT (Earnings before Interest and Taxes) gross margin, asset turnover and financial leverage]. Otis Russia's ROE declined during the 1997-1998 period and has picked up somewhat since 1999.

	1997	1998	1999	2000
Asset Turnover	1.32	0.52	0.61	1.43
EBIT Margin	0.005	(0.072)	(0.01)	0.021
SG&A/Gross Sales	0.162	0.196	0.249	0.213
Gross Profit Margin/Gross Sales	0.249	0.222	0.258	0.243

Two possible reasons for Otis Russia's low ROE are (1) lower asset turnover, meaning that the company is getting fewer sales per dollar of assets, and (2) lower EBIT margin (EBIT divided by sales times 100). EBIT is synonymous with operating income, which is calculated by subtracting the company's cost of goods sold and its selling, general and administrative expenses from net sales. Has Otis Russia's EBIT margin been declining? Have SG&A (Sales, General and Administrative) expenses increased as a percentage of sales in every year since 1997? Have cost of goods sold remained fairly constant over the period? All these ratios give an indication of how efficiently Otis Russia is performing. As one can see from the ratios above, Otis Russia's performance has certainly improved in 2000. Yet, there is significant room for improvement in operation. The lesson for analysts as Otis Russia matures is to keep a watchful eye on the company's efficiency and SG&A expenses.

Cash Flow: Although analysts tend to focus on revenue and profit when evaluating a company's performance, the amount of cash on the company's books also needs attention. This is because of the fact that a company with a lot of cash can better survive an economic slump, when and business slows and revenues and earnings suffer. Unfortunately, having a lot of cash is not as nearly as important as what is done with the cash or how the cash is utilized. How cash is used, and where it goes, is known as *cash flow*. Cash and Cash Flow are two very different things. The distinction often is key to determining whether a stock is worth buying or avoiding. For example, if Otis Russia has a higher bank balance at the end of the year after all expenses are met, that is a positive cash flow. But if the balance is lower after the bills are paid, the cash flow is negative. Unfortunately, for Otis Russia the cash flow has always been negative reflecting the fact that outflow was much greater than inflow since, as indicated before, a significant amount of money was held up in inventory and accounts receivable.

While it may sound as if Otis Russia's cash flow would be the same as profit, it is not. The cash flow from selling/servicing elevators does not reflect certain accounting costs, such as interest expense, allowance for factory wear-and-tear; instead these items are reflected in the company's bottom line known as profit or earnings. Young companies often have negative cash flow because they are building for the future. But ultimately the company has to balance its books or run into trouble (cash flow problems). While a company with a lot of cash on its balance sheet may look like a good investment, it is the cash flow that really matters. If Otis Russia could generate extra cash by speeding up collection (accounts receivables) of debt, trimming of inventory and selling unused assets, the price of its stocks will rise despite a flat revenue. Companies with positive cash flows will generally be rewarded by the market.

Otis Russia's cash flow statement lists income for the year, but it also shows how much money is flowing into inventories of parts and finished goods. It lists the amount of receivables, or money still owed on completed sales. And it lists accounts payable -- money still owed by Otis Russia for its purchases. A company with negative cash flow from operations may be earning income, but it is being tied up in places such as inventories and uncollected debts where it cannot be used for other things or drop to bottom-line profit. So, a company with lots of cash may find itself losing ground because of negative cash flow.

8. What is the outlook for Otis Russia? Should Otis Russia shut its operations? If not, why? Based on a detailed analysis of Otis Russia's income statement and balance sheet, devise a corporate strategy for the company's management that would strengthen Otis Russia's financials.

Otis Russia's fate is closely tied to Russia's economy. Given the fact that Otis had taken the step to set up manufacturing facilities in Russia and not an "arms-length" relationship with the country as Kone and Schindler have done, Otis Russia will need to take a long term view of its operations in the country. Foreign direct investment in the form of plant and equipment in Russia implies that Otis is committed to the long-term viability of its operations in the country. With the collapse of the ruble in 1998, it became obvious to foreign investors that most Russians could ill afford imports and multinationals were forced to consider localization. Local production makes sense since it reduces foreign exchange risk, utilizes domestic resources and encourages potential exports.

As a transition economy, Russia is bound to go through periods of stress as its leaders learn to manage the economy better. Experts argue that firmer stance on economic management is necessary since the chaotic liberalization of the Yeltsin era. They believe that Russia is too big a developing nation to be governed exactly like a western country. Democracy is fine in principle, but it must be managed. To prevent chaos and gradually get people to respect the law, it is necessary to first establish a sense of order and authority. Only a tightly run state can push through liberal economic reforms, which in turn will create a strong middle class, which will eventually become the foundation for a solid democracy and the rule of law. The changes implemented so far have, however, done little to create the conditions for sustainable development, i.e., efficiency, accountability and transparency.

Change in Russia is only a matter of time. Yet, a recent survey of Russia by *The Economist* (July 21, 2001) asks a thought-provoking question. Is Russia under President Putin heading for regeneration, stagnation or decay? The survey argues that Russia is going in all three directions at the same time. Most people who are knowledgeable about Russia agree on the economic and political direction the country has to take: it must embrace the free market system, private property, a stable convertible (at least in the current account) currency, regular elections and freedom to travel. Reforming the post communist system of government is a challenge. For Russia, a country that is almost unmanageably vast and has little experience in the rule of law, private property, and public participation, the task is awesome. Russia today is relatively calm both economically and politically. Russians attribute this stability to Vladimir Putin, the president whom they see as its architect. Unless this stability can be reflected in sustainable economic growth, stagnation or decay will be the result.

Russia's new leaders have made three big changes in the way the country is run. The first is to recentralize government, such as tax authorities, the security service, the police, and the prosecutor's office under the control of the Kremlin, which helps to counteract local barons. The second big change has been to clamp down on tycoon-politicians to curb fraud and embezzlement. The third change is referred to as political "consolidation" – a political system that is recognizable to the West, but works from the top down rather than from bottom up. Mr. Putin's reforms appears to have made the state a little stronger and quite a lot more stable, but not noticeably more efficient, and certainly no more accountable or transparent --conditions necessary for sustainable economic development. This is largely due to the fact that people in the position to make changes are precisely those who benefit from things staying pretty much as they are.

Russia's economy is still dominated by state-sanctioned monopolies in energy and uncompetitive industries that receive various forms of state protection. The gas and electricity monopolies are forced by the government to provide low-cost services to unproductive firms, which undermine the more-productive companies that do not receive the same support. Combined with high tax rates, the implicit subsidies create a lack of transparency in accounting practices and entail high social costs. In addition to sustaining an inefficient arrangement in which businesses largely pay each other and the government in kind rather than in cash, the Russian system breeds corruption and uneven enforcement of tax laws, since most large firms negotiate their dues to the state.

The uncertainty and chaos occurring in Russia today largely reflect the drastic changes in the economic and political landscape of the country since the fall of communism in 1991. Although almost a decade has passed since the monumental change in the country, most Russian managers have not been able to adjust their mindset to a free-market system. Nor have they had the time or inclination to acquire the business skills (such as in accounting, finance, management, marketing, and operations) necessary to function effectively in a free-enterprise system. The transition –from a passive order taker to a more proactive business manager-- continues to be a challenge for most Russian businessmen. In addition, American companies face legal and labor problems in Russia with high turnover of key personnel. Despite the transition process, i.e., movement from the command economic system to one based on the free enterprise system, Russia's business culture is still heavily influenced by its national history and totalitarian roots (mistrust stemming from the Stalinist era). Russian managers score low in future orientation, low in uncertainty avoidance, and very high in "power distance" or authoritarianism. The reason is not lack of intelligence, but a lack in those behaviors that are linked to society-in-transition factors: uncertainty avoidance, human relations or power distance.

Because of Russia's vastness and diverse culture, there are at least three different business cultures in the country. First, is the traditional culture --one in which companies are quite successful under a paternalistic, state-run system. They are not interested in any kind of social policy, and managers are more interested in prosperity and survival of their business. Second, is the predatory culture --cheating on the state, cheating on partners, and cheating on consumers. Here the rule is profiteering and growth at any price with no role for business ethics. Finally, the socially responsible culture --businesses that are trying to build loyalty and support of customers and employees. One could argue whether these business cultures in Russia are a result of the country's totalitarian past or a function of dysfunctional institutions and half-baked economic reforms.

Russia, despite its economic malaise, is a big elevator market that Otis Russia does not want to ignore. The issue before Otis Russia is not whether it should leave the country. Otis Russia is there to stay, as Vladimir Morov of Otis St. Petersburg has indicated. Unless the economy falls apart, Otis Russia is committed to the country. Given Russia's changing (hopefully for the better) economic environment, the key issue is how should Otis Russia change its ways of operating in Russia. This is where a financial analysis of the company will help. The instructor needs to first discuss the analysis done in Question#7 above and then continue with the following details. What should Otis Russia's corporate strategy be for the future? Here are some strategic issues that Otis Russia will need to address to strengthen its financials.

1. Is Otis Russia focusing on core or recurring revenue rather than total revenue, which may be based on one-time events? The company needs to focus on "repeat sales". This means focusing more on maintenance service and sales of spare parts. Elevators are mechanical equipment and will therefore require routine maintenance to perform optimally. Certain components will need replacement due to wear and tear. Since Otis Russia has a manufacturing facility for spare parts (for Otis as well as other brands of elevators), that competitive advantage needs to be exploited fully. Otis Russia also services and installs all brands of elevators. Again, this is an area worth focusing on.

As a developing country, Russians will want to prolong the life of their elevators. This calls for greater need for spares and service. It is likely that sales of new elevators as replacement for old dilapidated Russian elevators will grow over time. But, this will be a function of economic growth. As Russia's economy grows, so will the demand for new Otis elevators, and since these will be almost entirely domestically produced, they will be cost competitive with local brands as well as imports from Finland and Switzerland. Otis Russia needs to focus on its "core competency" and at the same time improve its efficiency. Based on economic fundamental, the outlook for Russia's ruble is not very encouraging. All the more, this calls for localization of production and service as a way to beat foreign competition.

2. Beyond just increasing sales, Otis Russia will want to make sure that the company is actually received hard cash for its sales and is not involved in batter arrangements. If not, revenue means little. Batter deals are not only inefficient, they are counterproductive and often lead to increase in bad debt allowance, which Otis Russia will need to minimize to strengthen its balance sheet.

3. Who the customer is, does matter. Otis Russia's customer base needs to be closely scrutinized. Does Otis depend primarily on a few key customers? Is the customer list broad based (well diversified)? Does Otis depend primarily on a few large customers, even if it had a long customer list? How solvent (weak or strong) are the key customers? Otis Russia needs to focus on financially strong customers who pay their bills regularly and who use Otis for repeat sales and service. If this can be achieved, Otis Russia's cash flow position will improve considerably. A major problem that Otis Russia faces is irregular payment from government agencies that own and operate apartment complexes. With the squeeze on government finances, various agencies are loath to make payments on time or prefer to make payments in kind. The latter leads to problems identified earlier on.

4. How close is the relationship between Otis and its customers? The question is whether Otis Russia is involved in arm's-length relationship with its customers as far as transactions are concerned. If well-established customers are also investors in the company (Otis Russia), it is hard to know whether their sales are really an endorsement of the product. Furthermore, such sales could sour if relationships fall apart. Also, such sales could potentially lead to unfair pricing behavior.

5. How would one evaluate growth of Otis or the elevator market in the Russian context? Evaluating growth of elevator demand may not be as straightforward as assessing demand for cell phones. Regardless of how one feels about Otis Russia as a company, a lower potential market size would mean weak financials thereby make investing in Otis a very different proposition. So even the most careful analysis of elevator companies cannot overcome market

sentiment. Is the market for elevators in Russia cyclical? If not what are the determining factors? Based on the analysis of the Russian elevator market, what is the outlook for Otis in Russia?

Finally, anyone analyzing Otis Russia will need to look closely at every line item on the income statement as well as the balance sheet to see how changes can be made to strengthen the company's financials as a whole.