

## **CHERKIZOVO GROUP: RUSSIA'S LEADING MEAT PRODUCER<sup>1</sup>**

In 2016, Cherkizovo Group was Russia's largest meat producer and integrated agro-industrial holding. In 2015, the company had a consolidated revenue of 77 billion roubles. Through organic growth and acquisitions, the Group's net profits had grown at an annual average rate of 25% in the previous 6 years. In spite of this success, in 2016 the management team, headed by CEO Sergey Mikhailov, looked at the future trying to overcome new challenges: How to find growth opportunities in the face of decreasing consumer income and falling meat prices? How to meet retailers' growing demand for higher service levels? Was it the right time for more acquisitions? Was Cherkizovo prepared to be globally competitive and export to international markets?

### **HISTORY OF CHERKIZOVO**

In 2016, founder and Chairman of the Board of Directors Igor Babaev<sup>2</sup> and his family controlled 65% of the group's shares (the remaining 35% were publicly traded in the London and Moscow Stock Exchanges). Mr. Babaev, originally from Southern Russia, received a Master Degree from Krasnodar Polytechnic Institute and started his career in the meat industry. By his late twenties, he was general director of one of the largest meat plants in the Soviet Union and later he was put in charge of the meat distribution for Southern Russia. In 1988, Babaev was appointed chief engineer of the Cherkizovsky Meat Processing Plant in Moscow.

The original Cherkizovsky plant was a typical Soviet Food processor: its production had begun in 1974, with boiled sausages and hot dogs comprising 83% of the total production. At the end of the Soviet era, it was the smallest of six meat processing plants serving Moscow. Babaev became manager of the plant in 1991 and led it during the

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<sup>1</sup> Case published by the Research Division of Instituto Internacional San Telmo, Spain. Prepared by professor Manuel González Toruño in collaboration with Anylu Vidal Romero as a research assistant. This case is developed only as the basis for class discussion. Cases are not intended to illustrate any judgement on the effective or ineffective management in a specific situation.

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<sup>2</sup> Igor Babaev graduated from Krasnodar State Polytechnic Institute and holds a Ph. D from the Moscow Technological Institute of the Food Industry (later renamed the Moscow Technological Academy of Food Industry).

privatisation process in the newly capitalist Russia that started in 1992 under the mandate of its first democratically elected president in Russia, Boris Yeltsin.

In anticipation of economic reforms in post-Soviet Russia, Babaev formed a limited liability company in December 1991 with all 600 employees of the plant. The terms of the privatization arrangement with the Moscow State Property Fund allowed Cherkizovsky to reinvest the plant's profits in the business, with the increasing value of the enterprise accruing to its shareholders. At the same time, various agencies of the Moscow local government made a passive investment of some 15 million USD in Cherkizovsky Ltd.

Over a two-year period, Babaev himself made additional capital investments in the company and bought up shares of other employees who were willing to sell. With the help of a 5 million USD personal bank loan, he increased his stake in Cherkizovsky Ltd. to more than 60%. During this period, a massive modernization and expansion of the plant was launched, increasing the workforce to around 3,000. Babaev continued to buy up employees' shares, and in 1995, Moscow State Fund sold him 6% of its 18% interest in the company. By 1997, Babaev owned 82% of Cherkizovsky, the Moscow government owned 12% and employees held the remaining 6%<sup>3</sup>.

During these and the following years, Mr. Babaev and his team upgraded the plant and expanded the marketing and sales functions within the company. The collapse of the USSR led to the collapse of agriculture. Almost all meat was imported from abroad rendering the industry highly dependent on the dollar, so when the rouble crashed in 1998, chicken prices rose twofold and even threefold in a 3-week period.

Babaev realized the need for import substitution of the food market and therefore bought and upgraded poultry production facilities, pork complexes, feed mills and meat processing plants. In his opinion, vertical integration was a strategic choice based on the need to ensure a steady supply of meat. *"For me, Cherkizovo Group is more than just a business. I see our company's mission as providing Russian citizens with high-quality products at affordable prices"*, Mr. Babaev commented.

In 2001, Igor's oldest son, Sergey Mikhailov, joined the company as marketing manager in food processing. He became General Manager of AIC Cherkizovsky in 2003 and CEO of Cherkizovo Group in 2005. Sergey was a Finance graduate by Georgetown University (USA). Prior to joining the family business, he had worked for investment bank Goldman Sachs and for Morgan Stanley, and had founded and managed his own telecom company.

In 2005 AIC Cherkizovsky and AIC Mikhailovsky agro industrial complexes (both majority-owned by the family) merged into Cherkizovo Group and in 2006 an I.P.O.<sup>4</sup> of nearly 30%

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<sup>3</sup> Part of the information on early years of the company collected from "The Cherkizovsky Group (A)", Harvard Business School case study # 9-399-119, year 1999.

<sup>4</sup> Initial Public Offering of shares.

of the shares was successfully carried out both on the Moscow and London Stock Exchanges. In 2009, the company's consolidated revenue crossed the 1,000 million USD threshold for the first time. In 2012, a further step was taken towards vertical integration with the creation of the grain division, which harvested grain on their own land for the first time.

## THE BUSINESS

Cherkizovo Group was the largest meat producer in Russia with an output of over 800,000 tonnes of meat in 2014. The company controlled each stage of production: crop growing, grain production, feed formulation and production, chicken egg incubation, pork and poultry breeding, slaughtering, meat processing and distribution. That year sales amounted to 68 billion roubles or 1,796 million USD with and EBITDA of 439 million USD<sup>5</sup>.

The Group was organized in five divisions: Poultry, Pork, Meat Processing, Feed and Grain. It had 8 full-cycle poultry production facilities, 15 modern pork production facilities, 6 meat processing plants, 6 feed mills and more than 140,000 hectares of agricultural land. It was second largest in Russia for poultry and meat processing, and third in pork. An overview of the five Divisions in terms of market position, products, brands, facilities and capacities can be found in exhibit 1. Exhibit 2 shows the evolution of the company in the last years both in terms of volume and of revenues.

The investment cycle was long in the agricultural sector so most of the companies were highly in debt. Cherkizovo was no exception; it got financing from banks at the usual rate of 12-14%. Nonetheless, there was a system for government reimbursement of interest expenses for agriculture companies. The effective cost of debt for Cherkizovo was 3.5% in 2014 and 3.3% in 2015. None of Cherkizovo's debt was in foreign currencies, which had protected the company against several rouble devaluations in the last years.

### Building its position

In 2006, a successful IPO took place in Moscow and London. The holding sold 27.8 % of its shares for 251.3 million dollars. However, the company was not so large at that time. It operated the Cherkizovski meat processing plant; in poultry, two factories had been bought and started to be upgraded: Petelinskaya in Moscow Region and Vasilievsky in Penza Region. The pork division was still at a very early stage and the grain division did not exist yet. Russia was a hot market then, attracting the interest of international investors. The money thus received allowed expansion and further growth.

#### *Poultry*

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<sup>5</sup> The company reported its data in USD. Equivalent in roubles to these figures according to the Annual Report 2014 and considering exchange rates at that time, were over 68 billion RUB in sales and about 17 billion RUB of EBITDA.