

Fast Forward Corporate Strategies in Russian Entrepreneurial Firms

Frances M. Amatucci
School of Business, Salem State College
352 Lafayette St., Salem, MA 01970
Office: (978) 542-6823; Fax: (978) 542-6027
E-mail: famatucc@salem.mass.edu

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Abstract

Diversification is prescribed as an appropriate corporate strategy for firms with strong competitive positions in slow growth industries. Yet, startups in Russia employ vertical integration and diversification growth strategies almost immediately. Based on field and case study research of Russian enterprises, the strategic and economic rationale for these fast forward corporate strategies are examined. The results suggest some entrepreneurs diversify for reasons similar to Western firms, i.e., sharing of core competencies. An unusual is the “reverse cash cow” situation whereby managers diversify into other product/market activities to generate cash flow *to invest into the core business* rather than from it.

Introduction

This paper explores the strategic behavior of entrepreneurial firms in Russia. Since the floodgates controlling foreign investment in Russia opened in 1988, there has been an unprecedented flurry of entrepreneurial activity. New businesses enterprises have developed from new venture creation and the privatization of pre-existing government-controlled industrial complexes. A large market consisting of approximately 149 million people and significant pent-up demand, especially for consumer goods, afford ample potentially lucrative business opportunities. At the same time, a business environment, complicated by political instability, currency devaluation, and corruption, creates formidable threats.

As new venture creation takes root in Russia and other transitional economies, a unique phenomenon is evident - the surge of opportunistic diversification by small, entrepreneurial firms. While Western management theories suggest diversification, as a corporate strategy, is most appropriate for firms approaching the mature phase of the life cycle, evidence suggests that Russian entrepreneurial enterprises employ this strategy in the growth stage. It could be that because of the distinctive features of the Russian national and economic context that theories about the diversification and organizational growth models, which were primarily developed from Western firm practices, do not apply. The field of comparative management emphasizes the context-specific nature of management (Boyacigiller and Adler, 1991; Spender, 1993.) This research addresses the following three research questions:

How do the growth patterns of Russian entrepreneurial firms differ from those in the Western business world?

What are the strategic, economic, and sociocultural explanations for diversification in small Russian firms?

Do diversification prescriptions that were developed from Western business practices apply in Russia?

Several streams of research relate to the theoretical and empirically derived relationships regarding diversification - strategic management, transaction cost economics, organizational growth and development, and entrepreneurship. These are summarized in the following sections.

Literature Review

Diversification as Corporate Strategy: Corporate diversification, the cornerstone of corporate strategy, is a well researched topic in the field of strategic management (Goold and Luchs, 1993; Ramanujam and Varadarajan, 1989.) National patterns of diversification have been examined in Britain (Channon, 1971), Germany (Thanheiser, 1972), Japan (Kono, 1985), France (Pooley-Dias, 1972) and many other countries. Chandler's (1962) seminal research on strategy and structure suggests that firms progress through a developmental pattern of expansionary strategic behavior - single business, volume/geographic expansion, vertical expansion, diversification. This pattern was derived inductively from 70 longitudinal case studies of U.S. firms. Later, Chandler (1990) replicated this work in a transnational sample of firms in the United States, Germany, and Great Britain.

The rationale for corporate diversification identified from empirical research on Western firms focuses on two points: 1). value creation through the corporate portfolio from the synergistic effects of transferring distinctive (core) competencies across the value chains of strategic business units and, 2). building on experience, cognitive schema, or "dominant logic" of the top management team (Goold and Luchs, 1993; Prahalad and Bettis, 1986.) A contingency framework for matching corporate strategy alternatives to a firm's situation suggests that given its competitive position and the industry growth rate, strategic options (e.g., growth through single business expansion, vertical integration, international expansion, related or unrelated diversification; stability; and retrenchment) are appropriately determined. Growth through diversification tends to be the *most* attractive strategic option when the firm has a strong competitive position and the industry is in a mature or declining stage of its life cycle. The classic example is Philip Morris, Inc.'s diversification from the tobacco business into food and brewing. Diversification is the *least* attractive strategic option when the firm's competitive position is weak and the industry's growth rate is strong. Although diversification can be achieved through acquisitions, internal development or strategic alliances, in Western firms, it most frequently occurs through acquisitions.

Another perspective regarding diversification comes from transaction cost economics (Williamson, 1975, 1985.) Oliver Williamson suggested that firms make decisions about strategy and structure based on the transaction costs associated with

dealing directly with the "market" vs. internally (thus, creating the "hierarchy".) High levels of uncertainty, complexity, opportunism, and information asymmetry, as well as decision maker bounded rationality, contribute to expanding organizational boundaries to avoid excessive transaction costs from market contracts.

Diversification in the Organizational Life Cycle: Scott (1970) introduced a model of organizational development in which firms progress from Stage I (single product with an informal structures) to Stage II (single product with a functional structure), and finally to Stage III (multiple products with multidivisional structures). Salter (1970) similarly offered a four-stage model of organizational growth. Galbraith and Kazanjian (1986) offered yet another model, which summarizes extant research and empirical evidence of dynamic strategy-structure relationships. Once again, most U.S. firms follow the path suggested by the aforementioned researchers, i.e., volume expansion, vertical integration, related diversification, unrelated diversification, international expansion.

Diversification in Small, Entrepreneurial Firms: Diversification and entrepreneurship appear to be strange bedfellows in North America and Western Europe. Most popular entrepreneurship textbooks do not even mention diversification. Dollinger (1995) includes conventional strategy-structure growth patterns, such as those mentioned in the previous sections. In keeping with traditional thought, he suggests that diversification occurs after demand is satiated and growth opportunities in the initial business have diminished. Kazanjian and Drazin (1989) empirically test an organizational growth model for technology-based new ventures. Although the latter stage suggests second general product development for new growth opportunities, there is no support for diversification

Holt (1992, p. 474) goes further by actually identifying diversification options for new ventures. However, he warns "*too much diversification can result in a quagmire of misdirection; entrepreneurs simply lose track of what they do best by trying to do too much, and they do nothing well.*" A case in point is a recent article in the American entrepreneurship magazine, *Inc.* It describes how two founders of a very successful muffin baking company decided to try their luck at yogurt and other related products - only to find a decline in the firm's performance until they divested the new businesses and focused once again on muffin baking.

Oviatt and McDougall (1995) offer a provocative look at start-ups that are bucking the historical trend of beginning as a domestic competitor and then expanding geographically (and globally.) They analyzed twelve start-ups that began global at inception.

Research Methodology

The research methodology in this study follows a two-stage research design, which is primarily qualitative, using field, case, interview, and content analysis as techniques for collecting, organizing, and analyzing the data. The first stage began in March, 1995, when interviews with six managers of small firms in St. Petersburg were

conducted. In most instances, the manager was also a founder of the company. The interviews were in Russian, requiring simultaneous translation by an interpreter. They were not tape recorded. A semi-structured questionnaire guide, was developed with many open-ended questions. Interview notes were analyzed according to the guidelines suggested by Miles and Huber (1984), and six minicases, or caselets, were developed from the data.

The second stage of the research design occurred one year later in June, 1996, and again in July, 1997. Follow-up interviews were conducted to create a longitudinal dimension to the study. The interview methodology was similar to the first stage; however, three of the six firms could not be contacted. The cases, with some commentary regarding corporate strategy development, are provided below.

Orienteer

Orienteer (means “direction”), which was founded in 1990, initially started as a college preparatory school. Yevgeni Nicholaivich has been a professor at the school since its creation, and was one of the founders. At the time of the interview, there were three official employees and twenty-five unofficial ones. Because the preparatory school was cash poor and faculty salaries were low, they began to develop other businesses to generate cash flow. Approximately six months after *Orienteer* was founded, the managers established a business manufacturing bulletproof glass. Because of the high crime rate in the city of St. Petersburg, demand for bullet proof glass was high and the firm immediately acquired contracts, especially with some of the local banks. This has been a profitable business.

From 1991 to 1994 the managers became involved in numerous other diversification attempts including wholesale food and computers. However, the tax policy was devastating. In fact, they entered children’s apparel retail for awhile because taxes were lower. In 1993 they developed and marketed laser light technology, which was first introduced by a local technical institute. Later that year, they began to market hip and shoulder joint prosthetic technology. Their expertise was relevant because the prosthetics contained a memory implant. However, body rejection was problematic. In early 1995, the managers formed a joint venture with another firm. Ornyx, to be a regional distributor of Brother computer hardware and software in the St. Petersburg. The joint venture also provided computer support services to industrial firms and the preparatory school. It became what Yevgeni considered to be a second core business.

One year later, in June 1996, the joint venture was the primary core business. While founders received “moral satisfaction” from their activities associated with the college preparatory school, the distribution of Brother computers, printers, fax machines, scanners, and sewing machines has increasingly become more important. Moreover, given the 10 percent annual growth rate, this business was a major source of sales and profits for the

company. Concurrently, interest in the manufacture of bulletproof glass and joint prosthetics diminished during this timeframe.

Although this firm was founded in 1990 as a preparatory school for the university, it quickly expanded into other businesses. The growth pattern appears to be single business (college preparatory school), related diversification and vertical integration (computer hardware/software), geographic expansion, and finally unrelated diversification (bullet proof glass manufacturing). The founders were professors from the university who used their intellectual capital to create the preparatory school, and later applied their technological expertise to enter other high growth businesses with minimal entry barriers. They exhibit a reverse cash cow phenomenon whereby diversification occurs to bring resources into the core business, rather than from the core business. All businesses were start-ups with the exception of a joint venture in 1995.

LTD

Victor and another individual founded LTD in 1994. He has formal education in engineering and construction, and has twelve years work experience in construction. The firm is located in St. Petersburg, and has fifteen permanent employees with ten to fifteen part-time employees. The business is forestry and wood processing. It is vertically integrated in that it is involved in cutting the trees, transporting them, and wood processing to produce wooden planks for industrial use.

The managers have engaged in minor business activities such as food retail, manufacture of industrial products (doors and window frames), and transportation. However, except for the latter, tax policy has made them unprofitable. The managers want to keep the firm small so taxes will be low. A wholesale business of alcoholic beverages has been instrumental to generate profits and infuse capital into the forestry business. Excess trucking capacity is used during down times for alternative purposes. The core business is cyclical with profitability in winter and summer; however, poor roads in the spring and autumn hinder operations.

The core business of this firm is forestry and wood processing with opportunistic moves into food retail and transportation. The growth pattern appears to be vertical integration (wood processing and door and window frame manufacturing), related diversification (use of trucks for alcoholic beverage transportation), and unrelated diversification (food retail.) All activities were start-ups.

Temp

Temp (means “pace”) was founded in 1991 by Vladimir and several others. His background consists of twenty years experience working in the construction industry. *Temp* has sixty permanent employees and fifty temporary ones. At times the payroll goes up to as many as one hundred fifty.

The firm is a vertically integrated construction firm located in two towns outside of St. Petersburg - Pushkin and Pavlovsk. It processes wood and manufactures other building materials which are then sold internally to their construction restoration business. *Temp* has had several contracts restoring old palaces and deteriorated buildings in St. Petersburg.

The business was developed vertically integrated because the founders felt it was cheaper to make their own materials rather than purchase them. Approximately ninety percent of factory building material is sold to the construction firm (internal transfer pricing) and the remaining ten percent is sold on the market. They hope to sell more on the market in time. During the first year, the founders also attempted to make bricks. However, when they found that using sawdust as a raw material was ineffective, the effort was aborted. The founders prefer to keep the firm small since the image of large-scale means paying higher taxes and Mafia interference.

Likewise, this firm is a vertically integrated company, which simply expanded geographically over time. This construction company integrated backward (wood processing) and forward (manufacture of construction materials), presumably to decrease transaction costs associated with the market.

Telecort

Yevgeny K. founded *Telecort*, along with seven others, in 1992. He has a doctoral degree in mathematics from St. Petersburg State University. He worked in a large state run factory, which developed television and camera security systems, and he has twenty-seven years of experience in this field. The firm has fifteen full-time employees. All founders/owners work actively in it. *Telecort* was formed as a vertically integrated company when the state run factory was broken up. Then it became related diversified and expanded geographically.

The current business portfolio includes the following businesses: television and camera systems/security systems; computerized automobile diagnostics; and development of products using electronic measurement technology (e.g., electronic thermometers for public transportation, weight, gasoline level barometers, etc.) All businesses have a national presence. The television camera business generates most of the profits and sales. There are many competitors in this industry due to the break-up of the state factories and privatization. Based on their collective technological expertise, the managers created start-ups in computerized auto diagnostics and electronic measurement to reduce risk from being in the television business. The autodiagnosics business also has many competitors, but *Telecort* has no competition in electronic measurement. Future endeavors include developing a plane that flies without a pilot for the Ministry of Emergency Situations and robotics for entering dangerous places such as Chernobyl.

One year later in June 1996, *Telecort* continued to be in the three businesses described above with 70 percent of sales coming from TV and

camera security systems, 15 percent from auto-diagnostics, and 15 percent from electronic measurement. Annual turnover was approximately \$200,000 (5,000 rubles/US \$). The firm is a market leader in its core business and has developed a very good reputation over time. Recently there have been large orders from the government, including systems in the Marinsky Palace and Smolny Cathedral. Plans are in process to focus more on systems installation and source manufacture of components outside of Russia. A new product in the electronic measurement business was introduced - a measuring device for gasoline wholesalers.

A new direction for *Telecort* involves the development of a technology used as safety equipment for ocean and mountains. It involves a “push” technology that can initiate avalanches or hoist safety equipment in deep seas. The firm has won a bid for the government order by the Federal Ministry of Extreme Situations, the Ministry of Navy, and municipal authorities. They are involved in the research and development, production, marketing, and sales of this technology, and expect that it can be more profitable than the core business.

Telecort was created in 1992 as a manufacturer of TV/camera security systems. The founders quickly diversified the firm by transferring technological expertise to related applications. The firm was created as a vertically integrated entity which employed related diversification (computerized automobile diagnostics and electronic measurement) and geographic expansion strategies for growth. These related businesses exhibited attractive growth opportunities with minimal entry barriers.

OKKO

Alexander founded *OKKO* with his wife in 1991. Although he did not complete a degree at the University where he studied radio technology, he worked as a laboratory chief in the Research Institute of the Ministry of Electronics (laser and microelectronics primarily for defense applications.) His wife has a university degree in finance and economics and served as the chief accountant for the firm. The initial business involved production of medical equipment, primarily for physical therapy. This included rehabilitation equipment, hydrotherapy, inhalation therapy, and the production of oxygen cocktails.¹ This business is not directly related to Alexander’s educational background or work experience, but he was an invalid when he was nineteen years old. The idea came from an elderly friend who worked for a small state run medical center and complained about low quality medical equipment.

The factory is located in St. Petersburg and serves state-run medical clinics in 88 regions in Russia. Product prices are determined by what the clinics can pay. There is no backward integration and the firm conducts little marketing since it has a captive market. Once they advertised, and received so

¹ Oxygen cocktail is a foam-like substance made from various herbs and containing albumin which stimulates stomach digestion and clears the liver. It creates energy “like working several hours in the woods.”

many orders they were unable to fill them. A typical monthly production is 120 oxygen cocktails, 80 inhalation therapy kits, 5 pediatric hydrotherapy kits, and 50 telephones for the deaf. The firm receives special tax breaks because it produces equipment for invalids. There is little competition in this area. Once they produced electropuncture equipment, but when competitors appeared, the firm exited the business. Alexander stated he prefers to operate in businesses where competition is nonexistent or minimal because he knows what kind of criminal activity it brings.

In the spring of 1992 *OKKO* created a semiprecious stone finishing business. Alexander had developed this skill in special classes he took while an invalid. He used his experience as an engineer, especially ultrasound and some laser technology, to finish the stones. After his work generated a great deal of interest, he decided to start another business. This business segment has only four full-time employees. The firm purchases stones, finishes them, and then sells them to three construction firms as building materials for country dachas. This firm is the only supplier of kitchen tiles installed in the dachas. Some competitors exist, but lag behind because of obsolete technology and higher prices. The third business is a cereal wholesale business. Alexander states that this business is profitable occasionally, but inflationary pressures squeeze profits. He thinks it is not a long-term business because when the warehouse gets a good manager (the current one is lazy and doesn't work.), they will realize that they don't need him.

Finally, in late 1994, Alexander and some of his competitors began to pool their financial funds and invest in bonds. He began a financial investing business. This has been the most profitable of his business activities, and he plans to use this cash flow to expand the medical equipment business. Alexander's long-term vision for the firm is to develop a medical equipment project in Finland. However, the core business tax advantage ends in early 1995 and he has no idea what the government will do next. Alexander described how difficult it is to plan when the rules are constantly changing.

OKKO was a start-up created in 1991 as a single business involved in the manufacture of physical therapy equipment. The firm evolved from single business to geographic expansion to unrelated diversification (semi-precious stone finishing, cereal wholesale, financial investing.) The unrelated businesses were developed because they were profitable, (even if only short-term) and created a reverse cash cow phenomenon whereby the core business would be the beneficiary of excess cash flows.

APETE

The word "*apete*" refers to the physical and intellectual games once played in ancient Greece. Valeri has a mechanical engineering degree from Baltic Technical Institute, but is also a sports enthusiast who enjoys throwing the shot put. This firm was created in 1992 to develop and produce artificial

joints for the hip, elbow, and shoulder. *APETE* is located in St. Petersburg, but its customers are hospitals located all over the former Soviet Union.

There are six engineers (three Ph.D.s) in the research and development part of the business and approximately thirty employees involved in production. The firm has a national reputation and does some advertising; however, most hospitals contact it for orders. Product prices are determined by what the hospital (actually the government) can pay. Quality, reliability, and product durability are extremely important. There are few competitors, but they lack the technological edge that *APETE* enjoys. In 1995 the firm was not vertically integrated and Popkov had no plans for diversification. He believed that other entrepreneurs diversify because “they haven’t found themselves yet.” He enjoys this business because it is interesting and there is a great deal more to learn about it.

One year later in June 1996, *APETE* continues to manufacture joint prosthetics and surgical instruments, but had diversified into the manufacture of steel lockers. Sales in the core business continue to be constrained by the decline in the federal budget for health care expenditures and adverse conditions in the health care sector of the economy. The steel lockers are produced as containers for computerized equipment in harsh weather conditions along oil pipelines; they are sold to a major Russian oil company. This business has generated profits, which have been used to reinvest in the core business.

Interestingly, this firm was founded as a manufacturer of joint prosthetics and employed a strategy of geographic expansion. Although the founder did not favor diversification, in time he also turned to it to generate cash for reinvestment into the core business.

Insert Table I here

Discussion

The case studies in the previous section and summarized in Table I, illustrate the unconventional strategic behavior of a small sample of Russian entrepreneurial firms. It is obvious that Russian diversification patterns differ on various dimensions from Western firms. These differences are summarized in Table II.

In terms of growth patterns observed in this sample, it is evident that only three firms began as single business, and of those only two progressed directly to geographic expansion. The other three began as vertically integrated firms. Four of the six engaged in diversification fairly early in the firm’s life cycle. In all cases, when diversified occurred, firms were Stage I, having informal internal organizational structures and operating in growth markets. Although the predominant mode of diversification for Western firms is acquisition, and increasingly joint venture, with the fewest numbers occurring through

internal development, or greenfield, most of the Russian firms diversified through start-ups. While related diversification is preferred over unrelated diversification in most Western firms, unrelated diversification in Russian firms is quite prominent.

As for the motives for diversification, there is some evidence that Russian firms diversify because of similar, but not the same, motives. For instance, there is evidence of transferring skills across value chain activities, economies of scope, industry attractiveness, low cost of entry in this sample. Obviously, none of these firms diversified to reduce dependence on a mature business, but a few attempted to reduce dependence on a single business. Use of the dominant logic of the manager/entrepreneur was observed in some, but not all cases. Opportunism and decreasing transaction costs associated with dealing with underdeveloped markets appear to be very important. Legal/registration policies in Russia are important, especially tax policy. Finally, while many Western firms diversify to balance cash flows by channeling excess cash flows from cash cow business units to those with more growth opportunities, Russian firms exhibit a “reverse cash cow effect” in that diversification often occurs to generate cash *for* the core business, i.e., new businesses are started to generate cash to nurture the initial business.

Insert Table II here

There are caveats in accepting the findings of this research. This most obvious is the small sample of entrepreneurs who were interviewed in this study. Although this is a legitimate criticism, it should be noted that the occurrence of small firm diversification in Russia is quite obvious. The question is not *if* small firms diversify, but *why*. The purpose of the multi-case research design is to collect evidence which explains why diversification occurs, and to understand the cultural, political, and economic contexts in which Russian entrepreneurs make these decisions. This helps us to understand further the context-specificity regarding diversification decisions. More importantly, it assists Western business people to understand the mindset of Russian entrepreneurs as they quickly create conglomerates and practice management strategies that appear to be anathema to the Western world.

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Table 1. Corporate Strategy in Russian Entrepreneurial Firms: Case Summaries

Firm	Year Founded	Initial Business	Portfolio Composition	Growth Pattern²	Mode of Diversification	Motive for Diversification
<i>Orienteer</i>	1990	College preparatory school	Man. bullet proof glass Computer hard/software distributor Computer support services	1,4/3,2,5	Primarily start-ups JV in 1995	Transfer technological core competence Industry attractiveness Low cost of entry Opportunism Reverse cash cow
<i>LTD</i>	1994	Forestry and wood processing	Food retail Man. doors and windows Alcoholic beverage transport	3,4,5	Start-ups	Transaction costs Opportunism
<i>Temp</i>	1991	Construction Palace restoration	Wood processing Man. construction materials	3,2	Start-ups	Transaction costs
<i>Telecort</i>	1992	TV/camera security systems	Computerized auto diagnostics Electronic measurement (R&D and manufacture) “Push” technology for avalanche and oceanic crisis	3,4,2	Start-up from state run factory	Transfer technological core competence Industry attractiveness Low cost of entry Opportunism
<i>OKKO</i>	1991	Physical therapy medical equipment	Semi-previous stone finishing Cereal wholesale Financial investing	1,2,5	Start-ups	Opportunism Decrease risk Reverse cash cow
<i>APETE</i>	1992	Joint prosthetics	Manufacture steel lockers	1,2,4/5	Start-up`	Reverse cash cow Some technical transfer

² 1. Single business; 2. Geographic expansion; 3. Vertical integration; 4. Related diversification; 5. Unrelated diversification.

Table 2. Western vs. Russian Views of Diversification

	Western	Russian
Growth Pattern:	Single business, geographic expansion, vertical integration, related/unrelated diversification	Vertical integration/single business, diversification, geographic expansion
Life Cycle:	Mature; Stage II or III	Growth; Stage I
Mode:	Acquisition, joint venture, greenfield	Start-up, joint venture
Type:	Related; unrelated	Unrelated; related
Motives:	<ul style="list-style-type: none"> Transferring skills across value chain activities Economies of scope Industry attractiveness Low cost of entry Reduce dependence on mature business Dominant logic of manager Opportunism Decrease transaction costs Legal/registration policies Balance financial/cash flow situation 	<ul style="list-style-type: none"> Same Same Same Same Less important (military, steel) Same Very important Very important Very important, esp. tax policy Reverse cash cow effect