

MODA TEXTILE FACTORY¹

Bishkek, Kyrgyzstan

Sergei Ivanov and his wife Olga faced some important decisions regarding the future of their small sewing business in downtown Bishkek. The company, founded eight years before and now employing 15 people besides themselves, produced made-to-order women's suits, dresses, skirts and raincoats for local wholesalers that supplied the raw materials and designs and sold the finished goods to retailers across the country and region. Sergei and Olga had long dreamt of producing quality, fashionable cashmere coats and they now sought partners and financing to move their company in this direction.

The Soviet Period

In 1985, Sergei Ivanov and Olga Ivanova thought their entire life was planned out. They lived in Maili-Sai in southern Kyrgyzstan, a closed Soviet town of 23,000 people created under Stalin as the site of the Soviet's key electric light bulb factory and a uranium mining and processing operation (see map [Exhibit 1](#)). Both Sergei and Olga had good, reliable jobs at the prestigious electric bulb factory, the region's largest supplier of electric light bulbs and a major producer of electric equipment and devices for the entire Soviet Union.

Sergei was a technician and mechanical specialist who oversaw the maintenance and repair of the factory's heavy equipment. Olga was the director of the department of technical documents which maintained all information on factory machines and equipment. Although their salaries were modest, the positions they held at the factory were prestigious and they were well respected professionally and in their community. Sergei recalls: "The production process worked very well—we used a scientific approach. But I think that the organizational structure of the production process is the same everywhere—whether or not it is a capitalist or

socialist system. The planning system was logical and met people's needs. In Kyrgyzstan, we call the new system 'wild capitalism,' because the system is irrational, and sadly the old Soviet factories are practically not operating."

Sergei and Olga worked eight-hour days, five days a week at the factory. Life was stable and predictable. They lived in a close-knit community with the other factory workers and the social welfare system took good care of their basic needs. Their colleagues were also their neighbors in the factory-owned housing units that they rented. They ate lunch Monday through Friday with their co-workers at the factory's subsidized canteen. When they needed medical care, they went to factory-owned health clinics and hospitals. The children in Malisai attended factory-owned schools. In the summer, they vacationed at the factory-owned sanatorium on Lake Issyk-kul. Though their wages were low, they had few worries. Food, housing, education, and healthcare were practically free. Sergei and Olga thought they would have their jobs for life.

They only needed to pool their resources and budget in order to buy big ticket consumer goods, such as a refrigerator, television, washing machines, which were expensive and in short supply. "There weren't many interesting things to do, though," Sergei admits. Traveling outside of the Soviet Union was impossible as were opportunities for earning a higher salary. "However," he quickly adds, "life was stable and logical."

Private businesses were prohibited during Soviet times but the entrepreneurial spirit persisted through an underground micro-business sector operating in homes where families engaged in activities such as knitting and sewing, tutoring, dentistry, silversmithing, and shoe repair services. People were discreet about these activities, though, and generally one only negotiated such services with friends and relatives whom they could trust.

Political Independence and Transition to a Market Economy

After the break-up of the Soviet Union, followed by the independence of the Kyrgyz Republic in 1991, the country suffered a major economic downturn as it began the transition to a market-based economy. With money from Russia drying up, industries and factories shut down completely or began operating at minimal capacity, leaving much of both the skilled and unskilled workforces unemployed. Sergei described the collapse of the Soviet Union as an earthquake because it was so unexpected and happened so quickly. People struggled both financially and psychologically to deal with the massive changes that began taking place. Many social problems developed as a result of the country's economic instability.

In 1992 Sergei and Olga, both in their mid-20s, lost their once securely held jobs at the electric bulb factory. Desperate to survive through the difficult transition, they decided to move to the capital, Bishkek, 800 kilometers or 15 hours away, in search of a new life. They hoped that living in Bishkek would provide job opportunities and a more stable place for starting a family.

Eventually the factory was purchased by a large Russian electro technology company, B.A.B.C. Company, and the factory continued to employ 3,000-5,000 workers. Many people emigrated. The town, however, came to be regarded as ecologically unstable due to its historical role in uranium waste disposal.

Starting a Trade Business

"Perhaps my entrepreneurial spirit is part of a family tradition. My grandfather in Russia was a merchant. Many people in my family now have private businesses – my brother has a sausage factory and my sister has a café," said Sergei. "Olga is also from a family of merchants." But Sergei quickly explains that some of his former factory colleagues and friends have also taken the same route, initially starting a trade business and eventually opening a small production business. Trade was the easiest business to get into after the factory.

After Sergei and Olga arrived in Bishkek, they wanted to start a trade business selling clothes wholesale at an outdoor market in Bishkek.² Several markets were springing up at the time, replacing casual markets that existed before independence as the alternative to government-run shops. Many people were buying and selling household goods. The biggest problem was finding the start-up capital to purchase the inventory. Sergei and Olga had only \$50 to invest in their first buying trip. Fortunately, they were able to borrow \$650 from family and friends, who charged them a daily interest rate of 1%. Olga soon left for her first buying trip to India. She returned and within a short period of time the couple sold the goods, paid back the loans and, after covering all expenses, still earned

a profit of \$300. Olga's buying trips for clothes continued to India and China and Sergei began buying jeans apparel in Turkey for retail sale in Bishkek. They planned to invest their earnings in the future in opening a small sewing workshop.

Expansion of the Trade Business

Their business was turning a small profit by late 1993 but growing very slowly due to the constant problem of lack of working capital. Taking out a loan through the formal financial sector was impossible as banks were not lending to small businesses at that time. The only credit opportunities were from moneylenders who charged outrageous interest rates, or from family and friends whose capital was limited. Even so, they continued to borrow small amounts of money from their friends to finance buying trips to Turkey to expand their inventory of jeans apparel.

Over the next ten years (1994-2003), Sergei made over 80 buying trips to Turkey to purchase wholesale jeans apparel. Eventually the government closed down the outdoor market where Sergei first sold his jeans, not compensating stall owners for the disruption. He then rented a stall in the city's largest department store, Tsum, where the rent was high (\$400/month) compared to the outdoor bazaar (\$50 rent/month) and inventory turnover was slower. He was in a retail space with 200 vendors, located on the second floor. Nonetheless, the business was profitable because his prices were competitive with jeans sold at the city's largest clothes bazaar. Olga continued making trips to China and India to buy clothes and accessories, but soon they realized that the jeans apparel business was more profitable. They stopped the wholesale clothes side of the business and focused completely on the jeans trade. Soon they opened up an additional stall in another smaller department store and hired several salespeople to work the stalls. Sergei briefly considered opening a jeans apparel factory, but he was unable to locate appropriate production equipment in Kyrgyzstan.

Opening of the Sewing Factory

The wholesale jeans apparel trade business was profitable and stable, but Sergei and Olga dreamed of something bigger. If they had a sewing workshop, they could be different. In the mid-90s, Sergei and Olga discussed starting a family-owned sewing factory of high-quality apparel. They dreamed of making fashionable Italian-imported cashmere coats, but the market demand was too small in Kyrgyzstan alone. They knew that in order to be profitable, they would need to find good partners and access to foreign markets, a major challenge for any small business operation. In addition, they did not have access to capital needed to purchase equipment. They had few business contacts abroad and government customs and tax regulations were undefined or difficult to maneuver. They decided to postpone this business idea for a few years once Olga became pregnant and planned to stay home for a few years and take care of the baby.

In 1997 Sergei and Olga decided to invest the profits from the jeans apparel business to begin manufacturing clothing at a new sewing factory. They wanted to produce made-to-order women's suits, dresses, and raincoats. Since Olga was working at home taking care of the baby, Sergei began searching for a business partner with whom to open the sewing business. New to the private sector, Sergei was naive and inexperienced in selecting a partner and, in retrospect, he made his decision much too abruptly.

One summer day, Sergei was stopping by his stall in Tsum to deliver new jeans jackets and skirts inventory imported from Turkey. He ran into his old colleague, Igor, who had worked with him for many years at the electric bulb factory in Malisai.

"Igor Nikoleivitch, Hello! It's good to see you! It has been, what, five years since the last time we saw each other? How are you?!" said Sergei enthusiastically at their greeting.

"Sergei Ivanov, it's great to see you, too! I'm doing okay – looking for work, actually. My wife, Ludmila, is pregnant with our third child now, and I've just been making ends meet with machine repair jobs here and there. You wouldn't know of anyone who might need my skills, would you?"

While Sergei had not worked directly with Igor, he remembered his reputation for being a responsible line production manager and mechanical engineer at the factory. He knew most people liked him. His mind began to roll: Perhaps Igor could be just the partner he was looking for? Surely he didn't have any money to invest. Well, maybe that didn't matter. Sergei needed someone qualified and Igor had just the skills he needed.

"Well actually, Igor, I'm looking to open up a sewing workshop..."

By the end of the year (1997), Sergei and Igor had opened the Moda sewing workshop, purchased three sewing machines and a stitching machine, and hired three seamstresses and a cutter. They rented the bottom floor of a building in northeast Bishkek owned by a local Kyrgyz bank. According to the contract, the bank could force them to leave at anytime with 30-days notice and without due cause. The building site was not optimal, and Sergei hoped to renovate it when the business turned a profit.

Igor managed the workshop full-time while Sergei still spent most of his time running the jeans apparel business. Sergei had attracted several fairly loyal clients to the factory who were wholesalers at Dordoi market, a 12-year old market outside town, but business was unsteady. Wholesale clients supplied the material and patterns for the women's suits, dresses, and skirts they wanted made and the workshop filled their orders according to each client's specifications. Each wholesaler supplied from 3 and 20 retailers. Style development was a dynamic process. Retail sellers expressed their ideas to the wholesalers who collected them

and brought them to Sergei and Olga. They then modified the design based on discussions regarding styling for the new products.

Management Problems and Corruption

After a year and a half in operation, the Moda workshop was not doing as well as Sergei and Olga had expected. Profit levels were low, business was unsteady, and the work climate in the shop was tense. Sergei and Olga discussed the situation and decided that Olga should review the financial records and monitor Igor's performance more closely over the following month. Meanwhile, Sergei would visit clients to determine their level of satisfaction. If profit margins did not improve soon, they reckoned they would probably close the workshop. After several weeks, Sergei and Olga discussed the situation again.

"I've checked the accounting records and financial statements and I really don't understand why our profit margins are so low. I have a big suspicion Igor is stealing money from the business and manipulating the accounting records to cover up for taking 30% of the profits earned," explained Olga. "He's also late in paying salaries and that is causing the low morale and negative work environment."

Sergei and Olga decided that Igor needed to be confronted immediately. The following morning, Sergei and Igor met in the factory and a heated discussion ensued.

"Igor, I know that you have been purposely covering up our real profits and stealing from the factory. Why have you done such a dishonest thing?! Don't you understand that investing profits back into the workshop over the long-term is more beneficial than destroying the business by stealing our profits? Since you didn't invest in this business, you didn't think you had much to lose, but now you are losing your job. I can't trust you any longer. You have financially hurt the workshop, our workers, and yourself," said Sergei.

"I'm sorry, Sergei, but I have three children at home and a wife to take care. I needed the money to feed my family. Please reconsider. I understand what I did was wrong," implored Igor.

The Sewing Factory under New Management

Olga and Sergei decided that if the business were to continue, major management changes were needed fast. They removed Igor from the business and Olga started working again, now in multiple roles – as the general manager, head accountant, and human resource manager at the workshop. Sergei spent about 30% of his time on marketing and sales for the workshop, cutting down to 70% the time he spent with the jeans apparel business. He had already hired three employees to work the two stalls at the mall where they sold jeans.

One of Olga's primary tasks was to create a family atmosphere in the factory. Based on her five years of management experience at the electric bulb factory, she developed new incentives to raise employee morale. Olga began keeping records of employee birthdays and they celebrated them at the factory. She gave the employees small presents on special holidays such as International Women's Day and New Year's Day. If employees worked late or on weekends to finish an order, Olga brought in cakes or other treats.

Olga believed that "the factory is and should be more than a workplace. It should be a second home for our employees. Many of my workers see me as their mentor and ask for my advice. The factory is small so I can still treat each worker according to her individual needs. I try to provide emotional support and sometimes even financial support to the women." Olga drew a flower on some paper explaining that "the pistil in the center represents the workshop that unites all the petals. Each petal represents one aspect of the workshop, i.e. family, customers, equipment, and workers. All are important in contributing to the success of the workshop." Sergei then added, "Three-fourths of a company's success depends on the loyalty of the employees."

Olga appreciated the respect she earned from her employees and felt emotionally rewarded by her work. She publicly commended good employees and was quick to add that she depended on her right-hand woman, Natasha Nikolaevna, who had worked with her since the beginning. [Exhibit 2](#) portrays employees at work in the factory.

Labor and Work Conditions

The workshop officially operated six days a week from 8 a.m. - 5 p.m. in winter and 8 a.m. - 9 p.m. in summer. Wages for sewers were based on production, and therefore some employees chose to work after hours. Often sewers worked through the night or all weekend in order to complete an order.

There were seventeen employees in total, including the general manager/head accountant/human resource manager (Olga) and the sales and marketing director (Sergei); technician; cutter/assistant manager; one cutter; five senior seamstresses; four junior seamstresses; one assistant seamstress; and two pressers. The organization chart appears in [Exhibit 3](#). The most productive seamstresses were 28-30 years old.

When Olga took over as general manager, she knew that timely paychecks were a key incentive for increasing productivity. She made sure that all employees were paid every Friday. She believed that employees were generally content working at the workshop because their wages were higher than what similar workshops paid and wages were paid regularly and on time. Occasionally, Olga had to fire seamstresses who performed well for several days but then slacked off. However, she made an effort to promote

internally as an incentive. Over half of their current staff had worked at the factory since it opened. The layout of the factory floor appears in [Exhibit 4](#).

When Moda had a job opening for a new seamstress, Olga placed a small advertisement in the local newspaper. Generally, at least forty people applied for one opening, however finding qualified candidates was still difficult. Sergei explained that the two principal technical sewing schools in town were not producing qualified seamstresses, designers, etc. However, Olga tried to develop a creative solution to the problem by making special agreements with one of the technical schools to hire for a trial period their competitive graduates who were unable to find a job.

Olga and Sergei discussed their desire to improve working conditions by renovating the building. They wanted to install a fan or air conditioner for the summer and a heater for the winter. The problem was that according to the rental contract, the lessor, the bank, could force them to leave at any time with 30-days notice or due cause. They were afraid that once they invested in the building and made the improvements, they might be asked to leave. They did not have enough money to buy space for a workshop and at the time mortgage loans were unavailable in Kyrgyzstan.

Although the Moda workshop paid rent in a timely fashion and in all respects was a model tenant, Olga had ongoing problems dealing with the landlord. Recently, the bank wanted to put in a 24-hour currency exchange office in their building next to the workshop. This concerned Olga because of the unsafe traffic it would generate, particularly in the evenings. She successfully convinced the bank not to do this, but she worried that other problems might arise in the future to strain their relationship.

Business Challenges

Access to Credit

When Sergei and Olga first opened the sewing workshop in 1997, a major challenge was the lack of access to credit. Banks were still not lending to the small business sector and international organizations offering small and medium-sized businesses credit lines had not yet entered the country. Although the workshop was profitable within a month after Olga took over as General Manager, business growth was slow due to continuing cash flow problems. One of the biggest problems was lack of working capital. Sergei explained that Moda was always short of cash and the business had grown slowly as a result. Olga inquired into the possibility of taking out a loan from their landlord, Tolubai Bank, but a loan officer advised them against it stating that their loan terms were more equivalent to a moneylender than a formal banking institution. The major banks in Kyrgyzstan also had a reputation for being corrupt and money was limited. People readily operated using U.S. currency. The main street was lined with currency exchange shops.

In 1999, Sergei read in the *Bishkek Evening News* newspaper about a lending program managed by Mercy Corps, an international NGO, which offered credit to small businesses. Olga and Sergei were skeptical about this opportunity but they decided to meet with a loan officer and learn about the loan terms. In September they took out their first loan for \$5,000 to build their jeans trade inventory. Over the next three years, they took out five more loans averaging \$4,000 each. The loans were used for working capital and equipment purchases for their growing sewing workshop, and to increase the volume of jeans sold in their trade business.

The Mercy Corps loans helped them expand their business faster. They always took short 6 month loans because they were afraid of the risks of holding debt for longer periods of time. Generally they paid more than the minimum monthly payment and usually paid off each loan ahead of schedule. Since collateral registration was regulated by government and the borrowing process was lengthy and costly for small businesses, Moda extended the term of their most recent loan to one year to avoid the lengthy registration procedure.

Even with these business loans, the workshop remained short of cash. Sergei's jeans apparel business was less impacted by seasonality, however, so he was able to help the workshop with its cash flow problems.

Fiscal Policy and Legal Environment

Fiscal policy was still in a nascent stage of development in Kyrgyzstan. The tax police had a reputation for corruption and regulations were nebulous and incomplete. Small businesses operating in the informal sector often kept two accounting records, one for submission to the tax body and one for internal recordkeeping. Businesses avoided paying required income taxes because continued operations were nearly impossible with such a high expense.

Sergei explained, "Because of the economic situation in the country, we keep two accounting books. I know the taxes we pay do not go to the national budget for education, hospitals, etc. Our tax police are corrupt. When I'm certain my taxes will go to the country's operating budget, I'll report my real income." He continued: "If I reported my taxes accurately, I would have to pay 37% of my gross revenue. I couldn't survive."

Both Sergei and Olga promised each other not to share their financial statements with anyone, including employees and family.

Financial Issues

Moda's annual profit was stable but with minimal growth. Sales were about \$60,000 or 2,400,000 soms (40 soms = US\$1). Fifty percent of Moda's sales went to salary expense, 30% to other administrative expenses, and 20% was net

income. This breakdown appears in the pie chart of [Exhibit 5](#).

The business of producing women's clothes was seasonal. July and August were generally slow months, averaging about \$400 in monthly net income. So was January and February following the big New Year's holiday. The busy season was generally March through June and September through December, with average monthly income of \$1,300.

2001 was an off year because of the September 11th events. The couple expected to net \$1,500 in September but only netted \$500. The remainder of that fall was also very slow. The slowness continued through summer 2002 because of critical border problems involved in exporting. Unclear customs laws and the VAT (value added tax) requirement created a situation in which businesses were forced to pay VAT twice when trading between Russia and Kyrgyzstan.

Production Issues

Women's suits retailed for \$15. The average output per worker was five suits or dresses per day. Because orders varied seasonally, the workshop ran at 70-80% capacity. Olga believed that similar workshops in Bishkek ran at 40% capacity on average.

Clients brought in the fabrics, accessories and patterns they wanted produced. The fabrics were generally synthetic, including polyester or acetate. Fabrics typically came from Korea, China or Turkey.

Over the past five years, Sergei bought 16 sewing machines (Japanese, German, and Russian-made) and ten special technical machines, including four stitching and button making machines.

Olga and Sergei constantly dealt with seasonal risk in their business. If clients did not place orders, the workshop still kept employees on board and paid them their salaries.

Access to Markets / Partners

Moda still wanted to make cashmere coats and raincoats for export to the U.S., Europe or Russia, but they had no established contacts in any of these areas until recently. Sergei knew that finding honest, stable partners would be difficult. Last year he tried to establish a business partner in Russia, but in the process he spent over \$900 on transportation, telephone and fax expenses. After the negative experience with Igor, he knew he had to be discriminating in finding partners. To help him in this process, Sergei attended a course on the "Psychological Aspects of Running a Business" where he learned useful skills for dealing with business partners. Some suggestions were to use a prepayment system and engage a lawyer when making deals. He was advised to pay attention to the track record of potential partners, investigating their reliability and length of time in the market.

In order to find contacts in Russia, Sergei believed he should go on a marketing trip in the summer and distribute a winter clothes catalog. However, he did not have capital to invest in producing a catalog or making a marketing trip. Over the past six months, he looked for other ways to establish contacts. He recently bought a computer and had plans to hire a web designer to create a web page on the USAID/Pragma SME Trade Center website. He hoped that advertising through this medium would help his business reach new partners and buyers in the future.

Crossing the borders overland to transport goods was a major problem for all trade operations. When Sergei and Olga were only involved in the import business, they were afraid to cross the borders overland carrying the goods even with the correct trade documents because custom officers commonly demanded bribes. When Olga went to China, she registered her goods through a travel agency to prevent problems. One time Sergei tried to transport goods through Uzbekistan but the goods were almost confiscated by customs officers.

There were additional risks at the borders because they could suddenly close due to unexpected political disruptions and security concerns, especially in light of the violent conflicts taking place in other countries in the region.

Competition

There were about 500 sewing workshops in Bishkek of varying size. Many of them operated illegally out of people's homes. The intense competition meant a high turnover among workshops. New shops often opened and old small shops closed.

The competitive advantage of Moda was its stable staff of skilled workers. Of their 15 employees, one third had been working for the company for more than 3 years. Other advantages were the company's reputation for producing quality output, filling orders on a timely basis and paying salaries on time every week.

Wholesalers and Retailers

All Moda's clients were wholesale traders at the Dordoi market. Dordoi was a relatively new market that and it was considered very risky selling to just this type of customer. Wholesalers who had stalls at Dordoi sold their goods to retailers who come from Kazakhstan, Russia, and other parts of Kyrgyzstan. Al Maty, Kazakhstan was just two hours away; the border was 45 minutes away. The retailers placed orders with the wholesalers who then came to Olga to place their orders with Moda. Clients brought required material and patterns at order time, but they only paid for the goods when they were delivered, never in advance.

Sergei worked to establish a solid and loyal customer base. He had known many of his clients for 10-15 years. They were old personal friends with whom he had traveled during

buying trips to Turkey. All clients had worked with Moda for at least the last 2-3 years.

Recently the company added some new customers, but they were also old personal friends. Sergei and Olga wanted to diversify their client base and somehow capitalize on the fact that current clients had their customer bases in Russia.

Conclusion

When asked how she feels about the business potential and work ethics of women, Olga proudly said, "One woman can accomplish anything she wants, but two women together (referring to her right-hand woman, Nina Nilolaevna) are like a fast moving train." She was confident that her team could perform their work well and that this capability would keep the business growing. The challenge now was to find better ways to reach potential customers and secure the financing required to move in new directions.

Study Questions:

- (1) How have Sergei and Olga's lives changes since Soviet days? Are their lives better?
- (2) What is Moda Textile Factory's competitive advantage? How can they use it to expand the business?
- (3) How would you characterize Olga's management style? How was it shaped by the Soviet system?
- (4) What kind of person(s) should Sergei and Olga look for as a business partner(s) to help them expand their market outside Kyrgyzstan? How should they find a partner they can trust? What can they do to build trust with this person?
- (5) What steps can Sergei and Olga take to address the cash needs of their business?
- (6) How can Sergei and Olga begin producing fashionable women's cashmere coats in their factory? Is this feasible or should they give up this dream? Propose an action plan to move their business in this direction.

Exhibit 1 Map of Kyrgyzstan



Source: CIA World Factbook, <http://www.cia.gov/cia/publications/factbook/geos/kg.html>.

Exhibit 2 Photos of the Factory at Work

2a. Women Operating Sewing Machines



2b. Women Discussing New Designs



2d. Seamstresses Aligning Fabric



2c. Cutter Preparing Fabric for Cutting

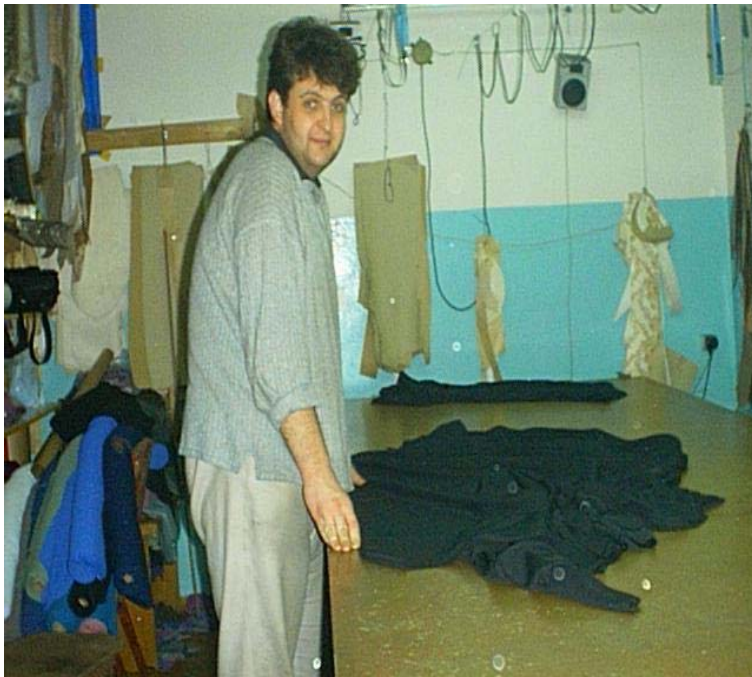


Exhibit 3 Organization Chart

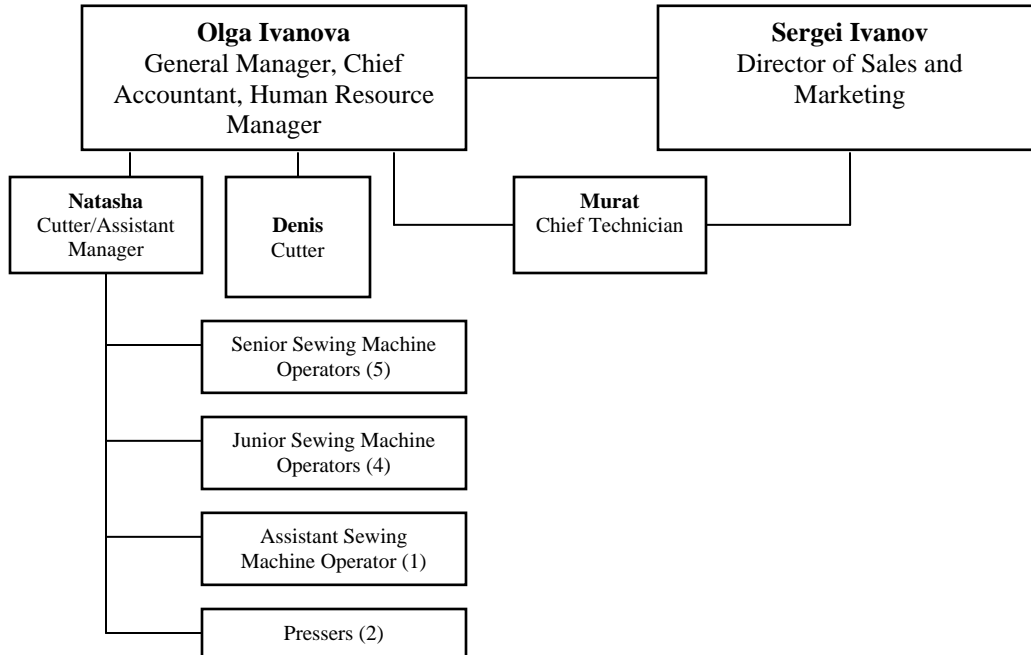


Exhibit 4 Moda Factory Floor Layout

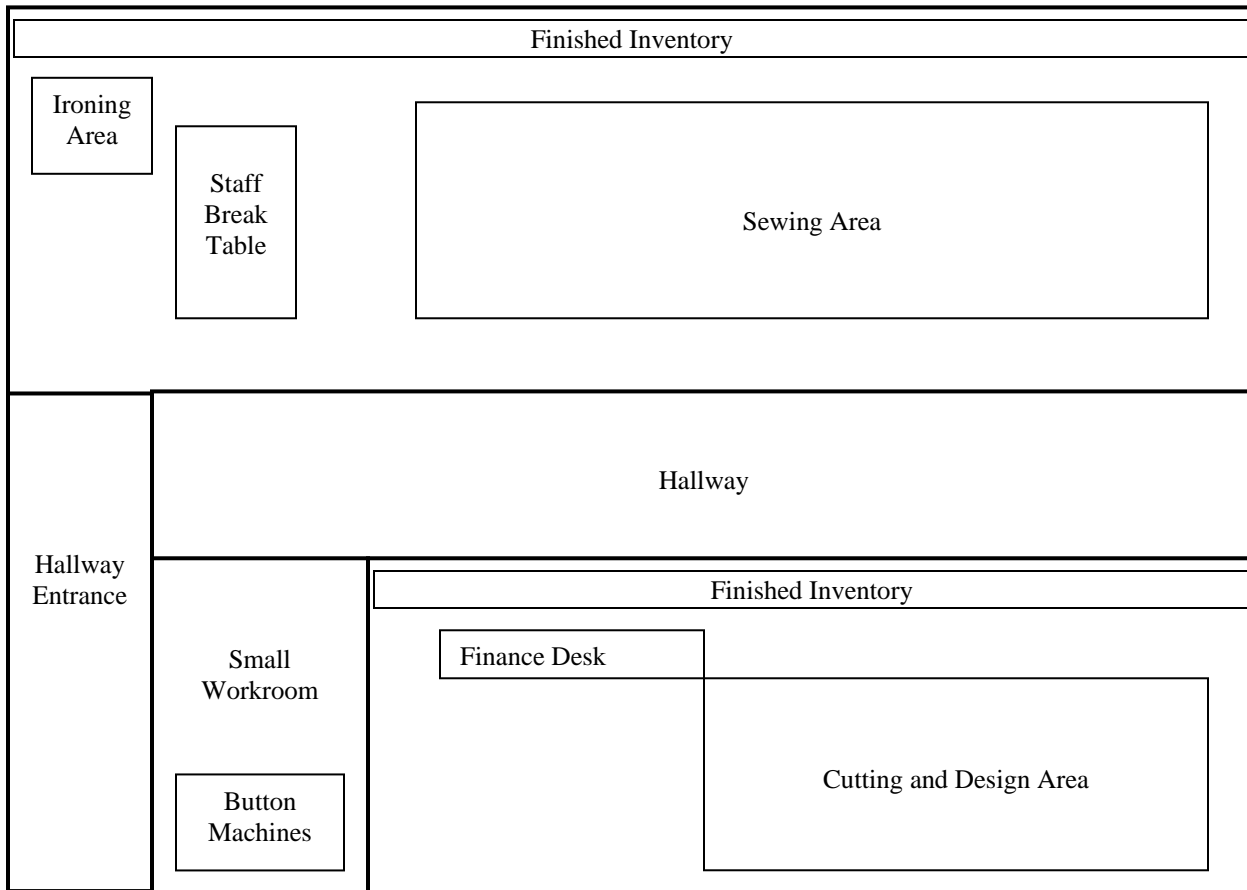
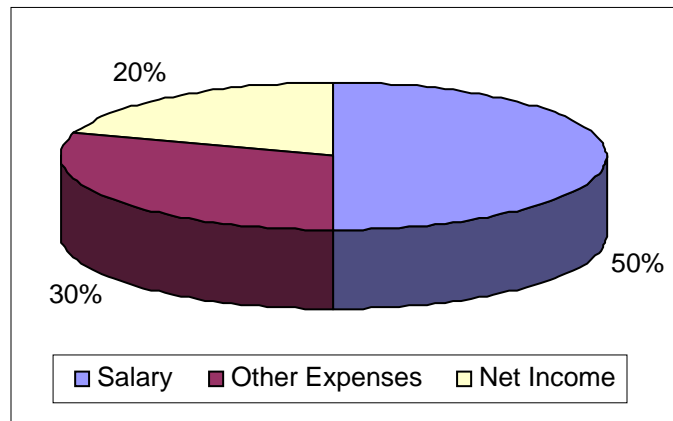


Exhibit 5 Distribution of Gross Income



ENDNOTES

¹ This case was written by Sherry Spouseep of the Kogod School of Business at American University in Washington, DC under the supervision of Professor Richard Linowes. It was produced in conjunction with the Emerging Markets Development Advisors Program (EMDAP) under the sponsorship of the US Agency for International Development (USAID) and managed by the Institute of International Education (IIE). The case is meant to serve as a basis for class discussion.

² Factories, which previously manufactured cotton and wool garments, were no longer operating at full capacity in the country. The private trade sector flourished bringing needed goods into the country. Small groups of traders began traveling together to neighboring countries and Turkey to purchase wholesale garments for resale in Kyrgyz markets. Private stores were uncommon at this time, and outdoor markets were established for selling fruits, vegetables, food products, clothing, and household items.