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Columbia Business School Student Research Paper

Case Study: Beeline—Launching a Mobile Phone Operator During Russia's Turbulent Economic Rebirth

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Introduction

In the early 1990s, during the last days of the Soviet Union, entrepreneurship was legalized in Russia and many businessmen started to launch new ventures. Private property, nonexistent under the Communist regime, started to emerge along with the booming economy. In those turbulent days, Dmitry Zimin, the head of a secret radio-technical military institute in Moscow, sought opportunities to start his own business. Already 60 years old at the time, he was a highly respected and influential man. Nonetheless, he foresaw little future at the institute designing antiballistic missile equipment and anticipated only a limited pension payout in light of the ongoing collapse of the USSR and skyrocketing inflation. Zimin's colleagues at the institute shared his prospects and sentiments.

Zimin and his team considered several options, and the outstanding radio-technical skills they possessed were at the center of their business plan. What these brilliant minds needed was capital to launch their venture.

The Birth of VimpelCom

In 1992, Dmitry Zimin met Augie Fabela, a venture capitalist who specialized in cellular communications. Together they decided to launch a wireless communications operator in Russia. Fabela was able to arrange several million dollars of direct investment in the new company, raising sufficient cash to proceed with further development of their business. This is how VimpelCom was born.

The launch of the company required consideration of numerous issues: What operating standard to choose? What frequencies to use? What equipment to buy? How to claim resources in the post-Soviet legal environment, with the absence of regulations in some fields and serious restrictions in others? How to sell the service? How to brand and to name the firm?

During 1992, Zimin's team considered various options for the equipment and standard they would adopt. Eventually, they struck a deal with Ericsson, the Swedish telecommunications supplier, which agreed to lease equipment to Vimplecom. This was an attractive deal for VimpelCom, given that a base station could cost up to $1 million. The company adopted the AMPS/DAMPS standard, a second generation of cellular communications (2G), which had already been deployed in the United States and Canada. This standard was considered advanced at that time, allowing for a smooth transition between digital and analog transmissions. The overall sound quality and connection were better than in the previous generation technologies. Another feature of the standard was that it operated on 800MHz frequencies, which in theory belonged to the Russian military but in reality were temporarily unoccupied. Only Zimin, with his unique radio-technical background and special knowledge and connections, held this knowledge and could base the future of VimpelCom on this information.

In 1993, VimpelCom launched its pilot network, capable of serving 300 subscribers. The very first transmitter was borrowed from the Russian Ministry of Foreign Affairs. It was placed atop the ministry's main office, a Stalinist skyscraper in the heart of Moscow, just several kilometers from the Kremlin. The first network covered less than 5 percent of Moscow City, mainly the central part. Clearly, VimpelCom benefited from Zimin's extensive connections when arranging the deal.

In the 1990s, cellular phones quickly became a status symbol, with prices starting at $2,000 and going up to $5,000. At the same time, an average Russian's monthly salary slipped below $100 as hyperinflation hit 1,000 percent.

VimpelCom's main clientele consisted of a newly born social class of nouveau riches, or the so-called New Russians. This class consisted of successful businessmen and rich criminals—racketeers. As cell phones became a fashionable accessory for many, a new market for fake cellular phones, simply imitating the real ones, developed.

Zimin's company was named Vimpel Communications, after the military contractor at the institute. A brand name of Beeline was chosen to differentiate the newly born operator from the other Russian telecom companies, which used abbreviations and Cyrillic transliterations. Choosing a Western-sounding name proved to be a successful strategy in an emerging market that was hungry for anything coming from the West.

And yet, VimpelCom remained highly vulnerable, operating military frequencies without legal grounds. Again Zimin used his extensive connections within the Ministry of Defense and the Ministry of Communications. Having utilized frequencies meant for the military forces for its first year of operations, VimpelCom was finally granted commercial rights to the already occupied frequencies by the Ministry of Communications.

In 1994, VimpelCom completed its pilot tests and launched full-scale commercial operations in Moscow. The new network was capable of servicing 10,000 users. This expansion took place during highly volatile times in Russia. The country's first major bank crisis, which emerged in the autumn of 1994, caused the ruble to fall 30 percent against the dollar in just one day.

By 1995, Fabela could no longer finance the company from his venture sources. At the same time, VimpelCom had leased the maximum possible amount of equipment from Ericsson. Therefore, the company needed financing for further expansion into the greater Moscow metropolitan area. To obtain financing, VimpelCom could either apply for a bank loan, issue bonds or go public. At that time a bank loan was not an attractive option because of high real interest rates. No bank in Russia could afford to take on millions of dollars of risk. In addition, fixed income markets were virtually nonexistent in Russia.

Therefore, the only remaining option was an initial public offering (IPO). Since the Russian stock market was in its infancy, VimpelCom decided to go public on the NYSE.

IPO

As VimpelCom was the first Russian company to list on the NYSE since 1903, the preparation for its IPO was no an easy task. Fabela spent long hours in the early 1990s shaping VimpelCom's operations, sales, marketing and, of course, its finances. Fortunately, United States GAAP standards had been applied almost from the start, allowing the company to submit financial reporting for three consecutive years before the IPO.

> *"It was just a matter of simplicity," said Richard Bernard, the NYSE's top in-house lawyer. "Right from the beginning they had the influence of Western-style accounting."*[1]

The IPO itself was executed in a standard manner, with road shows through 30 European and 15 American cities. The lead managers were Donaldson, Lufkin & Jenrette Securities Corp. and Renaissance Capital Group. Twenty percent of the firm's equity was sold at $20.50 per American Depositary Share (ADS). However, the bankers underestimated the market's demand for the VimpelCom offering. Investors were willing to pay a substantial premium to purchase a stake in the first Russian enterprise they had seen in their lifetime. The stock appreciated 50 percent in just a few months. As a result, VimpelCom raised $111 million in capital, which was earmarked for further expansion. In 1997, a secondary offering took place.

> *"The increase in the price range really verifies my feeling that the deal will do well. Before I thought it would rise a point or more, now it's probably more like two. People really like their story," said Vincent Slavin, IPO analyst for Cantor Fitzgerald.*[2]

Overall, VimpelCom's IPO unveiled Russia to Western investors, who started paying attention to the lucrative opportunities in this emerging market, where many companies historically had been undervalued because of the absence of developed local financial markets. Exhibit 1 charts VimpelCom's stock price growth.

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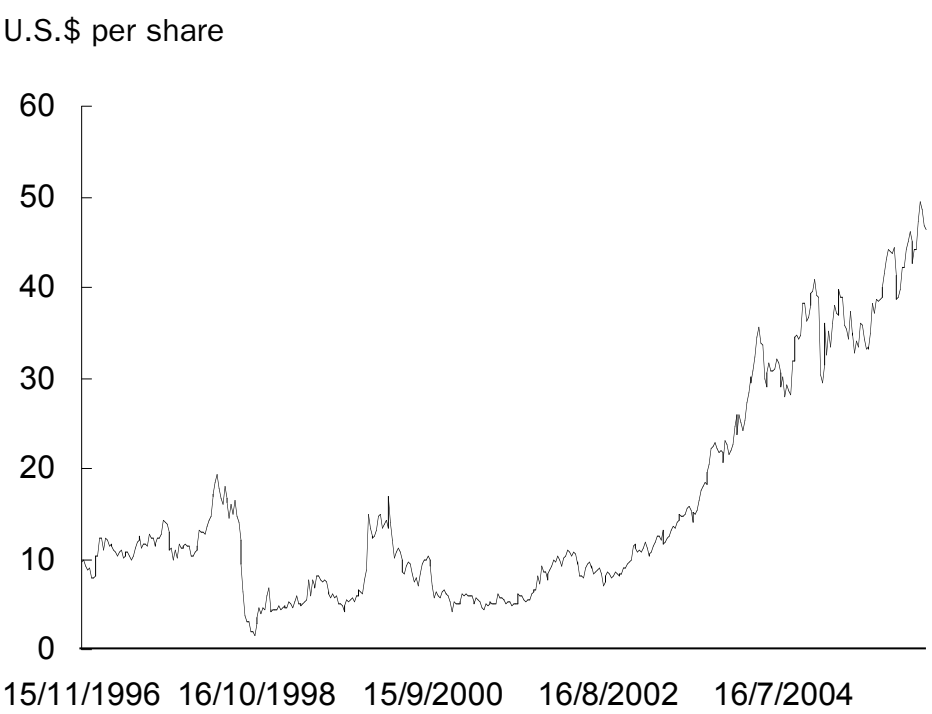
[1] "Russia's VimpelCom Storms into Wall Street," *The Las Vegas Review,* November 16, 1996.
[2] Reuters News, "IPO Spotlight: Russia's Vimpel Looks Hot for IPO," November 14, 1996.

Exhibit 1. Stock price growth on the NYSE, 1996–2004



Source: Yahoo! Finance.

Post-IPO

In the late 1990s, the cellular communications market became highly competitive, with the emergence of MTS, a telecom provider operating on a more advanced standard, GSM-900. Accordingly, VimpelCom had to invest more into its network and had to expand into adjacent regions. Simultaneously, it became obvious that the D-AMPS standard was starting to lose ground to GSM in terms of cost and quality of communication. Beeline had fallen into the trap of the first-mover disadvantage, as technology evolved at a breathtaking pace. This led to a decline in VimpelCom's market share as MTS expanded into the market.

In 1998, the Russian economic crisis dealt VimpelCom another blow. The cellular industry experienced a sharp increase in the number of nonpaying subscribers, reduced minutes of airtime use per subscriber and, consequently, reduced revenues. At the same time, negative investor sentiment was limiting access to capital for many Russian companies, slowing the rate of development of the Russian economy as a whole and the telecommunications industry in particular. To overcome the nonpayment problem and reduce bad debt, VimpelCom launched a prepaid card program, eliminating monthly fees

and connection costs for its customers. But still, for the first time in its history, the company reported a loss in net income in 1998.

When VimpelCom was awarded four new GSM-1800 licenses, it became clear that the time was right to seek an experienced strategic partner to help develop these licenses and transform VimpelCom into a national cellular telecommunications provider. In December 1998, VimpelCom signed a strategic investment agreement with Telenor, Norway's leading telecommunications company. Under the terms of the agreement, Telenor was to purchase newly issued shares of VimpelCom common stock representing 25.7 percent of VimpelCom's total voting power (31.6 percent of VimpelCom's common stock) for approximately $162 million or $18.19 per share ($13.64 per ADS). Since this alliance took place right after the harsh financial crisis of 1998, VimpelCom worked to assure Telenor that wireless communications would not suffer further from the crisis and would bounce back quickly. By that time, VimpelCom already covered 22 regions of central Russia.

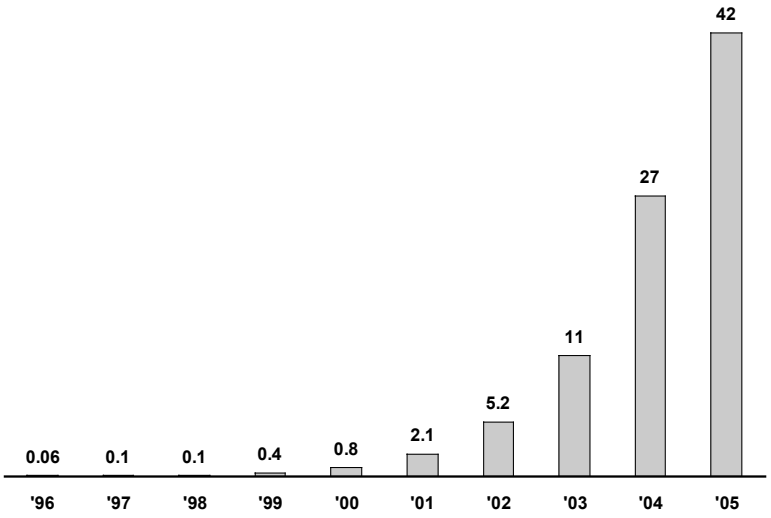
Telenor's experience in developing and implementing new products, value-added services and marketing techniques and in positioning different cellular networks in the same market enhanced VimpelCom's strong competitive position in Moscow and Russia. In addition to cellular expertise, Telenor was (and still is) an experienced provider of wireline telephone services, Internet and satellite communications. This experience and practical knowledge helped VimpelCom develop into an operator providing a variety of complementary telecommunications services. Telenor's experience in creating a mass cellular market was very useful over the following years as the Moscow cellular market matured.

By December 2001, with two million subscribers, VimpelCom began earning its first profits, eight years after its initial launch, despite the 1998 crisis that stole about two years of growth. (Exhibit 2 charts VimpelCom's subscriber growth, and exhibit 3 demonstrates revenue and net income growth.) Nonetheless, even Telenor's participation was not sufficient for subsequent development of VimpelCom. A significant stake in the company was sold to oil and banking tycoons from the Alfa Group. In November, $103 million was invested as part of the first tranche. For the next several years, Alfa continued its capital investments in VimpelCom, although the company started to generate substantial cash flows itself.

By 2003, VimpelCom was operating in an already mature market with decreasing margins, so it began expansions into adjacent countries. It acquired KaR-Tel, a wireless operator in Kazakstan. In 2005, the company continued expansion, pressed by Alfa Group management. Its next acquisition was in Ukraine, a country with a population of 40 million and attractive growth opportunities.

Exhibit 2. Subscriber base growth, 1996–2005

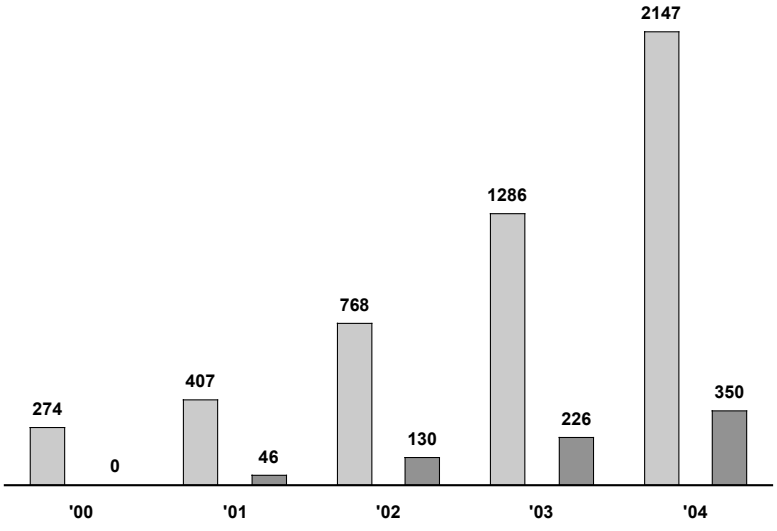
Million users



Source: http://www.vimpelcom.com/.

Exhibit 3. Revenues and net income

U.S.$ million



Source: http://www.vimpelcom.com/.

Conclusion

In contrast to many of the state-owned enterprises that underwent privatization, in VimpelCom a multimillion-dollar company was built from scratch without relying on Soviet-era assets. International investors were involved from the very beginning, influencing corporate standards and helping the company through an IPO in a quick and streamlined manner, even by American standards. Finally, the company's accumulation of capital occurred though a transparent process, unlike many other Russian enterprises in the telecom, oil, metals and mining industries.

In this case, the company's founder was able to "capitalize" on his connections within the country's ministries. He was capable of starting the business without regulation and using assets belonging to the military and other governmental bodies. Although VimpelCom's example is not a replicable business strategy in the developed world, it may provide insight to those launching businesses in emerging market economies.

Exhibit 4. Timeline of events, 1992–2005

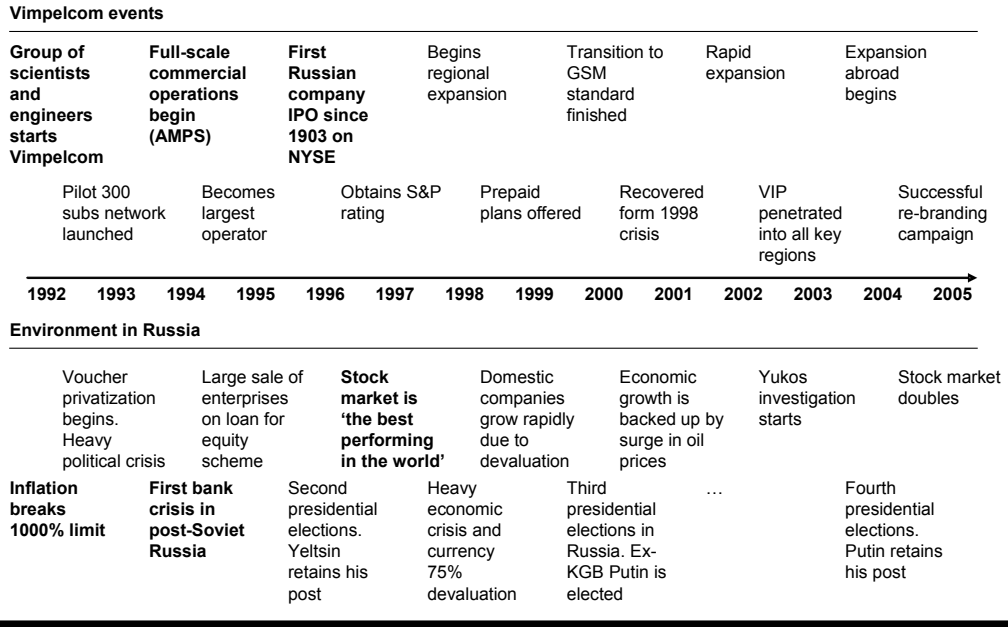


Exhibit 5. Financial statements

Vimpelcom Financial Statements (million USD)

Balance Sheet	12/31/04	12/31/03	12/31/02	12/31/01	12/31/00	12/31/99	12/31/98	12/31/97	12/31/96
Total Current Assets	798	530	488	247	235	105	72	114	99
Total Current Liabilities	926	699	419	196	111	143	119	97	64
Total Assets	4,784	2,319	1,693	866	700	578	536	482	298
Total Liabilities	2,622	1,132	932	391	331	274	324	268	149
Total Common Equity	2,160	1,005	663	475	369	295	203	207	146

Income Statement	12/31/04	12/31/03	12/31/02	12/31/01	12/31/00	12/31/99	12/31/98	12/31/97	12/31/96
Sales	2,147	1,286	768	407	274	248	930	302	220
CostOfGoodsSold	392	236	153	108	96	103	255	94	70
Net Income	350	226	130	46	-78	-43	-12	63	48

Statement of Changes	12/31/04	12/31/03	12/31/02	12/31/01	12/31/00	12/31/99	12/31/98	12/31/97	12/31/96
Net Cash Flow Operating	805	493	222	97	9	23	182	94	77
Net CashFlow Investing	1,517	572	402	156	85	-49	130	120	83
Net CashFlow Financing	855	-35	294	52	193	-48	-32	6	33
Dividends Per Share	n/a	0	0	0	0	0	0	0	0
LT Debt Reduction	288	337	147	38	139	30	32	5	8
Total Capital	3,555	1,581	1,235	651	557	396	376	350	211

Source: http://www.vimpelcom.com/.