Instructor's Manual to Accompany

Cases in Management in Eastern Central Europe and Russia

International Institute for Applied Systems Analysis
Laxenburg, Austria

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Cases in Management in Eastern Central Europe and Russia

This volume contains cases and notes on doing business in economies in transition in the countries of Eastern Central Europe and Russia. These countries are in transition from central planning to market systems. The emphasis is on transition as central planning collapsed, but fully functioning market economies are still years away in some countries, and in Russia, perhaps decades away.

The Business Environment in Transition.

Government reforms, especially since 1989, made some enterprises independent, for-profit entities. However, these reforms went only part-way toward market economies. Managers have to make decisions in a system which is in transition and where the pace and timing of the changes are uncertain. Despite governmental pronouncements to conversions to market economies, there is still very significant government involvement in allocation of resources and regulation.

The gradual reduction in the degree of involvement of governments in the economies challenges a company manager. These challenges include, among others, ceasing to be the sole producer, the loss of state subsidies, the repayment of loans (received in the form of past subsidies), removal of price controls (their extent and timing being uncertain), inventory accounting rules that make production for stocks in seasonal businesses extremely difficult, the eventual removal of the governments' no-layoff policies (again, extent and timing uncertain), the convertibility of the currencies, and an accounting system that makes both balance sheets and income statements difficult to interpret. Last but not least, a management, which at the present, has little experience in market intelligence or, indeed, in marketing.

Organization of this Volume.

One of the challenges in compiling a general book of cases is one of balance. While it might be possible to edit a book of cases encompassing all areas of management, this was not attempted here. In any case, not many scholars or practitioners would agree what "all" means in this context. Rather, the major subjects were addressed; particularly those of special interest to the firms of Eastern Central Europe and Russia. The twenty-one cases and the two notes have been organized into six groups: business strategy, finance, joint ventures, marketing, negotiations, and operations.

The cases are in one volume and the accompanying teaching notes in another. (Teaching notes must be specifically requested, and the requester must be a member of a teaching faculty. The request must be submitted on official stationery.) A teaching note provides a synopsis of the case and of the issues it raises. It tends to provide suggested assignment questions, alternate ways of using the case in the pedagogy, and/or how to conduct the class discussion. Finally, a teaching note provides an analysis of the situation and of the manager's options.

This volume could be used in a variety of courses in Eastern Central Europe and Russia at the undergraduate, graduate and executive program level. The classes themselves bring different levels of experience and sophistication to the discussions. In North America and Western Europe this volume could be used on Eastern Central European and Russian management or as a module in any kind of course, at all levels, in management of international business.

Dunstan, Mark R. Eaker, Elliott N. Weiss, and Research Associate Sheilia Terranova.

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Spring 1993 Leslie E. Grayson

Charlottesville, Virginia, USA
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BUSINESS STRATEGY

Graduate School of Business Administration
University of Virginia

UVA-G-425TN

THE CSEPEL MACHINE TOOL COMPANY

Teaching Note

PURPOSE

This case illustrates some of the problems facing firms that have been operating in centrally managed economies and are attempting to evolve into publicly held companies competing with those in industrialized nations. A general lack of strategic-planning capabilities, an entrenched management, and outdated machinery and process capability make the transition difficult. This case also demonstrates the difficulties in formulating and implementing solutions to these problems.

DISCUSSION QUESTIONS AND ANALYSIS

1. What are the major problems facing Csepel?

The problems Csepel faces are serious and can be roughly categorized as: operational, managerial, financial, and competitive.

The company's operational problems include inefficient process flow resulting, in part, from poor layout at the two plants and the 250-kilometer distance that separates them. Poor information systems have resulted in inadequate control of inventories and a parts-numbering system that cannot identify or cross-reference part substitutions. The firm's antiquated machinery and technological backwardness hinder productivity gains. Finally, Csepel's reputation for quality is being jeopardized by inadequate quality-control procedures.

Csepel's management is also a source of problems for the organization. Top management appears to lack strategic vision and spends a great amount of time in the day-to-day running of the plants. The bonus system distorts behavior, as seen in the R&D engineers spending much of their time solving problems on the shop floor and

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This teaching note was prepared by Joseph Wolfe of the University of Tulsa and the International Management Center, Budapest, Hungary, and revised by Professor Leslie E. Grayson of the University of Virginia.

so that real, long-term solutions are found for Csepel's financial and product-mix problems.

Finally, Toth's statement regarding the maintenance of "...the company's traditionally good relationships with its creditors" reflects misinformation, in light of the company's poor financial condition for at least the past two years.

Other reasonable strategies available to Hajnoczy would fall into two general categories: process-flow management and organizational structure.

Management should review the product lines and drop those products that are obsolete. This move would help overall process flow and reduce cost. Production and engineering resources could then be redirected into developing new products and new process capabilities suited to the evolving market.

The two existing plants do not produce a product from start to finish, and parts are exchanged between the two plants in what appears to be a disorganized fashion. If the plants were more specialized by product lines, Csepel could realize savings from transportation, cycle-time reduction, and in-process inventory reduction.

The quality-control system does not provide a means to catch quality problems as they occur, and the incentive system entices workers to sign off on poor-quality work to receive quantity bonuses. The incentive system should be altered to include quality targets as well as quantity targets, and a means of tracking defects back to problem areas should be implemented.

The scheduling system for the manufacturing operation is inadequate. Csepel should implement a sales-forecasting system that will level out production during the year and allow for a longer term scheduling horizon. This step would help reduce component and raw-material shortages by permitting better purchasing and scheduling decisions. It would also eliminate overtime problems at the end of the year and thus reduce the loss of skilled employees. Although significant investment may be required, the inadequacies of the computerized production-scheduling system must be addressed in order to ensure the integrity of the schedule.

As for problems in the organizational structure, first, the higher level executives, including the managing director, need to divest themselves from day-to-day operating decisions of the departments and concentrate on strategic planning for the firm. The introduction and use of management-performance goals and measurements would allow delegation of decision making to lower levels while providing direction for lower level management.

The engineers are currently overburdened by maintenance and manufacturing issues and are unable to spend any time developing new products and processes. A

A component supplier interested in forward integration into machine tools might be a possibility.

SUGGESTIONS FOR CLASS PRESENTATION

The case is oriented toward business operations in any of the Eastern European economies, i.e., economies under transition from central planning to market. Because doing business in Eastern Europe involves such issues, however, the case could be used in conjunction with the "Hungary in 1990" (UVA-G-424) note.

After covering the discussion questions, the class might usefully pursue the following practical matters:

- How could a non-Hungarian firm find a prospective partner in a country such as Hungary? Research a firm?
- How could Csepel go about searching for a joint-venture partner abroad?
- What might be some of the problems experienced by a foreign investor when trying to repatriate profits?
- What is the most effective way to research and ensure compliance with local regulations and/or laws?

One means of stimulating a realistic discussion of these practical issues would be to choose a case about a company that Csepel would be interested in approaching as a joint-venture partner. Half the class could split and be asked to develop a venture proposal from the different company's perspective.

TAURUS HUNGARIAN RUBBER WORKS

Teaching Note

PURPOSE

This case can be used in conjunction with the other Hungarian-company cases in this set or as a stand-alone case. It may be prefaced by "Hungary in 1990" (UVA-G-424). The Taurus case is best suited for analyses of strategic management and business policy, both within and outside an International Business curriculum.

The case deals with strategic management: what decisions are to be made. Issues are those that would occur in a centrally planned economy: nonconvertible currencies, labor requirements, lack of investment for technological improvement. The implied question is, "Are the problems attributable to the company, or are they symptoms of a centrally managed economy?"

Taurus has recently become a shareholder-owned corporation (previously it had been the state-owned rubber monopoly). It is, in global terms, a small company and is competing in a mature slow-growth industry dominated by giants.

The slowdown in growth can be partly attributed to the general economic downturn, which is reflected in lower car sales, the introduction of longer lasting rubber products (tires, gaskets, hoses, etc.), and the introduction of substitute products (ceramics and plastics).

In an effort to combat these developments (basically, to stay in business), the rubber companies have been forced to look for new ways to cut costs and maintain sales and market shares:

- Mergers or joint ventures
- New automated and increasingly efficient manufacturing plants

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technological and capital requirements, and intense competition. Growth is modest, and most rubber firms now compete on an international level. The huge operating scale required for efficient plant operations creates a scramble for markets, and because growth opportunities no longer exist in many of the manufacturers' home countries, the companies must look to other, international markets.

Several very large rubber companies have been created as manufacturers have acquired firms in other countries or have entered into international joint ventures in order to increase their global penetration. Taurus, although a large firm by Hungarian standards, ranks 30th in the rubber industry with sales a mere 3.5 percent of those obtained by the industry leader, Goodyear. Although the high barriers to entry in this industry may preclude much competition from new entrants, Taurus's position in this mature rubber industry is a poor one.

Taurus is competitively positioned in several market segments, however. Its truck-tire operations, although small by international standards, has respectable sales both in the West and in other CMEA countries. Its PALMA line of camping gear has a world market share of 15 percent, and in large-bore hoses, Taurus is the world leader with 40 percent of the market. In addition, as a Hungarian firm, Taurus has greater access to and experience in CMEA countries than many firms, which might give Taurus a competitive advantage, albeit temporary, in those markets as they open.

At the company level, Taurus has a number of strengths and weaknesses. On the one hand, Taurus is a well-run company with a good management team, as evidenced by the company's ability to reduce costs and increase profits while simultaneously making the transition from a state to a private enterprise. Another indication of the quality of management is its efforts to develop a strategic plan to help the firm be proactive in the new competitive arena. Indeed, Taurus recently invested in capacity expansion of its truck-tire operation and is bringing several new tires to market, including a new supersingle tire produced under a licensing agreement with an American tire manufacturer. Moreover, the Machines and Molds Division gives Taurus a degree of vertical integration that enhances its ability to keep its cost competitive.

Taurus's product line is diversified and, as noted, contains several products that are strong in their segments. The firm has been successful in the export market; fully 38 percent of total sales and 58 percent of Tire Division sales are outside Hungary, sales both to the West (North America, Western Europe, and North Africa) and to CMEA countries. The Trade Division has been earning high margins trading internationally (purchasing, distribution, and sales) for both Taurus and other Hungarian firms.

On the other hand, Taurus's plant and equipment are 73 percent depreciated; that is, much of its equipment and facilities are antiquated. Any efforts to improve this situation would be hampered by the company's heavy debt load, of which 242.1 million consider both the pros and cons of such an organizational form so that real benefits can be realized.

ADVANTAGES

- Provides logical means for decentralizing a diversified organization
- Places authority closer to each business's unique environment
- Allows top management to deal with corporate strategy instead of business strategy
- Places clear profit-and-loss accountability
- Improves coordination among products or businesses facing similar competitive environments
- Facilitates the creation of distinct strategies and focused strategic planning

DISADVANTAGES

- May increase overhead costs by duplicating various staff functions within each business unit
- May lead to rivalry between SBUs for top-management attention or corporate resources.
- May distance corporate management from situations faced by SBUs
- Increases the number of organizational levels
- May allow SBUs to pursue goals that differ from corporate goals and philosophies
- May create difficulties in deciding which decisions can be decentralized and which should be retained by top management

Dividing the company into SBUs based on the industries they serve (i.e., automobile, truck and bus, or construction and building), Taurus has increased the number and types of alliances it can pursue. Furthermore, by basing its criteria for accepting an alliance on profitability and growth potential, Taurus shows that it is willing to consider any and all types of alliances. On the other hand, Taurus could end up with a very diversified and uncoordinated growth strategy. Its business risk could, therefore, be increased if the combined products and/or businesses lack synergy in corporate administration, production technology, customer base, or marketing channels. It might be wise for Taurus to look for an alliance with a company in one of the *same* businesses in which it is currently engaged. A conglomerate diversification strategy should be pursued only after the company has exhausted the possibilities of finding backward and forward vertical integrations to strengthen its competitiveness.

TEACHING PLAN

The points in this case are numerous, but the important ones center around strategic issues. The case can be broken down into three main segments:

1. Taurus and its position within the Hungarian rubber industry and within the world industry. What is the company's problem? Is there a problem? Is it local (caused by government policies and restraints) or international (market change, increased competition)? Some time should be spent looking at the company's financial position (see Exhibits TN1 and TN2), which will help frame future courses of action. What should Taurus do? How should it be done? Why?

2. The worldwide rubber industry. What are the new developments--new technology, new corporate structures, environmental issues? Who are the key players? What are their strengths and weaknesses? How do they affect Taurus? Should Taurus be concerned? Why? How do East European influences come to bear? What new issues are developing in the East Bloc that could make a material difference to Taurus and to outside companies?

3. The outside-investor issue. What sort of issues/concerns does an outside investor face? What factors in the economic/political arena should investors be aware of? What would you (the student) do? What conditions would you require to make an investment? Should that investment be a joint venture or should it be an independent operation? What safeguards would you require? Students should seriously consider the very different ground rules that exist in an East Bloc country and the difficulties associated with a foreign presence.

Exhibit TN2

TAURUS HUNGARIAN RUBBER WORKS

Divisional Revenue Return Rates by Fixed Assets and Employees
(in billions of forints)

	Tire		Technical Rubber		Machines & Molds	
Revenue Returned by	1988	1989	1988	1989	1988	1989
Gross fixed assets	1.27	1.55	2.35	2.58	0.79	0.83
Net fixed assets	2.25	2.83	5.41	6.41	1.72	1.79
Employee	1.65	2.13	1.66	1.87	0.38	0.44

Interpretations: The revenue generated by each employee within the Tire Division increased dramatically from 1988 to 1989, while employee productivity remained basically the same in the Technical Rubber and Machines and Molds Divisions. The Technical Rubber Division obtains a very high rate of revenue productivity per asset, mainly because its assets cost less while it produces sales revenues roughly comparable to those obtained by the Tire Division. The Machines and Molds Division does not appear to be very productive based on this analysis, but remember that it is an important in-house supplier to the work performed by the company's two main divisions.

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TRENMOS
TEACHING NOTE

SUMMARY

This note begins with a short analysis of the cases, focusing on the difficulties that TrenMos, the first American/Soviet joint-venture restaurant in Moscow, encountered setting up a business in the Soviet Union. An analysis of issues in the business environment and a recommended teaching plan follow. The teaching plan emphasizes the roadblocks met when working within the Russian system, and it discusses the ever-changing environment in what was once the Soviet Union.

This case series was designed to introduce students to the politics, economics, and operational issues facing new ventures in the Soviet Union. It fulfills two specific purposes. First, it acquaints students with the challenges of doing business in the complex and constantly changing Russian environment. Second, it allows students to apply decision-making skills and strategic thinking in an unfamiliar cultural, political, and economic setting.

Case A. The A case setting involves the need for Jeff Zeiger to decide whether to return to Moscow and continue working on opening TrenMos focusing first on the background issues that led to the idea of TrenMos, then moves on to describe the problems and obstacles Shelley and Jeff Zeiger faced during the set-up stage of the restaurant. The case concludes just before the opening of TrenMos.

Cases B & C. The first follow-up case outlines what happened when TrenMos opened for business. It discusses TrenMos policies, decisions, hard times, and eventual success. The C case picks up in late 1991. It addresses the Zeigers' expansion plans within the tumultuous Commonwealth environment.

ANALYSIS

This analysis section is based primarily on the concepts outlined in Darden Technical Note UVA-G-0451, "Foreign Direct Investment in the Commonwealth of Independent States: Understanding Values and Beliefs as the Key to Success."

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their needs. TrenMos chose to trade a consistent menu for quality supplies. They source over 95% of their raw material needs from local markets and adapt their menu according to availability. Recently they have been able to develop relationships with vendors, and they no longer re-create their menu each day. Jeff does feature specials that are highly dependent on market availability.

Currency issues and consumer acceptance. At the time joint ventures were first permitted, the exchange rate set by the Soviet government was approximately $1.6 per ruble. Because it was (and still essentially is) illegal for Soviet citizens to hold hard currency, an active black market developed over the years. The black-market rate by the time of the case had risen to over 20 times the official rate. Recognizing the disparity between the official and black-market rates, the Soviet government had begun raising the official rate in an attempt to eliminate the black market and renew the credibility of the ruble. By early 1992, the government had lowered the official rate to more than 100 rubles/dollar.[1] Joint ventures have chosen to use a variety of strategies to resolve the currency issues. McDonalds decided to accept only rubles in its first restaurant in Pushkin Square, but plans to open additional restaurants that will accept only hard currency. Pizza Hut's first restaurant, in contrast, had a ruble take-out line but a hard currency eat-in restaurant. TrenMos decided to accommodate both hard currency and rubles. Lunch service is generally rubles and dinner hard currency.

Many joint ventures must recognize the impact their currency decisions have on their public image. At this time, citizens of the Commonwealth tend to see the choices joint ventures offer as privileges rather than rights; consequently, they do not appear as offended by "hard currency only" restaurants as Westerners might expect. Nevertheless, as Russians learn more about democracy and free-market economics, they are likely to expect Western companies to provide equal access. At that point, a joint venture's currency decisions may play a pivotal role in its ultimate success.

Hiring and motivating employees. Leaders of a new joint venture must learn how to motivate Russian workers to provide service in line with Western standards. While Russians and Americans share many of the same core values - friendship, family, a desire for job satisfaction - the systemic differences between the two countries have created distinctly different views of the work place. The most conspicuous employee characteristics resulting from the Soviet system are a pronounced aversion to risk taking, a lack of individual initiative, and little attention to efficiency.

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[1]Traditionally, consumer preferences and marketing have been unnecessary or ignored by Soviet organizations. Without comparable competition or market research, new ventures must rely on their intuition to set prices for their products. As of early 1992, the ruble was not a convertible currency, which often made it difficult for joint ventures to meet their operating and financial objectives.

system, and the opportunity and risk inherent in developing business with the Commonwealth of Independent States. The class will then discuss the case, focusing on the specific hardships that the Russian environment places on a start-up venture. These issues will include an examination of appropriate currency, marketing, supplying and staffing strategies. The class will then move to the B and C cases to focus on the operational and financial decisions made. To conclude, the class could consider the broad future of business opportunities in the Commonwealth of Independent States and the importance of the timing of any investments. This discussion could include any events in the Commonwealth that have occurred since the date of the cases.

To set the stage for the discussion, pose the following:

> The Commonwealth of Independent States is an incredibly large market of consumers waiting for Western companies to attack and provide goods and services. Americans are always searching for new markets to capitalize on. What is holding us back?

Discussion of the Russian environment. This discussion will focus on the environment in Russia as it moves from a republic of the Communist USSR to one of the loosely bound Commonwealth republics. This discussion could begin with the instructor asking; What are the key factors affecting the success of a new venture in Russia?

The discussion can be channeled into the issues outlined in the Analysis section. To establish the overwhelming effect of the Soviet bureaucracy and the impact and chaos resulting from recent changes is critical. In dealing with the factors for success class might discuss strategies followed by various companies already established in Moscow: PepsiCo, McDonalds, or Pizza Hut. Comparisons with other countries (Eastern and Western Europe) can also be made. This discussion could be closed by asking a student to explain how the environment affected TrenMos and the decisions made by the Zeigers.

TrenMos (A). The class can now specifically consider the Zeigers' efforts to establish TrenMos as the first American restaurant in the Soviet Union. The discussion will focus on the hurdles they faced during the setup: the Russian partner, the lack of currency, the work ethic, the shortage of supplies. The discussion can define the problems, their causes, and potential solutions. Some of the problems are solvable, while some are structural (and must be accepted), and some are continuously evolving (they will grow worse or fade away).Possible questions are:

> Does Mussa Karkhov add value? Can he change to become more helpful? Do the Zeigers need an active Russian partner at all? Should the restaurant be all hard currency? All rubles? How can staff best be trained? What will motivate them to change their traditional behavior? Where will Zeiger get a reliable supply of quality raw materials? Will he need to import? Is this economically feasible?

HUNGARY IN 1990

Teaching Note

Purpose of Note

This material provides a social, political, historical, and economic overview of Hungary from World War I to 1990, with a focus on elements that may affect the decision-making environment for managers in Hungary. The note presents six central ideas:

1. Democracy does not translate into a free-enterprise system.

2. Economic change must occur on many fronts. People who are accustomed to working in a controlled economy cannot be expected to think like capitalists. Such change is a long, learning process.

3. A country's economic conditions are rooted in culture, which in turn is rooted in history.

4. Well-intentioned legislation does not necessarily solve economic problems. Often, it creates new ones.

5. The pressures on a government that is seeking change are enormous.

6. Foreign investors can and must function as agents of change.

Assignment Questions and Analysis

The material implicitly poses at least five questions:

1. Why have the many reforms of the 1980s failed to a substantial extent?

   It is one thing to pass a law, and it is another thing to have an economic strategy. Hungary failed in the areas of capital and investment. It did not generate the capital it

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Teaching note prepared by Joseph Wolfe of the International Management Center, Budapest, Hungary, and the University of Tulsa. Revised by Professor Leslie E. Grayson, University of Virginia.

The opening of Hungary provides access to a market previously closed to Western investors and creates an opportunity for expansion. Hungary is a natural steppingstone to other East Bloc countries and the Soviet Union. With its entrepreneurial zeal and commercial instincts, Hungary can become a natural conduit between the East and the West.

5. How is the situation Hungary faces in 1990 similar to and different from the situation it faced in 1968?

The major similarity is that Hungary is trying to establish a thriving economy driven by market forces. In 1968, the New Economic Mechanism was to establish profit maximization as one of the goals of the planned economy.

The primary difference between the two periods of Hungarian evolution lies in the strengths of the anti-Soviet and pro-market movements. In 1968, the movement was crushed abruptly as the Soviet Union interfered in Czechoslovakia which led to strong anti-reformist sentiment. Centralized control was re-established, and the state again controlled most of the economy. In 1990, however, Hungary's first freely elected parliament in over 40 years was voted into power.

FINANCE

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SCHWINN BICYCLE COMPANY (A) AND (B)

Teaching Note

The A case of this pair of cases outlines the issues and problems involved in setting up a joint venture in Hungary in late 1988. Tom Henderson, a senior executive with Schwinn, an American manufacturer of bicycles, faces the task of determining whether to form a joint venture with Csepel, a Hungarian manufacturer. Among the major issues in the A case are:

- How should Schwinn deal with uncertainties such as ownership, product pricing, redundant workers, and monopoly enterprises?
- How should Schwinn evaluate this proposed venture?
- Would such a joint venture fit into Schwinn's global strategy?
- Would the joint venture complement Schwinn's strengths or compensate for its weaknesses?
- What characteristics of the Hungarian economy are important to this decision?
- How will the policies of the Hungarian government in 1988 (i.e., tax reform and incentives, regulatory changes, tariffs, repatriation of profits, currency convertibility, etc.) affect this decision?
- If Schwinn decides to pursue the joint venture, how should participation be structured and control distributed?

The A case requires the student to draw upon a wide range of international business skills. The student should examine Schwinn's seemingly attractive strategic opportunity in the face of several complicating factors. The better student will address the major issues, while also considering the following:

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also ascertain if any devaluation of the forint is under consideration; a devaluation would make the Hungarian factory more competitive with the outside world.

Labor reaction to possible layoffs will be a problem unless some creative approach can be found. Schwinn needs to negotiate openly and actively to eliminate excess jobs, but such an approach might cause Hungary to reject the deal. Finding a unique solution would generate considerable goodwill for Schwinn. For example, employment might be found for the workers at the Csepel garment machine factory (see B case). The government's reaction to employment changes is uncertain, so many personnel issues must be addressed before final agreement.

Political risks exist along a continuum in this situation. A hard-line Marxist regime could return to power in Hungary, possibly resulting in confiscation of some or all of Schwinn's share of the venture ownership. Even under the current reform-minded regime, repatriation of profits could become a problem. One way for Schwinn to address political risks is by using a country risk factor in the cash-flow evaluation of the project. Another way to reduce this risk is by cultivating strong relationships with Hungarian Ministry of Trade officials.

Hungarian workers may have some trouble adapting to Schwinn's management methods, which stress productivity rather than providing guaranteed employment. The workers might not see any advantage in working harder for the same amount of pay as before the venture and no job security. The best way for Schwinn to handle this problem is to communicate the importance of increasing productivity, both for the factory and for the Hungarian economy as a whole. Hungarian middle and lower management should be retained. Some senior-management positions should be filled by Schwinn managers who can implement the necessary changes, but most senior positions should remain with Hungarians. In addition, if the operation grows, Schwinn will need to obtain the Hungarian government's agreement to rehire any workers let go as a result of the joint venture.

Csepel's monopoly status in Hungary makes the deal very attractive to Schwinn. Monopoly status, combined with import barriers, gives the joint venture a "captive market" as a base for future expansion. Without competition in Hungary, the venture is free to concentrate on internal improvements and developing export sales. Loss of monopoly status reduces Csepel's attractiveness to Schwinn.

Question #2: Against what financial and/or strategic criteria should Schwinn evaluate this venture?

Schwinn cannot look at this project from either a purely financial or purely strategic viewpoint. To ignore either fails to take into account information about the risks and rewards inherent in the project. Schwinn should take a long-term view but cannot lose track of short-term uncertainties that could prevent predicted long-term success.

- Title risk: Csepel is a quasi-government entity. Who/what really owns the land, buildings, companies in a post-Marxist country? This factory was seized by the Communists without compensation to its owners in the 1940s. Are claims possible?

Income: Csepel's bicycle unit has not made a profit in years. Supplier prices are not fixed, but the Hungarian government restricts the raising of domestic consumer prices. Can Schwinn realize adequate income from this venture? Do margins adequately cover the risk premium?

Control: Schwinn would like to keep control, since the products will carry the Schwinn name and Schwinn cannot afford to have its quality image hurt by inferior Csepel bikes. The Hungarian government prefers, however, to keep at least 50 percent ownership. Schwinn also needs to consider operational-control issues such as layoff policies, product development, and pricing to the domestic market.

Timing: Regardless of other risks, the time may be extremely ripe for this venture. Additional light can be shed on this issue by using a Porter Competitive Analysis such as provided in the next section.

Other: Among issues not discussed remain questions of: How does Schwinn get its profits out? Can the venture import components for reexport in finished product without paying duty? Is this venture a critical strategic move that should be looked at as an investment for the long term? Should Schwinn involve trading companies to help it repatriate profits?

Competitive Analysis. Schwinn needs to look at the overall competitive environment and decide how the proposed Csepel venture builds competitive advantage in Schwinn's worldwide markets.

Entry Barriers: Technical barriers are low; bikes are easy to build. Mass merchandising, however, requires an extensive distribution network and brand-name recognition. Schwinn has these assets outside Hungary, and Csepel has them inside. Therefore, entry to East Europe is facilitated for Schwinn with Csepel. Furthermore, Schwinn gains access to other East European markets such as the USSR. Because of past trading practices under COMECON,* Hungarian enterprises, including

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*Council for Mutual Economic Assistance (also known as CMEA): the USSR, Poland, East Germany, Czechoslovakia, Hungary, Romania, and Bulgaria.

The conclusion is that this venture is a strategically important opportunity. To make it a "go," Schwinn needs to examine its risks and determine how they can be managed.

Question #3: What do you recommend Tom Henderson do?

The student should provide a "go/no go" recommendation backed up by analyses applying case facts and judgment.

Class Discussion: A Case

What is the current situation?

A student or students should summarize case facts and present Tom Henderson's decision alternatives.

What does each party hope to gain from this venture? How?

Schwinn, Csepel, and the Hungarian government are the three parties interested in this deal. Each has different motives for the joint venture. Schwinn is concerned about its competitiveness; Csepel wants to become profitable; and the Hungarian government wishes to develop and stabilize its economy.

Schwinn. Because the bicycle industry is becoming multinational, Schwinn, in order to remain competitive, is in the process of building up its overseas operations in Pacific Rim countries through joint ventures. It has no facilities in Europe, however, and is thus falling behind other bicycle manufacturers such as Derby International of the United Kingdom. Schwinn finds Eastern Europe to be an attractive location because of its cheap labor, and Hungary provides the most favorable conditions for a joint venture.

In order for the new operation to be competitive, however, Schwinn would like to have a controlling interest in the joint venture so that it can ensure efficient operations and maintain its reputation for quality. Ideally, Schwinn would also like the Hungarian government to remove the tariffs on imported parts and to allow management to make its own pricing and labor decisions.

KKG (the bicycle division of Csepel). KKG has not been profitable since it became a commercial for-profit organization because of low capacity utilization and government restrictions on layoffs, pricing, and imported parts. Even worse, since government subsidies were cut, KKG does not have the financial resources to invest in more efficient assets or extra capacity and the Hungarian government will be sensitive to rising unemployment.

Csepel:

- Already in place are the mortar, bricks, land, machinery, tools, and equipment necessary for production. Schwinn won't need to start from scratch. KKG has plenty of excess capacity.

- Csepel can provide Schwinn with a low-cost labor pool; these workers will have to be retrained, however, at some cost. In addition, Hungarian workers will need to acquire a new mindset: pay commensurate with performance, rather than guaranteed pay and guaranteed employment.

- KKG is a monopoly that delivers a captive domestic Hungarian market to the joint venture.

- Csepel can provide Schwinn with access to Hungarian, Eastern European, and Western European markets through already established patterns of trade and channels of distribution and through experience-related general knowledge of how to operate in these business environments.

- Related to the preceding point are KKG's established relationships with suppliers, which will save time and resources.

- Csepel has contacts in the Hungarian government. This strength is critically important, because much of the venture's profitability potential will be in the government's control (e.g., through price controls, tax incentives, layoff policies).

Hungarian government:

- The government can offer tax holidays and other incentives (e.g., easy repatriation of profits), which could benefit Schwinn and would probably cost the Hungarian government little.

- The government can use its resources to offer support, denominated in forints, for capital funding of the joint venture (debt financing for capital expenditures).

- Since the government is interested in the success of this facility, it can offer protection of the domestic market by allowing and/or supporting the firm's monopolistic position.

- The government can either allow the venture to do its own pricing or provide a mechanism for pricing independent of government controls.

3. Other areas of interest to be covered:

   - ownership in Hungary
   - Schwinn's profit repatriation
   - whether the venture should immediately produce under the Schwinn name
   - profitability of the venture--under what assumptions
   - the riskiness of bicycle production in a venture with Csepel in comparison with Schwinn's other overseas activities
   - Schwinn's obligations to aid workers it lays off if the Hungarian government fails to develop such a program

Alternate Teaching Plan: Role Play

1. Distribute case and assign study and class-discussion questions.

2. The day before class is to meet, divide section into two groups that will, in class, each be divided into three teams representing the three interested parties. Students may be informed that role play will be used but should not be told which role they will be asked to play.

3. In class, divide each group into three teams representing Schwinn, Csepel, and the Hungarian government. Provide them with the guidance that each group's superiors want the deal to be consummated but in as favorable a way as possible.

4. Have the groups negotiate in separate rooms for 30 minutes.

5. When the groups return, they should brief the class. What were the structures of the joint venture each group negotiated? Were layoffs, price controls, and other operational issues agreed on? What points of initial agreement existed? Disagreement? Compromise?

6. Distribute the B case for use as indicated earlier.

RODALE PRESS IN THE COMMONWEALTH OF INDEPENDENT STATES

TEACHING NOTE

SYNOPSIS

Rodale Press is an American publisher of books, magazines, and newsletters on health, fitness, homes, and gardens. In August of 1989, the company became involved in a joint venture in the former Soviet Union. Although Rodale's primary intent was to publish a magazine that would teach individual Russian farmers the American way of farming, the company also agreed that the joint venture would produce port sausage. Unfortunately, after two years, the joint venture's magazine operations faced considerable distribution and editorial problems and the sausage factory still was not completed. The case details the creation and development of the joint venture and the mounting frustrations felt by Paul Wessel, a senior Rodale executive responsible for the venture. These experiences can help students better understand why joint ventures in the Commonwealth of Independent States might not be successful, despite what appears to be strong commitment by a foreign company, and what steps can be taken to improve a venture's chance of success.

PURPOSE

The purpose of this case is to give students the chance to:

1. Learn how a Western company developed business relations in the Commonwealth of Independent States.

2. Understand key differences between the economic infrastructure and the belief systems in Western countries, compared to those of a former communist country, where people are struggling to introduce the concepts of democracy and a market-oriented economy.

3. Identify the key factors that might lead to the success or failure of a joint venture in the Commonwealth of Independent States.

4. Recommend possible solutions for Rodale's predicament and consider the implications of pursuing various options.

This case was prepared by Virginia M. Syer, MBA 92 and Bonnie K. Matosich, MBA 92 under the supervision of Mark Eaker, Professor of Business Administration.

the economic area, democratic people believe in the right of the individual to own property and develop it into a productive enterprise in competition with others, and that this system will produce quality goods at affordable prices. Finally, in democratic politics, governmental bodies must become responsible to the people under the laws defining and limiting their authority and in preserving the right of minorities to become majorities.

In the United States workplace, most employees are required to accept some decision-making responsibility and are held personally accountable for product quality. Managers of businesses need to develop new products, lower product costs, and take other actions to remain competitive in the marketplace. Conversely, Soviet citizens were never given such responsibilities. Workers learned to "meet the production plan" and do nothing more. They were not rewarded for ensuring that their products were of high quality or for developing and producing a new product that better met consumer needs. The most conspicuous characteristics resulting from this economic system are a pronounced aversion to risk-taking, a lack of individual initiative, and little attention to efficiency.

This entrenched communist belief system was evident in the actions and statement of the PTS employees. For example, they:

- Felt a strong sense of community and believed that people should be guaranteed employment. None of them wanted to fire Naumov even though he was not following directions or producing a magazine that met Russian farmers' needs.

- Did not feel personally responsible for ensuring that the sausage plant was completed on schedule.

- Were accustomed to receiving orders from a single source, the State, and did not understand the concept of participative management. Consequently, they ignored input from Rodale.

- Had difficulty dealing with ambiguity and an unstructured environment. In fact, two employees resigned because they could not deal with these pressures.

- Did not understand the complexities of developing a consistent and thorough business plan in a competitive environment or accept the personal initiative required to carry out a business plan.

Question 2: Wessel and McCullagh may have been able to avoid their current dilemmas if they had taken several actions. First, they needed to learn more about Russian beliefs and culture and to apply those learnings in the management of the business venture. The comments on Question 1 should leave no doubt in students' minds that the systemic differences between the Soviet Union and the United States have resulted in distinctly different views of the workplace and a free-market economy. Westerners need to

Finally, Rodale almost certainly would have been more successful if it had maintained a clear focus for the venture. Rodale's areas of expertise are in publishing and healthy living. The company knows absolutely nothing about the production and marketing of sausage. Yet, during the negotiations, they did not restrict the venture's operations to areas where they could offer valuable management expertise. Instead, they seemed to get caught up in Gringaut's enthusiasm for being a free-market entrepreneur and followed his dreams for the venture even though he did not have a plan or the resources to achieve those dreams. As a result, two years later, the sausage factor had become a "black hole," requiring considerable capital investment and management attention. The lesson is that Western managers need to take responsibility early in the process for guiding the direction of their joint ventures. In general, a criteria for developing a successful joint venture in Russia seems to be: Keep the mission simple and focused.

Question 3: Certainly Wessel could choose to get out of the deal. But such a decision would leave the Russian partners, PTS employees, and government officials who were involved in the deal feeling that they could not trust Rodale employees, which could damage the company's ability to conduct business in Russia for years. Moreover, the problems confronting Wessel in November of 1991 are considerable, but probably not impossible to overcome.

Wessel might be able to make progress toward reaching the joint venture's primary objectives of publishing and distributing issues of the *New Farmer*, if he takes the following steps:

Take the time to explain to the Russian partners why he is frustrated with the current editor and then establish clear lines of authority and responsibility between Moscow and Emmaus. Specifically, Wessel might want to insist that DeVault be given the final authority on all articles included in the magazine. Because these rules will be new, Wessel probably should give Naumov the opportunity to cooperate on the next issue. If he fails to listen to DeVault at that point, however, then Wessel might have more support from Gringaut and Senatorov to fire him.

Send a Rodale employee to Moscow for several months to help the Russians overcome the distribution problems and to provide training on Western management techniques. Wessel and McCullagh seemed to expect the Russians to think and act like Westerners, without training them to truly understand concepts, such as participative management, customer service, and product quality.

Try to eliminate the pig farm from the joint venture agreement. Since Wessel and McCullagh initially agreed to a joint venture with the pig farm, they might appear to be "backing out on their word" if they *insist* that the sausage factory be eliminated from the deal. But, they might be able to convince Gringaut and Senatorov that the farm will not be a profitable and wise business venture and gain their agreement to

CONTROL DATA CORPORATION:

ENTERING THE SOVIET COMPUTER MARKET

Teaching Note

Teaching Objectives

This case illustrates the process by which a large computer-equipment manufacturer entered the Soviet market in the 1960s. The case is designed to convey a broad understanding of the process of developing a market presence in a foreign country. More specifically, it focuses on the issues associated with conducting a sales transaction with an organization within a centrally planned economy--one with which diplomatic relations are strained.

Teaching Plan

The discussion questions are designed to stimulate thought about the major issues in the case and to guide the classroom discussion in reaching relevant conclusions about conducting business in an uncertain environment. Key discussion points include:

- The risks and rewards of foreign trade.
- The potential obstacles of entering a foreign market.
- Strategies for developing a business relations with a foreign entity.
- Conducting business in an uncertain political environment.

Discussion Questions

1. Describe the potential rewards and risks of each stakeholder in this case.

2. How can the U.S. government improve the economic and political situation without threatening national security?

This teaching note was prepared by Professor Leslie E. Grayson and Research Assistant Grace S. Fogg, University of Virginia.

3. What should a U.S. company consider prior to entering a foreign market?

   - General economic, social, and political conditions.
   - Existing and potential trade barriers.
   - Currency risks.
   - Ethical issues (e.g., should a company risk national security for money-making purposes?).

4. What should Miles do now? Describe his options.

   Move Ahead. In this option, Miles should take advantage of the recent entry into the Soviet market while the opportunity exists by contacting the Mashproborintorg as soon as possible to pursue a deal for the sale of the 6600 computer to the Soviet Weather Service. He should make application with the Department of Commerce for the export license and appeal to the Commerce and Defense departments for their support.

   Wait and See. Another option is to wait until after the election to determine what stands the new U.S. administration will take on the Soviet trade issue.

   Do Nothing. If students deem the risks of pursuing the transaction to be too high, they will choose this option. They will conclude that the company is unlikely to get the export license and that a protracted negotiation would quickly erode the potential profits from the sale.

In either the second or third option, CDC risks relinquishing the lead in Soviet computer sales to IBM. CDC could take advantage of this situation, however, by keeping a watchful eye on IBM's transactions with the Weather Service and on the U.S. government agencies' proceedings. If IBM is successful, other opportunities will follow.

Epilogue

CDC's plans for expanded trade with the Soviet Union came at an unfortunate time. In August 1968, the U.S.S.R. invaded Czechoslovakia, and political relations became strained. As a consequence, CDC made little progress developing sales with Soviet customers.

Significant improvement in relations between the Soviet Union and the Western World did not begin to take place again until the late 1980s. COCOM dropped most of its restrictions on technology exports at this time, and the U.S. government followed suit. In particular, U.S. export restrictions on high-technology products and services were relaxed.

JOINT VENTURES

ABB AND BERGMANN-BORSIG

Teaching Note

PURPOSE

This case is an analysis of a 1991 acquisition opportunity in Eastern Europe for a Western company; it examines Asea Brown Boveri's (ABB's) analysis of the potential acquisition of Bergmann-Borsig, a formerly East German manufacturer of power-generating equipment. The case presents the investment decision and the strategic implications for ABB.

ASSIGNMENT QUESTIONS

1. If you were Fritz Linnebach, what questions would you ask of:

   a. the German government and the *Treuhand*?
   b. Bergmann-Borsig?

   Organize your ideas into three or four major issues; don't just create a list.

2. What questions do you expect to be asked by the board of ABB?

3. What are the minimal conditions needed before you would recommend going ahead with the acquisition?

4. How would you characterize this investment? Does the potential acquisition fit the strategy of the companies involved?

5. When is the right time to make the move into emerging East European economies? Is it 1991? 1996? Later?

This teaching note was prepared by Professor Samuel E. Bodily and Research Assistant Sheilia Terranova, University of Virginia.

At the same time, we must make sure that ABB is ready to make this kind of investment. Of course, there are political, financial, partner, and competitor risks. What kind of company is ABB? The potential in Eastern Europe is in the form of people, land, resources, market size, and desire, but the potential can be developed fully only when a company makes the necessary effort. The question should be: does ABB have the time, ability to micromanage, patience, resources to offer, and commitment to make this venture work?

Teaching Plan

This case can be combined with "GM Hungary" (UVA-G-0453) and "Praha Hotel" (UVA-G-0457) in a discussion of emerging investment opportunities in Eastern Europe and the strategies of multinational firms for carrying out such investments. It may be used, of course, on its own, probably with some additional reading about, for example, privatization in the former German Democratic Republic (GDR) or global strategy formulation.

Supplement

For a discussion of the outcome of this case and subsequent events, please see the Supplement to this note. The instructor may wish to give students this Supplement at the end of the case discussion.

After taking over the active management of the plant, ABB realized that most of the information it had received from Bergmann-Borsig was misleading because of different interpretations of the terms backlog, revenue, and other financial measures. "We should have spent much more time on detailed investigations at the Berlin site than we did" was the summary of ABB's experience. ABB took several short-term measures to eliminate bottlenecks and inefficiencies in the work process and to turn the company from a manufacturing to a business orientation. Approximately DM30 million was spent on some 20 projects. The major ones were as follows:

- **Revision of the plant layout to help make the facility more efficient.** The facility went from 310,000 square meters to 140,000 square meters without affecting capacity. The leftover space was to be rented to other businesses. ABB wanted to keep ownership of the land for now.

- **Reduction of material stock.** Some 5,000 tons were sold as scrap, which helped to clean the facility up. ABB also established a new policy of ordering material only as needed.

- **Implementation of automated processing instruments, conversion of the production process to ABB standards, and installation of a modern telecommunications and electronic data-processing system.** The latter helped information flow throughout the ABB organization.

- **Reorganization along functional lines, which focused on establishing a marketing and sales department and on training the employees according to Western management standards.** During these efforts, ABB emphasized employee involvement and tried to maintain favorable labor relations. Layoffs were needed. The reduction was made through an early-retirement program and by letting many "indirect" employees go. Training efforts concentrated on how to go about selling, how to sell, how to prepare quotations, how to handle projects, and how to manufacture in an efficient way.

Improving productivity was to be the goal of the next project. As one ABB manager stated,

> Technicians know each nut in each bolt of a turbine. What they need to get, they need to get a broader view on the business. They need to be able to judge the business upon its dividends, a turbine-generated business. How much turns it out, how much profit do we make, and what do we need profit for?

Reaching this goal would involve a change in mentality and would take time, but it was considered to be essential to making ABB Bergmann-Borsig a competitor.

GM HUNGARY

Teaching Note

PURPOSE

This case is an analysis of an acquisition opportunity in Eastern Europe by a Western company; it looks at General Motor's examination of the entire East European car market, the narrowing down of potential opportunities to the Hungarian market, and the negotiation process with the Hungarian government and a potential joint-venture partner. GM, which had been considering purchasing a facility, wound up having to build its entire business in Hungary from scratch.

ASSIGNMENT QUESTIONS

1. If you were Robert Jones, what questions would you ask of:

   a. the Hungarian government?
   b. RABA?

   Organize your ideas into three or four major issues; don't just create a list.

2. What questions do you expect to be asked by the board of GM?

3. What are the minimal conditions needed before you would recommend going ahead with this project?

4. How would you characterize this investment? Does the joint venture fit the strategies of the companies involved?

5. When is the right time to make the move into emerging East European economies? Is it 1991? 1996? Later?

This teaching note was prepared by Professor Samuel E. Bodily and Research Assistant Sheilia Terranova, University of Virginia.

RABA: 51% ownership and full control to GM; distribution of profit/loss based on ownership positions; capital contributions required after initial capitalization based on ownership; identical buyout provisions granted to both partners.

4. GME's strategy in Hungary can be characterized as a pioneer strategy. If it goes forward in Hungary, it will be the first vehicle manufacturer in the country. This venture will also be GM's first investment in Eastern Europe.

GM's corporate strategy is to sell cars in every country in the world, and Hungary appears to be a viable market. The opportunity also to locate the engine facility there is an added bonus but should not be the driver behind the decision. In addition, GM's tremendous size makes it better able than some other companies to take on the risk of this project. The support of the Austrian facility is also a key factor in the project.

5. The time is right to go forward in Hungary now, because the Hungarian government is very supportive of the venture. Thus GM will be able to negotiate favorable conditions, which will set an excellent precedent for future investment in Hungary and the rest of Eastern Europe.

Teaching Plan

This case can be combined with "Praha Hotel" (UVA-G-0457) and "ABB and Bergmann-Borsig" (UVA-G-0452) in a discussion of the emerging investment opportunities in Eastern Europe and the strategies of multinational firms for carrying out such investments. It may be used, of course, on its own, probably with some additional reading about, for example, joint ventures in Hungary or global strategy formulation.

Update

The instructor may wish to read from the following 1992 news release:

> (ECONEWS, March 14, 1992) Friday, March 13, 1992 is expected to be General Motors Hungary's lucky day! It's the day when the first Opel Astra rolls off the production line at the company's brand-new Szentgotthard, Hungary plant...
>
> GM Hungary hopes to market half the 10,000 Astras it turns out this year in Hungary. In principle, output not absorbed by the domestic market will go for export, meaning the amount of exports will largely be determined by Hungarian demand...
>
> The engines will arrive in kit form until the Szentgotthard unit starts its own engine production in July.

PRAHA HOTEL

Teaching Note

PURPOSE

This case is an analysis of an acquisition opportunity in Eastern Europe by a Western company; it details the quest of a group of U.K. real estate developers, in a consortium with Swiss Bank, to purchase and operate the Praha Hotel, which was formerly the playground of the Czechoslovakian Communist Party. While the case concentrates on the consortium's bidding and negotiating strategies, it also introduces the issue of pros and cons in being one of the first investors in post-communist Czechoslovakia. At the time, no defined paths existed for carrying out such an investment and making the venture work; most of the mechanisms would have to be established.

ASSIGNMENT QUESTIONS

1. If you were the consortium head, what questions would you ask of:

   a. the Czechoslovakian government?
   b. the Municipality of Prague 6?

   Organize your ideas into three or four major issues; don't just create a list.

2. What questions do you expect to be asked by the Advisory Group board of the consortium companies?

3. What are the minimal conditions needed before you would recommend going ahead with this purchase?

4. How would you characterize this investment? Does it fit the strategies of the companies involved?

This teaching note was prepared by Professor Samuel E. Bodily and Research Assistant Sheilia Terranova, University of Virginia.

3. Minimal conditions:

Government: Approval of proposed offer and expansion plan; full interest in hard-currency flows for secured lenders; government guarantees on convertibility and liquidity; clear title to property.

Prague 6: 51% ownership and full control to consortium; distribution of profit/loss based on ownership position; approval of Hyatt as hotel manager; capital contributions after initial capitalization to be based on ownership; identical buyout provisions granted to both partners.

4. The consortium's proposed strategy with the Praha Hotel project can be characterized as a pioneer strategy. If it goes forward in Czechoslovakia, it will be carrying out the first privatization of a hotel in the country. The deal will also be Czechoslovakia's first mortgage financing or project financing done without any guarantees by the central bank. Because no laws existed at the time governing this type of transaction, the consortium and its advisors would basically have to make up most of the documentation and regulations as they went through the project. While this situation would provide them with a great deal of flexibility, it would also be slow and arduous. Having the Municipality of Prague 6 as a partner could, however, prove to be a real benefit during the approval process.

The project decision comes down to a risk-and-reward decision, and depends greatly on whether or not the consortium and Hyatt are ready to make the commitment.

5. The timing of this purchase in Czechoslovakia is questionable. As in any decision, we do not have perfect information and the information available here is probably less clear and definite than usual. Welcome to Eastern Europe! Before the investment is made, members of the consortium should spend time in Prague with the parties involved. Face-to-face contact allows much more information to be passed, and perceptive people can pick up a lot more that is left unsaid. There is a lot to be said for gut feel.

The Czech government seems to be unorganized and unprepared to handle the 4,000 privatizations that it wants to do. The lack of defined regulations will cause delays and most likely set this project behind schedule. The stigma on the property of Communist Party association will also cause the Czech government to move cautiously. A nonpioneer strategy would seem to be a better option than making this purchase at this time. "Following" would allow someone else to blaze the trail and endure the time and cost of setting the precedents. A minimum wait of three to five years before entering Czechoslovakia would probably be required under this scenario.

Teaching Plan

This case can be combined with "GM Hungary" (UVA-G-0453) and "ABB and Bergmann-Borsig" (UVA-G-0452) in a discussion of emerging investment opportunities in Eastern Europe and the strategies of multinational firms for carrying out such investments. It may be used, of course, on its own, probably with some additional reading about, for example, joint ventures in Eastern Europe or global strategy formulation.

MANUFACTURING BICYCLES IN HUNGARY
Teaching Note

Purpose: This case uses a Hungarian example to demonstrate the constraints that a centrally planned economy places on the growth of an enterprise and on the options of its management. In this case, the bicycle manufacturer KKG faced challenges thrust upon it when government reforms made it an independent for-profit entity and removed subsidies upon which it had formerly relied. Such reforms are necessary if centrally planned economy enterprises are to be competitive in an increasingly global marketplace. However, the case demonstrates that reforms that only go half way are only slightly better than no reforms at all. In addition, managers who have learned to manage for survival under state support do so at the expense of developing modern management skills required in a market system. "Manufacturing Bicycles in Hungary" provides a realistic view of change in Eastern European economies. Realism will be a valuable asset for western managers as they increasingly meet East Bloc counterparts both as competitors and as potential partners in the international marketplace.

Assignment Questions:

1. Which of KKG's problems were attributable to the Hungarian centrally planned economy under which it operated? What was the major flaw in the reforms?

2. What advantages did KKG have going for it?

3. If you were the manager of KKG, what would you have done to try to increase your enterprise's profitability and competitiveness?

4. You are a foreign investor. Is KKG an attractive candidate for a joint venture partner?

This teaching note was prepared by Professor Leslie E. Grayson and Research Assistant Daniel S. Zisk, University of Virginia.

On the domestic market, KKG had very little control over the pricing of its products. The enterprise's margins were squeezed because price controls at home (a common inflation-fighting tool of centrally planned economies) limited its ability to pass along high raw material costs to Hungarian consumers.

Inventory policy, like most economic policies and regulations in centrally planned economies, was promulgated from the top down. The obvious problem is that central planners very often lack adequate knowledge or information about the needs of specific industries or enterprises. Under Hungarian inventory-accounting regulations, KKG was not allowed to hold large inventories in anticipation of sales during the high season for bicycles. Therefore, it was unable to meet demand during peak season and had underutilized capacity at other times. Bicycle production had to be done in long runs in order to be profitable. The lack of inventory capabilities precluded long runs.

In short, the fundamental problem with the Hungarian government's economic reforms was that they were piecemeal. The decision to use profitability as a yardstick by which to measure the success of enterprises was wise and laudable. However, without providing an environment in which profitability can be attained, it was an empty gesture. Central planners are understandably loathe to rescind price controls and allow wage or workforce reductions because these measures are unpopular and might breed discontent. Inflation and unemployment are the inevitable price a centrally planned economy country must pay for a revitalization of its economy through market forces.

2. About 57 percent of KKG's revenues came from its production of garment industrial machines. This segment of the enterprise's business yielded profits averaging 20 percent. Future prospects for KKG garment industrial machine sales were favorable and expected to grow beyond present capacity. The down side of this successful business was that almost all sales were to the Soviet Union and did not result in hard currency earnings. However, the success of this venture should give KKG some bargaining power in its relations with government policy makers.

3. Under the existing economic policies, it would be difficult for KKG to successfully export its products. In addition to the fact that its bicycles are of inferior quality and overpriced, the firm lacks the marketing know-how needed to crack western markets. Instead, KKG must concentrate its efforts on the Hungarian market. Its children's models are up to international standards. The enterprise should make every effort to dominate this segment of the domestic market. If it can impress Hungarian parents with the quality of the bikes they buy for their kids, perhaps they will be willing to purchase a KKG for themselves when they need a new bike. However, KKG must continue to

2. Alternative: Use a bicycle as a visual aid. Bring a bike with a variety of defects into the classroom. A flat tire, a seat positioned backwards, a poorly adjusted front brake, missing spokes, and a broken speedometer all to varying degrees inhibit efficient operation of the vehicle. Each defect should be flagged with an explanation of the defect. The bike can be used as a metaphor for the enterprise, with each defect representing a governmental policy or regulation. Not all defects are equally obstructive. For example, as painful as it may be, one can ride a bicycle with its seat turned backwards. Similarly, the policy of full employment does not necessarily completely cripple an enterprise. However, one can only ride so far on a flat tire. What governmental regulation might this represent?

MARKETING

MARKETING SOVIET VODKA IN GERMANY:

V/O SOYUZPLODOIMPORT

Teaching Note

Teaching Objectives

This case study is designed to introduce some of the complexities of trade between centrally controlled countries and those with a free-market economy. The trade activities of V/O Soyuzplodoimport (SPI), a Soviet foreign trade organization responsible for the export of liquor, and Cherry Import, a West German distributor, are used to exemplify problems that may be typical of the Soviet foreign trade process. The case explores the relationship between the Soviet trade organization and its West German trading partner within the context of the economic and competitive environment of the Soviet vodka market in West Germany.

Teaching Plan

One aim of the class discussion is to analyze the situation and make decisions regarding this specific trade organization's strategy. However, although the case focuses on a single example, its lessons are applicable to many areas of foreign trade and the problems associated with international trade arrangements. The discussion questions are designed to lead to an understanding of the issues and to provide a framework for analysis.

Assignment Questions

1. Analyze the relationships among SPI, Plodimex, and Cherry Import. What are their roles and main interests in the export of vodka to West Germany?

2. Discuss the advantages and disadvantages of the trade arrangement for Cherry Import; for SPI.

3. What alternatives to the current arrangement with Cherry Import might Chekov consider in preparation for his meeting with the Foreign Trade Ministry?

This teaching note was prepared by Professor Leslie E. Grayson and Research Assistant, Grace S. Fogg.

3. What alternatives to the current arrangement with Cherry Import might Chekov consider in preparation for his meeting with the Foreign Trade Ministry?

Chekov might consider establishing a subsidiary of Soyuzplodoimport in West Germany for importing Soviet alcoholic beverages. In this move, SPI could decrease its reliance on foreign importers and gain control over the distribution process. Several hurdles are involved, however, in setting up a foreign subsidiary. The investment would require a capital outlay of already scarce hard currency. In addition, West German foreign-investment regulations might prohibit SPI from establishing a wholly owned subsidiary. The West German subsidiary would have to start from scratch to develop a network of sales agents in West Germany.

Alternatively, SPI might consider distribution arrangements with other importers in West Germany to gain some leverage over Cherry Import in negotiating future contracts. Evaluating the capabilities of other import companies would help SPI obtain the most beneficial arrangement possible. Finally, SPI could explore opportunities for expanding its position in European markets that are demonstrating better growth prospects than West Germany.

HERMAN CORPORATION

Teaching Note

Synopsis

The Herman Corporation, a well-known and respected US manufacturer of foundry equipment, faces the challenge of negotiating a contract with Metallurgimport, a Soviet foreign trade organization (FTO), a professional trade organization set up to negotiate commercial transactions with foreign firms. Herman has not transacted business with the Soviet Union for over 27 years and is at a disadvantage in the negotiations because of its lack of experience.

Robert Kaveny, president of Herman and chief negotiator, relied on the services of an outside consultant to help him prepare for negotiations. As he feels his way through the commercial negotiations, he realizes the consultant's preparation was valuable, but experience is really the key to becoming an effective negotiator.

Objective

The negotiation between Herman and Metallurgimport exemplifies the complexities of business transactions between organizations from countries with disparate social, political, and cultural environments. Preparation and experience are highlighted as essential tools for success. The case also observes that many unanticipated difficulties may be encountered after the contract is signed. The review questions noted here are to aid in analyzing the important issues and help lead the student to the conclusion that the unanticipated difficulties and mistakes encountered in a cross-cultural business transaction can be useful steps in the overall learning process.

Review Questions

1. What are the key issues for the Herman Corporation? Why does the company want this contract? What advantages does the company have?

Kaveny knew he was inexperienced in negotiating with the Soviet Union and showed good judgment in enlisting the help of Julian Hoffman in reparation for the commercial discussions. Hoffman, having represented numerous American companies in their dealings with the Soviet Union for two decades, helped Kaveny avoid many problems and pitfalls in negotiating with Metallurgimport. Hoffman's advice was invaluable, but Kaveny's lack of experience still put him at a disadvantage when compared with the Soviet commercial-negotiations experts. On the other hand, all discussions were held in the United States, which Kaveny gave a definite home field advantage throughout the negotiations.

Metallurgimport had the advantage of an experienced negotiating team in negotiating the terms of the commercial contract. Kaveny was intimidated by the fist-pounding strategy employed by the Soviets, and long delays in communications with Moscow frustrated him. As a result, Kaveny failed to identify loopholes in the contract that ultimately led to contract-performance problems that might otherwise have been avoided.

3. What specific aspects of the negotiations made the transaction difficult for the Americans? What was difficult for the Soviets?

The location of the negotiations worked to Herman's advantage. All of the sessions took place on American soil, which made the negotiations more convenient and psychologically comfortable for Herman than for the Soviets. The willingness of the Soviets to accept negotiations in the United States may have made the Soviets appear more eager to consummate the deal, however, than if they had insisted on holding at least some of the negotiating sessions in the USSR.

The lack of decision-making authority of the Soviet commercial negotiators created difficulties for both parties--delays and the potential for miscommunication. Kaveny's frustration with the system probably worked more to his disadvantage, however, because the Soviet negotiators were accustomed to operating under such constraints.

The cold war years between the Soviets and the United States resulted in caution, bordering on mistrust, from certain parties Herman needed to involve in the deal, which made it difficult for Herman to carry out certain fundamental tasks. For example, Herman's bank refused to supply a letter of credit to the Soviets, and the State Department had to grant clearance before Herman's engineers could bring their Soviet counterparts to see US foundry facilities.

4. What did Kaveny learn from his experience negotiating with the Soviets that could be helpful in future contract negotiations?

Graduate School of Business Administration
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UVA-G-0461TN

WORKING IN POLAND: HUTA IM. TADEUSZA SENDZIMIRA (A AND B)

Teaching Note

Purpose

The A case illustrates the mindset and working environment of the people and companies in a transforming centrally planned economy. In the case, the largest steel mill in Poland, Huta im. Tadeusza Sendzimira (HTS), has hired four MBA Enterprise Corps members to work in its newly formed Marketing Department. The Marketing Department is getting requests for guidance from all areas of the mill and must identify the root problems causing the mill's declining market. The people in the department lack most of the skills needed to gather, analyze, and use information about their market. In the midst of the information gathering, the acting general director requests a report proposing solutions to the mill's problems. The report is needed in one week in order to provide the Ministry of Industry information to use in the appointment of a general director. At the end of the A case, the MBAs must decide how to get the report done.

In the B case, the MBAs have decided to write the report by themselves in order to meet the deadline. The trust and relationships they had built with the members of the Marketing Department are diminished, and the report gets lost in a political battle.

The cases "Working in Poland: Continental Opakomet White Cap (A and B)" present another situation during the same time period. These cases can easily be used together to show the private-sector and public-sector transformations in Poland.

Assignment Questions

1. Describe the business environment in Poland in late 1991.

2. What should the four MBAs do: write the report without their Polish teammates, write it with them, or take some other approach? Present the pros and cons for each solution.

This note was written by Research Associate Sheilia Terranova, Darden '91, and Professor Leslie E. Grayson.

Teaching Plan

The A case could be supplemented by some articles on Poland's political and economic situation. The B case can be handed out at the conclusion of the A-case discussion.

The cases illustrate the experience of working in Eastern Europe at the time a market economy was being developed. Leading questions in class might include: What does the A case (later, the B case) tell us about doing business in this part of the world? What type of strategy would you use for beginning a job in a company like HTS? What amount of time would you expect each task to take? How would you deal with the scale of problems?

WORKING IN POLAND: CONTINENTAL OPAKOMET WHITE CAP (A AND B)

Teaching Note

Purpose

The A case illustrates the mindset and working environment of the people and companies in a transforming centrally planned economy. In the case, a joint venture involving a Polish packaging company, Continental Opakomet White Cap (COWC), has hired an MBA Enterprise Corps member to help build a Sales and Marketing Department. Both aggressive selling and the term marketing are new concepts to Poland. The people in the department lack most of the skills needed to gather, analyze, and use information about their market to reach the goals of the company. Although some progress is made, the resignation of the company director and the traditional summer vacations seem to halt the momentum just as the Corps member's stay is up.

The B case introduces a letter she receives from her COWC department after her return to the United States. The letter provides a ray of hope that the systems put in place are being used independently by the Sales and Marketing Department.

Assignment Questions

1. Describe the business environment in Poland in late 1991 and early 1992.

2. What lessons did Corps member Irene Carlson learn while working at COWC?

3. What do you think happened after she left?

Discussion of Questions

1. The A case points out the political and economic uncertainties of the situation in Poland at the time. A westerner would question the timing of an investment in a country of so much change. Poland needed to develop its own market economy that could work with

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westerner might know a way to get to the answer and have tools to be applied to certain situations, but there are no magic answers. Getting the East Europeans to accept that work is needed to get to the answers is the challenge.

- Projects or tasks should be broken down into short-term tasks. This helps build a sense of accomplishment, and people can see change quicker. Problem areas will be recognized sooner also.

- The westerner will have to find different, resourceful ways of doing things, but using what one has and making it work build innovative thinking skills.

3. A spectrum of answers could be considered. This question is really just a lead-in to the B case.

Teaching Plan

The lessons to be learned are the most important part of the case. Leading questions might include: What does the case tell us about doing business in this part of the world? What type of strategy would you use for beginning a job in a company like COWC? What amount of time would you expect each task to take?

The A case could be supplemented by some articles on Poland's political and economic situation. The B case can be handed out at the conclusion of the A case discussion.

NEGOTIATIONS

AMERICAN TECHNOLOGY CORPORATION:

THE PITTSBURGH GROUP

(Negotiating Technical Licenses)

Teaching Note

Purpose

The "American Technology Corporation" case is designed to address the challenges of international negotiations. Illustrating an East-West trade discussion, the case focuses on obstacles that are unique to dealing with organizations within a centrally planned economy. The discussion questions are designed to guide students in analyzing each side's objectives and constraints, and to afford the opportunity to discuss the outcome of the negotiations. The teaching plan provokes the interchange of ideas--including, cultural aspects, establishing negotiating positions, and guidelines for facilitating an agreement or terminating discussions--in order to develop an outline for the the negotiating process.

Discussion Questions

1. What are the objectives of American Technology Corporation and the Pittsburgh Group?

2. Identify the objectives the Soviets have conveyed to the Americans through their negotiating strategy and positions.

3. ATC has had plenty of experience negotiating technological licensing arrangements with foreign companies, but has never encountered such difficulty in preserving its product secrets, until now. What factors make the negotiations with Transimport unique?

4. You are "Stodgy" Hanson. What is your next move?

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3. Transimport is a government organization operating within a centrally planned economy. It does not enjoy the flexibility of a private enterprise. The Soviets are concerned about whether the resources will be available within the Ministry of Trade to insure a steady flow of production. They have indicated that the information is essential to their planning process. The Americans are not accustomed to dealing with such a rigid system and are not sure that the Soviets are negotiating in good faith.

4. The Soviets have indicated that a West German company with advanced converter technology has also expressed interest in a licensing arrangement with Transimport. Thus, although it might not be their best option, Transimport could pursue the licensing arrangement elsewhere. Hanson knows that Pittsburgh's product has advantages over the German technology from a market standpoint. The German converter, although fully developed, has not received patent approval. PX17i's patent has already been approved, and the product is ready for introduction in American automobiles.

   In addition, Transimport has already committed much time, money, and effort to the negotiations with ATC. Asseyev, as vice-chairman of Transimport, and Vakulinchuk, as a representative of the Ministry of Transportation, both have an interest in completing this transaction to distinguish themselves in improving East-West trade relations and to increase Soviet exports. If they walk away from negotiations without a licensing arrangement with ATC, there is no guarantee that they can successfully obtain a licensing arrangement with the German company or any other western company.

   Hanson has already been generous in explaining the product and in offering a three-year supply of C-Special. As a final offer, he could propose a technical-assistance program to help the Soviets evaluate the feasibility of applying the process to Soviet automotive production. Hanson should not divulge the sensitive process information without legal assurance protecting the value of the license--a signed license agreement or a confidentiality agreement that would transfer the information only for the purpose of evaluating the production feasibility.

   The potential cost of the Pittsburgh Group losing its technological edge in catalytic-converter technology is probably worth more to ATC than the cash flow and prestige of this one agreement. In sum, Hanson should go back to the negotiating table prepared to walk away from the deal if the Soviets refuse to compromise.

METACOM CORPORATION (U.S. and Soviet Versions)

Teaching Note

Purpose of the Case

The American and Soviet versions of this case illustrate the extent to which mistrust and a lack of cross-cultural knowledge can complicate negotiations between business entities from two very different systems. The licensing-agreement negotiations between Metacom and Licensintorg have dragged on because Metacom has failed to acquire knowledge needed to accomplish its goals, and because Licensintorg is involved in a mission that goes beyond the purchase of a license to manufacture and sell the APG. The goal of this case is to provide insights that will help students avoid some of the mistakes that have hurt Metacom.

Teaching Plan

1. One teaching approach is to assign half the class the Soviet version of the case and half the American version. Let students play the roles of John Howe and Herbert Gray for Metacom, and V. I. Efremov and the Transportation Minister for the Soviets in the next round of negotiations. Before the negotiations begin, have each opposing side leave the room during a short presentation in which its opponents brief the class on their objectives, going-in positions, and what they are willing to accept before breaking off talks.

2. Alternatively, allow two class periods for the Metacom case. First assign the U.S. version of the case and, during class, discuss the U.S. version questions given in the next section of this note. The instructor should try to elicit student opinions on what Efremov might do and, especially, on the reasons behind his cautious conduct during the process. At the end of the first class, assign the Soviet version of the case. In the next class, discuss how Efremov's expectations of Metacom during the negotiations differed from some of the assumptions students might have had about the workings of the Soviet bureaucracy. What were the reasons for his cautious approach to the process? If Howe

This teaching note was prepared by Professor Leslie E. Grayson and Research Assistant Daniel S. Zisk, University of Virginia. Rev. 4/92.

2. The major advantage that Metacom has is that the Soviets badly need the technology to modernize their railroads. The fact that Efremov assembled specialists from a large number of interested organizations means that the Soviets are waiting for him to obtain the technology. Efremov has reluctantly consented to involve the Transportation Minister in the next round of talks--a highly unlikely circumstance unless the Soviets consider the APG a high-priority item.

The main disadvantage that Metacom has is that the superiority of its APG technology is waning. The APG may soon no longer be unique. Thus Metacom needs a licensing agreement before the license loses value to the Soviets, which naturally reduces Metacom's bargaining power.

As peculiar as it may seem, another thing that Metacom might have going for it is that it has done almost all of the giving in the negotiations to date. It has not only agreed to a buy-back element in the payment plan, it has also agreed to a lower price. Metacom can point out these concessions and note that the time has come for the Soviets to make some concessions.

3. Simply stated, Metacom failed to do its homework. A number of issues contributed to stretching negotiations out longer than necessary. First, Howe was surprised when the Soviets suggested a combination of cash payment and a buy-back arrangement, but a common practice in the Soviet Union and other centrally planned economies where hard currency is limited is to try to arrange countertrade terms in order to conserve foreign exchange. Had Metacom investigated Soviet trade practices, it would have known that a buy-back offer was likely and could have assessed the quality-control and foreign-exchange implications of such an arrangement. Assuming that Metacom believed a Soviet deal was still worth pursuing, it might have come in with a higher starting price for the license and been prepared to bargain down once the countertrade was proposed.

Second, Metacom had a close call in acquiring the necessary export clearances from the U.S. Commerce Department Office of Export Control. Fortunately for Howe (who has plenty at stake professionally in the deal) and the company, governmental clearance for the export of the sensitive technology was obtained. If the government had prohibited the deal, Metacom would have had no way to recoup its expenses incurred in the early stages of the deal. Earlier consultation with the U.S. Commerce Department might have also alerted Metacom to the fact that it would not be allowed to let the Soviets visit its plant, which might have helped Metacom avoid the embarrassment and feeling of mistrust that incident engendered.

Howe showed savvy in working with the U.S.-U.S.S.R. Trade and Economic Council and with AMTORG, the Soviet trading company in New York. AMTORG was helpful in telling Howe who to contact, but naturally offered no help on how best to deal with Licensintorg. Howe should have concurrently sought U.S. Commerce Department information on Licensintorg and the process of negotiating in the Soviet Union. In be icing on the cake for the Soviets, but since they are assured hard currency from sales in Eastern Europe, the deal seems profitable enough without Western Europe rights. By agreeing to give up EEC rights, Efremov can appear to be conciliatory--something he has not yet had to do throughout the process.

2. Licensintorg is in a generally good position as it prepares for the meeting between Gray and the Transportation Minister. There are a number of reasons Efremov should be confident. First, the president of Metacom is coming to Moscow after a very expensive, two-year process, which demonstrates that Metacom still badly wants the agreement. Second, Metacom has proven to be pliable in negotiations up to this point. Third, Schlumberger is waiting in the wings if the Metacom deal fails. Fourth, the negotiations are taking place in Moscow, on Licensintorg's turf, with a counterpart that is still fairly inexperienced in East Bloc negotiations.

The main disadvantage that Efremov faces is that the negotiations have progressed in such a public fashion. The technical seminar he hosted was a great success, but it added an extra element of pressure to an already urgent mission--modernization of the Soviet rail system. The Soviet experts are no doubt anxious to have the APG technology in place. Also, Soviet ministers do not usually get involved in negotiations of such small magnitude. If Efremov appears to be wasting the Minister's time, the results could be damaging to Efremov's career. It is in his best interest to strike a deal quickly, which means he may have to give in to some Metacom demands.

3. Efremov has a tough job indeed. He is not an expert on railroads or automatic programming devices. Rather, he is a negotiator of licensing agreements for a wide range of things on behalf of many Soviet enterprises and ministries. His American counterpart, John Howe, on the other hand, depends on the APG and his knowledge of it for his livelihood. One would not blame Efremov if he felt extremely disadvantaged in these talks; yet he has done a remarkable job in extracting concession after concession from Metacom.

Unlike Howe, who must consider the benefits of a potential agreement for a single company, Efremov is on a mission of national importance. To Howe, the licensing agreement is for a device to be used to automate the Soviet rail system. Efremov and Licensintorg see the agreement with Metacom as a way of acquiring advanced technology for the overall development of the Soviet Union's economy, not just as a means of improving its railroads. The Soviets have traditionally viewed licensing agreements as a way of leap-frogging costly and time-consuming basic research and development. Acquisition of advanced technology through such agreements frees Soviet researchers to work on other crucial research. Because of this broad mission, Efremov has had to be doubly cautious in assuring that he is acquiring the best technology possible; thus he has proceeded slowly at times.

PHARMACAL CORPORATION (U.S. and Soviet Versions)

Teaching Note

Purpose

The "Pharmacal Corporation" cases (U.S. and Soviet versions) are designed to illustrate the difficulties that may be encountered in international or cross-cultural negotiations. In particular, the set of cases addresses those obstacles that are unique to dealing with organizations within a centrally planned economy. The discussion questions given here are to guide the students in evaluating each side's approach to the negotiations, and they afford an opportunity to restructure the negotiations to achieve a favorable outcome. The recommended teaching plan and class discussion will bring to light the importance of clear lines of communication and trust in successful negotiations by asking the students to play the roles of the negotiators in a mock bargaining session. The approach will also help participants understand the negotiation process, including how to facilitate an agreement and how to determine when negotiations should be terminated.

Teaching Plan

The most effective teaching plan for the "Pharmacal" cases is to allow two class sessions for analysis and discussion. In preparation for the first session, divide the class into two sections, assigning the Soviet version to one half and the American version to the other half. Have the students prepare for a mock negotiating session using the discussion questions as guides for developing negotiating positions. Various students should be called on during the class period to play the negotiators.

At the end of the class, distribute both versions in preparation for discussion the next day. During the second session, review the negotiations from the previous day, focusing on the assignment questions and additional questions that pertain to both sides of the case. Suggested questions: After reading both versions, how and why did each

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This teaching note was prepared by Professor Leslie E. Grayson and Research Assistant Grace A. Fogg, University of Virginia.

The Soviet scientists were wary of the intentions of the American corporation from the outset of the discussions, and as a result of the lack of communication, the scientists became distrustful of Pharmacal's motives. They interpreted the continued request for the samples as a ploy to obtain more advantageous business terms, and they suspected that the Americans wanted to secure the technology to produce Corydon in the United States without a licensing arrangement. In sum, if Pharmacal had understood the Soviet's constraints and if the scientists had understood Pharmacal's constraints, the stalemate in negotiations might have been avoided.

3. Clearly, the Soviets could break off negotiations with Pharmacal and seek a licensing arrangement with a pharmaceutical company in Western Europe where the requirements for distribution approval may not be as stringent as in the United States. This option may not, however, be the most desirable for Licensintorg. The Soviets have already committed much time, money, and effort to the negotiations with Pharmacal, and abandoning negotiations at this point would reflect negatively on Kravchenko's abilities as an experienced license negotiator within Licensintorg. D. Krabentsov and the Institute, for their part, have no guarantee that negotiations with another firm will be any easier, and the longer they wait to establish a distribution arrangement, the more time other pharmaceutical firms have to develop a drug comparable to Corydon.

Before going back to the bargaining table with Pharmacal, Kravchenko must do some preliminary research. Specifically, she must research the role the FDA plays in bringing a new drug to market in the United States. If she does her homework, she can decide whether or not the request for the five-kg sample to satisfy FDA test requirements is valid. In addition, she should consult with N. Andreyev to obtain his preliminary commercial evaluation. She should be fully aware of the economic value of the license for Corydon to the Institute before attempting to reopen the negotiations with Pharmacal.

Kravchenko may discover through her research of the FDA requirements and analysis of the commercial value of the license that continued negotiations with Pharmacal are not in the best interests of the Institute or Licensintorg, and she may begin to look elsewhere for a licensing arrangement. On the other hand, if she discovers that the request for the Corydon is valid and Andreyev has determined that obtaining the licensing arrangement with Pharmacal would be of significant value, she should advise Kozlinsky of her findings and develop a strategy to reopen negotiations with Pharmacal.

In preparation for the negotiations, Kravchenko should work with Kolinsky and Krabentsov to increase their confidence in the intentions of the Pharmacal negotiating team. Kozlinsky and Krabentsov must appreciate the constraints under which the FDA requires American pharmaceutical firms to operate, so that they can accept the legitimacy of Pharmacal's requests. It is time for the Soviet negotiators to arrange a schedule for production and transfer of test quantities of Corydon to satisfy the FDA requirements or transfer the technology to Pharmacal's scientists to enable them to

Institute operated. Elliott was frustrated about the length of time and correspondence involved in setting up the first meeting, he was surprised that the ministry overseeing pharmaceutical development was separate from the ministry that was responsible for production, and he did not understand how difficult it was to release information under Soviet patent restrictions.

The inability of the negotiators to get beyond the issue of the five-kg sample of Corydon needed by Pharmacal to satisfy the FDA requirements was a manifestation of Pharmacal's inability to appreciate the difficulties facing the Institute in operating within the Soviet system. Pharmacal assumed that the Soviets were holding back as a negotiating tactic and believed that it was being mistrusted.

When the two groups tried to turn the negotiations to the commercial aspects of the deal in an attempt to get the discussions moving, Elliott demonstrated his frustration through his insistent and defensive tone. As a result, the negotiators reached another impasse. Because of his inexperience and lack of understanding, Elliott had allowed the FDA sample size to become the stumbling block that would threaten to destroy the negotiations.

3. As advisor to Pharmacal, Maxwell's first course of action should be to make sure Elliott and his team understand the situation from the Soviet perspective. Maxwell should develop a negotiating strategy that helps create a sense of trust between the two parties. The Pharmacal negotiators must convey to the Soviets that they understand the Institute's constraints and objectives. The goal must be to advance discussions beyond the issue of testing and on to the commercial issues.

The strategy should include an outline of the test procedures required by the FDA. Pharmacal might offer to arrange a meeting with an FDA representative to make the Soviets more comfortable with the request for the large test quantity. In order to protect the value of the license, the Institute could not release all of the information Pharmacal needed to make both an economic determination, and satisfy the FDA standards. Pharmacal should offer the Soviets appropriate compensation and a signed secrecy agreement to secure the information needed to produce the Corydon sample in Pharmacal's own lab.

If Pharmacal cannot convince the Soviets that the firm is negotiating in earnest and does not get beyond the test-quantity issue by offering compensation and a signed agreement, negotiations should be terminated. However, if Pharmacal is successful in gaining a resolution about the test quantity, it should approach the commercial issue and be prepared to use the timing of the royalty payments to negotiate for the distribution territory.

OPERATIONS

DARDEN Graduate School of Business Administration
University of Virginia

UVA-G-0368TN

Numerically Controlled Machine Tool Production in Hungary

TEACHING NOTE

Purpose: To introduce students to the environment in which managers must work under a centrally planned economy. This Hungarian case illustrates the extent to which managers of enterprises in planned economies must manage extra-enterprise political relationships, as well as confront many of the same business concerns as their colleagues in market economies. The case also demonstrates the complexity of managing change within enterprises that is brought on by fundamental economic reforms — an important issue for the rest of this century as countries with centrally planned economies around the world seek to institute wide-sweeping economic reforms.

Assignment Questions:

1. What aspects of the centrally planned Hungarian economy limit Numerically Controlled Machine Tool's (NCMT's) management in its efforts to grow?

2. What advantages does NCMT have?

3. Was the licensing agreement with the Italian manufacturer of numerically controlled machine tools the appropriate way for NCMT to upgrade its product lines?

4. Given the constraints of the Hungarian system, what realistic alternatives does Mr. Pal Nagy have to try to save NCMT?

Discussion of Questions:

1. NCMT operates within the following guidelines that limit its autonomy and decision-making abilities:

a. In Hungary, funding for enterprises is provided only by the state. Therefore, NCMT does not have access to financial markets that western firms have in order to raise capital for research and development, plant improvements, or other investments.

b. Hungarian enterprises are not allowed to export directly to foreign markets. Rather, they must export through a state foreign-trading company. Because of this structure, NCMT is out of touch with the needs of western users and has not developed its own marketing capabilities.

c. Full employment is a major objective of centrally planned economies. Often it is of greater importance than competitiveness and profitability. Because of this socially oriented objective, NCMT is not able to lay off workers during slack times.

This teaching note was prepared by Professor Leslie E. Grayson and Research Assistant Daniel S. Zisk, University of Virginia.

foreign technology would probably be looked upon by the government with more disfavor than if the enterprise had failed on its own.

4. Mr. Nagy is being pulled from all sides. His employees are unhappy, there is a divergence of opinion within the enterprise leadership, and the government is threatening to withdraw its support from NCMT and possibly merge it with another organization. Mr. Nagy must not lose sight of his primary objective, which is to maintain the independence of NCMT. Profitability is not his main objective. Since it is the government that will ultimately decide NCMT's fate, Mr. Nagy must first turn his attention to politics.

Although NCMT depends on the government for support, it also wields considerable clout in its relationship with the authorities. First, NCMT has an established reputation as one of the CMEA leaders in machine-tool manufacturing. The state has already paved the way for shipment of OKE products to its CMEA trading partners. If NCMT must drop the OKE, not only NCMT will lose prestige in the Eastern bloc, but so will the Hungarian industry as a whole. Mr. Nagy must remind the government of its stake in supporting NCMT's technical improvements.

Second, the enterprise enjoys a large representation in the local Communist party organization. The implications of NCMT's loss of independence would no doubt cause local disgruntlement; it could even be a destabilizing event in the area. The government, therefore, may be susceptible to arguments that continuing to support the plant is in the government's best interests.

Mr. Nagy probably has no choice other than to mothball the OKE-2 project. It is simply not going to be a profitable one for NCMT under the present system. NCMT must, however, continue efforts to improve its products. NCMT may be able to continue the development of the OKE-1 if Mr. Nagy can get a commitment from the Hungarian government to provide the necessary funding for research and development and employee training. This commitment may be possible, because he has the leverage of the Hungarian industry having promised CMEA neighbors that a new product is on its way.

By shifting the focus back to the OKE-1, Mr. Nagy may be able to regain the interest and dedication of the technical-development team that was alienated when the licensing agreement was signed. He should try to rekindle the tradition of innovation that was previously a hallmark of NCMT. At the same time, however, he must not neglect the production of the "Z" products, which earned NCMT its reputation and gave the older employees a sense of pride. Efforts must also be made to deal with the inequities in the enterprise's compensation and benefits plans.

Teaching Plan:

1. Begin the class period by asking students what they would do if they were Pal Nagy. Students used to thinking about management problems in the context of market economies will probably need reminders of the constraints on the manager in a planned economy. For example, he will not be able to fire employees or seek capital for research and development from anywhere but the government. This reminder will lead to a more general discussion of the differences between centrally planned economies and market economies and the difficulty of successful transitions to market economies.

2. Let the students assume the role of an American businessperson considering NCMT as a joint-venture partner. The students should assess what NCMT would bring to the partnership, what NCMT should be looking for in a joint-venture partner, what the American company would have to commit to the venture to make it feasible, and what concessions it would ask of the Hungarian government before investing. If students do not believe that the conditions in Hungary are attractive enough to join with NCMT in a joint venture, and this may very well be the case, then the students should be asked to identify what Hungarian-government policy changes they would await before reopening consideration of a joint venture with NCMT.

DARDEN Graduate School of Business Administration
University of Virginia

PIZZA HUT MOSCOW

Teaching Note

Purpose

This case uses the entry of PepsiCo's Pizza Hut restaurants into Moscow to demonstrate the details of introducing a service facility in a former centrally planned economy. In this case, PepsiCo negotiated a joint-venture agreement with the city of Moscow to open two Pizza Hut restaurants. USSR joint-venture law, the inconsistent availability of quality goods, the lack of a good distribution system, no expatriation of profits, and the Russian employee's lack of management skills were all issues that had to be addressed to make this operation work. The 70-odd years of Communist rule and a planned economy did not foster the skills required in a market system.

This case outlines some innovative ways to tackle some of the differences between operating in the economy in Moscow and in that of a Western market system. It also reveals that each party had different expectations of the venture.

Recognizing the expectations and realizing the differences are keys to making an operation work in a new land. In addition, success can be seen to depend greatly on an understanding of the people--their culture, beliefs, and values -- and requires the drive and commitment to work within the system as it changes.

Assignment Questions

1. How has the cultural context in Moscow affected Pizza Hut's creation of its service-delivery system?

2. What expectations did the different parties involved--PepsiCo, Mosrestoranservise, new Pizza Hut workers, the customers, the suppliers--have? What impact do these have on the success of Pizza Hut in Moscow?

3. What has Pizza Hut done well in its Moscow restaurants? What should have been done differently?

This note was prepared by Sheilia Terranova under the supervision of Elliott N. Weiss, Associate Professor of Business Administration.

- No necessity to advertise: The Moscow government thought advertising was unnecessary, because the newness of Western companies entering Moscow was enough to promote the enterprise. Indeed PepsiCo's reputation allowed simple-word-of-mouth advertising to bring customers to the door. In general, companies in these environments

  cannot depend on market-research firms or advertising agencies to help gather information on consumer preferences or to advertise products and services; these services do not exist.

- Hiring employees: Three times the number of employees were hired for the Moscow restaurants than were normally hired in a Western Pizza Hut. These employees were also much better educated than employees in the West in similar positions. The employment pool was large, and many people jumped at the opportunity to leave their state jobs, make more money, and work for a Western firm. In some ways, Pizza Hut capitalized on the learning curve that McDonald's had started in teaching people about service. Because Soviet employment law required workers to work two days, with two days off and productivity was expected to be low, a larger number of employees needed to be hired.

  Pizza Hut established certain criteria for new employees (Employees were young, energetic people with another language and joint venture exposure), but as it turned out, these criteria did not create a permanent employee pool. Turnover was high. Workers evidently expected something different from a Western firm than what their old system offered. The high-quality candidates expected more, and when they did not receive it, they moved on.

- Training: Pizza Hut approached the management-training challenge by bringing managers to England to experience how Western restaurants operate. This move showed the managers a Western operation and prompted them to decide how to develop and implement a system in Moscow. Seeing an operation first hand is a more powerful tool than talking about how it works.

  Pizza Hut employees from other countries trained the 300 employees for two months prior to the opening, which helped build Pizza Hut's family atmosphere. The training for the initial group of employees was well planned, but training for employees starting after the first group lacked this detail.

  Full-service restaurants were a rarity in Moscow when Pizza Hut arrived, and the smallest details about serving and making the customer happy had to be explained. The "why" as well as the "how" needed to be taught.

- Customer: Pizza Hut segmented the market into three groups: Muscovites, with above-average earnings, Westerners, and the rest. Russians were not used to restaurants at the time, and whereas a Pizza Hut is considered a lower scaled restaurant in the US supplying the average American, in Moscow it was considered up scale and average people could not afford it. Hence, Pizza Hut geared its prices and service toward Westerners and more affluent Muscovites.

- Limited government assistance: Change and tensions were building during this time in the Soviet government. Pizza Hut was basically on its own to make the operation work.

2. Identifying the stakeholders' expectations of the joint venture casts a different light on the situation. PepsiCo wanted to expand its business in this part of the world. It already had a working relationship with the former Soviet Union, so Moscow was a logical place to open more operations. The public-relations benefits in the short term could be followed by a large market share in the long term. PepsiCo wanted Pizza Hut to be seen as a quality, full-service business.

The city of Moscow wanted foreign investment, transfer of skills and a new product for its people. The city wanted to be out of the loop and have Pizza Hut do the work to make the operation successful.

The customers wanted Western food and atmosphere. The average Russian wanted to be able to try Pizza Hut's food; the more affluent Russian wanted the prestige of eating at a Western restaurant.

The employees wanted to be treated like Western employees; they wanted to feel good about their work, be rewarded, be challenged, and maybe gain work security.

Of course, more stakeholders could be identified, but just by a few and seeing if their expectations match, the students can identify problem areas.

3. The risks of doing business in Moscow at this time (and now) were relatively high. PepsiCo's past relationships with the Soviet Union helped to form a partnership with the city of Moscow based on trust, mutual respect, and a clear understanding of each side's strengths and weaknesses. Altruism was partly behind Pizza Hut's motives, but the positive public relations that Pizza Hut received is hard to ignore as another motive.

The things that Pizza Hut did **well** in its Moscow restaurants were as follows:

- Spent time training and building trust with the initial group of employees. Pizza Hut did not instantly try to "westernize" but did ask managers to apply what they

In addition to young, energetic employees who speak a second language, Pizza Hut might consider other factors in order to add people who will stay at the restaurants. Knowing why people want to work for Pizza Hut (if they are highly educated for example, find out how this job fits into their goals), how flexible they are in working times, how reliable their transportation is to work, and asking employees to commit to a minimum contract time might eliminate some of the problems.

The incentive/reward program must keep the good employees so that quality can be maintained and training needs reduced. The system needs to penalize poor performance and reward exceptional service, and it need not be strictly monetary; awards to workers of the week, or other simple recognition methods, group functions for good service and sales, free pizza--all are examples that can make a difference in how people feel about their work.

Whether the Russians are ready to take over operation of the restaurant can be argued either way. Pizza Hut could make a mistake in this situation by evaluating the management only by "Western" standards; under those standards, the Russian management staff might never be ready to take over. The issue is more one of trust. Both Pizza hut that and the Russians have been in a learning process: Pizza Hut is learning to do business in Moscow, and the Russians are learning to demand quality in all areas of the operation. Both must be flexible and help the other understand the two environments.

Teaching Plan

The instructor can begin class by asking the students to describe the differences between opening a Pizza Hut in Chanute, Kansas, and Moscow, Russia. How do the approaches differ because of the working environments? Different issues can be highlighted by asking follow-up questions: How is the food (raw materials and final product) different and the same? How are the customers different and the same? How are the physical appearances of the restaurants different and the same? How is the service different and the same?

For the second question, asking the class to identify the expectations of the parties involved with the joint venture-PepsiCo, Mosrestoranservise, the customers, the workers, the suppliers--will help the class understand each group's desires, limitations, goals, and culture. Understanding those help them understand why they behaved or are behaving in a certain way. This discussion should underline the importance of businesses' understanding the people and the culture before investing in a new country.

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