

**CASES IN MANAGEMENT**  
in Eastern Central Europe  
and Russia

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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.

Business schools or schools of management prepare potential managers for the world of practical affairs. That world includes doing business in countries whose economies are in transition toward market economies. Overwhelmingly management books deal with private companies operating in a free enterprise environment. Although there are principles universal to all areas of management, certain concepts and techniques need to be adapted to the environments of the countries of Eastern Central Europe and Russia of the 1990's. This volume of cases and notes applies the major concepts of management to the business issues of this geographical area in this time of transition.

#### The Pedagogy.

Management education is professional training; its goal is to produce decision-makers and business practitioners, not theoreticians. The predominantly lecture method used in Eastern Central Europe and Russia is inadequate for management education. A mixture of lectures and case discussions is better. Case discussions encourage critical and independent thinking and force students to make decisions. Managers make decisions hourly, daily, weekly on matters large and small, and this decision focus needs to be replicated in the classroom. It is important that the students participate actively in the learning process - rather than passively listening to lectures -so that they can develop for themselves the analytical, organizational and communicational skills that they will need. Case discussion also encourages group discussions and group decision-making, both being prevalent in business.

A good case discussion produces a debate among students and the professor. It develops in the students an ability to listen to others, to raise appropriate questions and to arrive at a solution to the management issue or issues raised in the case. It also forces the students to prioritize the problems raised in the case so that they can address the really important ones, given the limited time available, just as in a business environment.

### 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.

### Acknowledgements.

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Leslie E. Grayson

Charlottesville, Virginia, USA  
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# **BUSINESS STRATEGY**

## THE CSEPEL MACHINE TOOL COMPANY

Gabor Hajnoczy, the managing general director of Csepel Machine Tool Company, knew the time had come to put together a strategy for this Hungarian firm, but a number of issues stood in the way. Should Csepel replace the plant's kerosene lanterns with electric lights? How could its creditors be persuaded to wait a few more months for payment? Could Csepel make do with the existing pool of bicycles for interplant transportation? (Although still usable, they weren't very stylish.) Hajnoczy hoped to confer with American manufacturing experts during his upcoming trip to the United States. Perhaps he could bring home some innovative management ideas from the business school he expected to visit.

The year 1989 seemed to be good for the Csepel Machine Tool Company. Since 1985 sales had increased an average of 7.5 percent a year despite Hungary's financial crisis through most of the 1980s. Management had been able to lessen the firm's dependence on domestic sales (particularly important because of Hungary's stagnant economy), and it had increased its vital hard-currency sales 23 percent in just 1 year.

Something, however, was seriously wrong. After allowing for Hungary's double-digit inflation, sales revenues were actually falling, and high costs were causing profits to decline. Accordingly, various managers questioned Csepel's customizing strategy, with its high attendant manufacturing costs, and called for the institution of strict cost controls and a modernization of the company's aging product line, a legacy of the past government's central-planning investment in outdated technology. Csepel faced the upcoming decade with a number of thorny issues and problems and no clear course of direction.

## MACHINE TOOLS AND THE MACHINE-TOOL INDUSTRY

The demand for machine tools (tools using rotary motion to smooth, sharpen, or otherwise "machine" surfaces) in 1990 was highly dependent on the amount of metal-working activity conducted in both heavy and light industry. Automobile manufacturers

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This case was prepared by Joseph Wolfe of the University of Tulsa and the International Management Center (IMC), Budapest, Hungary, and Jozsef Poor of IMC. Revised by Professor Leslie E. Grayson, University of Virginia. Copyright © 1991 by the Darden Graduate Business School Foundation, Charlottesville, VA.

and their suppliers had been the largest customers. Therefore, the demand for machine tools during the 1980s had been high in Western Europe and Japan and relatively low in the United States and Canada, as the Big Three car manufacturers deferred their purchases in the face of losses.

Machine-tool manufacturers in the United States had been faced with a sales growth that was less than growth in gross national product and profit margins of only 2.03 percent of sales. Thus, they had been forced to restructure or diversify out of the industry. In the near term, demand for machine tools by American automobile manufacturers was not expected to rebound. At the same time, as new materials replaced iron and steel, developing new technology to machine these new materials became important.

On the other hand, Japanese machine-tool manufacturers had been relatively bullish on the long-term prospects for the industry. They had been developing machines with improved efficiency and higher end-product quality and had been broadening the product lines they exported to the United States and other world markets.

## **THE HUNGARIAN ENVIRONMENT**

Hungary was a relatively industrialized country in 1990; the industrial sector, generating about 40 percent of the gross domestic product (GDP), provided employment for over 40 percent of the labor force and accounted for about 75 percent of the country's merchandise exports. The economy was highly trade dependent, with over 40 percent of the GDP traded internationally. Hungary traded with two markets--the socialists, primarily CMEA countries, and the Free World. The CMEA (Council for Mutual Economic Assistance or COMECON) was a political and economic union of most East European countries that governed trade and investment between member states.

Hungary's central-planning method had led to many market inefficiencies. It encouraged firm managers to hide the genuine capabilities of their firms and to obtain easy plans that could be achieved even if supplies did not arrive on time. Furthermore, under this system, the administered prices reflected neither resource abundance or scarcity nor world market prices. Enterprises were unable to perform economic evaluations of investment projects or determine the proper mix of imports and exports, which reinforced the need for central control of production, investment, and foreign trade.

In 1980 a new wave of reform was begun to increase the competitiveness of the economy in the international market, which would, the reformers hoped, generate hard-currency exports to service the country's foreign debt. The economy also faced a labor

shortage because of very slow growth in population and labor productivity. The only way to increase economic growth and generate hard currency was considered to be increasing labor productivity. The newest reforms were intended to create more market functions in the allocation of credit and to improve individual firms' access to export markets.

As with other formerly centrally planned economies, Hungary's industries in 1990 faced difficult problems as they attempted to join the world's markets. One of the thorniest problems within the Hungarian reform process concerned trade between Hungary and various Eastern European countries, particularly the Soviet Union. The trade relations with these countries were not based on the principle of free markets and had little to do with the world economy. Rather, each country in the East Bloc was assigned in quota, which was determined years in advance at rather inflexible prices. Settlement of accounts took place with transfer rubles. Rubles had very restrictive liquidation policies attached to them; they were only accepted as payment by the country that initially paid them. In other words, if Hungary sold machine tools to Poland, and Poland paid in transfer rubles, Hungary could not use those rubles to buy metal in Czechoslovakia. Hungary's own currency, the forint, had been overvalued by about 20 percent since the late 1970s. Although the forint was not convertible in 1990, the government did attempt to maintain its value at a rate close to true conversion through periodic devaluations.

### **THE CSEPEL COMPLEX**

The Csepel Machine Tool Company had its origins in the Manfred Weiss manufacturing complex, which manufactured primarily iron, steel, and military equipment in the late 19th century. By 1929 the company was also producing bicycles and airplanes as well as machine tools for its own use. In 1930 the company began to sell machine tools to other firms both inside and outside Hungary.

In the early 1940s, having formally declared war on the USSR, Great Britain, and the United States, the company supplied the Axis war effort under the guise of the Hermann Goering Werke. The Weiss family had been forced out.

After a series of military defeats, Hungary made peaceful overtures toward the Allies. In 1944, however, German forces occupied the country, a right-wing puppet regime was installed, and more than 450,000 Hungarians were deported to German extermination camps in Poland. Soviet troops invaded in the fall of 1944, and Hungary was forced to sign an armistice with the Allies in Moscow. Under Soviet military occupation, Hungary restored full diplomatic relations with Moscow and signed a long-term agreement with the USSR allowing close Soviet control of Hungary's domestic economy. In effect, Hungary became a Soviet puppet. Under a Three Year Plan

introduced in 1947, the government nationalized nearly 600 industrial firms, including Manfred Wiess, which became the Csepel Iron and Metalworking Trust.

From its nationalization in 1946 until 1983, the company operated within various Soviet industrial concepts. Hungary had a centralized form of economy characterized by a rigid top-down approach to macro- and microeconomic planning. A Hungarian Council of Ministers set output targets drawn up by a Central Planning Office. Targets were intended to ensure economic growth at a predetermined rate. Each state-owned company received hundreds, even thousands, of performance targets every year.

Performance targets fell into four broad categories: physical output goals; input goals regarding material and parts specifications, as well as supplier references, labor quotas, and wage allowances; financial guidelines for profits, maximum allowable debt capacity, and production costs; and strategic instructions covering new product and technology introductions and various capital investments to be made over the course of the year. While all plan elements were mandatory, some carried greater weight than others.

The state government assumed control of Csepel's import/export effort through the Ministry of Commerce, and the company's R&D function was transferred to the Institution for Mechanical Industry Research in Budapest. During this time, the company expanded its physical facilities and diversified its product line from drilling and milling machines to include lathes, grinding machines, and other precision equipment.

Hungary began moving from a planned economy to a market economy through various reform movements initiated in 1968. In late 1983, the company reorganized into an independent state-owned company. One of Hungary's largest industrial conglomerates, it was divided into 13 autonomous companies ranging from a bicycle venture to an education-and-development company. The new entity faced a difficult period, because it was burdened with nearly 700 million forints of debt and delinquent accounts receivable of 500 million. This situation forced the company to find new sources of cash to stabilize its operations.

In 1986 the company obtained equity financing by transforming itself into a publicly held shareholder corporation in an effort to allow the market to determine investment and capital formation. With this step, Csepel became a pioneer within the Hungarian economy. (Although the government had encouraged the creation of several secondary financial markets, including the first bond market in a communist country in 1984, a stock market was not established until 1989, at which time shares were issued in state-owned companies.)

In October 1988, the company split into two stock corporations: the Csepel Machine Tool Company and the Csepel Fixture and Tool Corporation. The Csepel

Machine Tool Company (see organization structure in Exhibit 1), capitalized at 860 million forints, manufactured drilling and milling machines, lathes, and machining centers. The Csepel Fixture and Tool Corporation, capitalized at 160 million forints, manufactured small fixtures, tools, and parts.

While Csepel's sales continued to climb, to about 2.6 billion forints in 1989, the firm's profits declined after the peak in 1987 (see Exhibit 2). Company financial statements are in Exhibits 3 and 4; Exhibit 5 displays the source of Csepel's sales by general market areas for 1985-1989. Over the next 3 to 4 years, Csepel expected to boost its sales to over 3.5 billion forints. Forecasts for 1990 revenues ranged from 2.05 to 2.19 billion forints and for profits from -55.6 to 66.6 million forints. Included in this amount was an estimated 700 million forints in new contracts for parts under joint ventures with Western companies to take advantage of recent government programs freeing import and export restrictions. Csepel's joint-venture activities were part of a planned revival of the flourishing business the firm had with the West in the 1970s.

The Foreign Investments Act of 1988 gave Hungary one of the most liberal foreign-investment environments in Eastern Europe. Foreign investors were assured freedom from adverse discrimination, compensation in original currency in the event of nationalization, the right to own up to 100 percent of firms, and the ability to transfer abroad dividends and up to 50 percent of wages. A big stumbling block for foreign investors in Hungary was eliminated in 1989 when investors' profits were allowed to be repatriated in convertible currency. To encourage international trade further, the government established reciprocal trade agreements with 25 countries, including France, Ireland, India, and China.

Within the Hungarian economy itself, Csepel was one of only 3 machine-tool manufacturers. Of them, SZIM Machine Tool Company, with 10 billion forints in revenue, was the largest. The other domestic competitor, DIGEP Mechanical Factory, had only 0.3 billion forints in revenue.

## **PRODUCTS AND NEW-PRODUCT DEVELOPMENT**

The Csepel Machine Tool Company produced five types of machine tools: radial drilling machines, computer numerically controlled (CNC) machining centers, CNC lathes, high-precision systems, and special-purpose systems. Exhibit 6 provides details of Csepel's product line. As can be seen, Csepel received different prices for its products in different geographical markets. In addition to standard products, Csepel made a significant amount of orders to customer specification; the proportion of custom work ranged from 2 percent of radial drilling machines to 100 percent of special-purpose systems. Csepel's products had gained a reputation for quality and low prices, and the company had no difficulty obtaining custom orders.

The slow rate of new-product development at Csepel was a major source of concern within the company. A shortage of skilled labor existed, and despite 58 state-supported colleges and universities, only 7.9 percent of the adult population possessed a university degree. In the words of Levente Godri, the Central Plant's chief designer,

We don't have enough engineers in the first place, and those we do have get too involved in daily operations--so much so, they don't have any time to do new-product development. We could hire some good people from the Technical University in Budapest, and they could staff a new R&D Department, but I don't know if that would really solve our problem.

Whatever we're doing, we have to do a better job than we're doing now. Unfortunately, our bonus system is based on the on-time delivery of machines, so our R&D people spend time in the shop helping to get orders delivered instead of spending time developing new products.

In the middle of this explanation, as if to underscore Godri's observations, the leader of the CNC-Assembly Machining Shop telephoned to demand that an engineer be sent immediately to the production unit to make a substitute part in the Maintenance Department. Godri sent the engineer, even though each shop had an on-duty technical assistant to handle these minor crises. He explained that this type of problem persisted because Csepel's part-numbering system did not disclose or cross-reference part substitutions.

In addition to the problems listed by Godri, the company's R&D expenditures had fluctuated widely in the past four years. They rose from 27.1 million forints in 1986 to 81.2 million in 1987, then declined to 55.7 million in 1988 and 18.7 million in 1989. Budgeted R&D for 1990 totaled 15.0 million forints.

## **FACTORIES AND MANUFACTURING OPERATIONS**

The company manufactured its machine tools and parts in two locations. The Central Plant and executive offices were in Budapest, and the second plant was located in Nyirbator, a city of about 30,000 people in northeastern Hungary. The specialization of the plants prevented either plant from building a complete machine tool. The Nyirbator Plant focused mainly on parts fabrication and subassembly, while the Central Plant produced some parts and completed final assemblies of the machine tools.

Outside experts considered the manufacturing equipment and techniques at both plants to be outdated and inefficient, although the newer Nyirbator Plant was slightly better. Overall, about 15 percent of the production equipment was less than 10 years old, 37 percent was 11 to 20 years old, and 48 percent was over 20 years old. The firm



owned only 24 numerically controlled machines (standard production equipment for the most modern machine manufacturers), and 59 percent of its equipment had been fully depreciated to scrap value.

Although maintenance and repair of the older manufacturing equipment consumed significant resources, replacement of old equipment would require large investments. Experts estimated that \$4.7 to \$6.0 million would be required to modernize Csepel's production equipment. In addition, \$12.0 million would be needed to introduce advanced production control and information systems and to provide the necessary production resources to extend the current product lines.

In the past, engineers and a highly skilled work force had bridged the technological gap at Csepel. By 1989, however, the workers had become dissatisfied with the working conditions and forced overtime. Consequently, the Central Plant had begun losing its cross-trained senior factory technicians and their trainees to local private-sector machine shops and small factories in the area. The Nyirbator Plant had not experienced as much of a loss because of limited alternative employment opportunities in that area.

The employment dilemma was exacerbated by Hungary's problems in human resources. Its population of 10.6 million had been declining since 1985, and the size of the work force fell 3.4 percent in the 1980s. The population was expected to continue to decline at an annual rate of about 0.15 percent, despite the government's attempts to reverse the trend. Many Hungarian workers were excessively tired from working multiple jobs or, alternatively, lacked dedication to their principal employer. Some observers believed that the labor force had begun to work itself to the point of psychological and physical exhaustion.

### **Central Plant Operations**

About 5 percent of the company's 24,000 parts and subassemblies were manufactured in the Central Plant. (The other 95 percent were manufactured by the Nyirbator Plant or were purchased.) The Central Plant handled parts requiring extreme accuracy and/or state-of-the-art technology. The nature of the products and the availability of production equipment in the Central Plant had led to a complex manufacturing process and material flow (see Exhibit 7). The plant layout was not rational, although efforts were underway to improve it.

Manufacturing Operations at the Central Plant produced a monthly manufacturing schedule for both Central and Nyirbator. Based on the sales forecast, the department also produced a portfolio of shop cards (raw-material requisitions) and time and labor charges by order number. The complete portfolio went to the Production Department, which launched a new shop order to the shop manager. The shop manager assigned the

order to a shop foreman, who scheduled the workers and the tools and gathered the raw materials as required by the shop order. Each worker inspected his/her own work and signed off on the order as the assignment was completed.

A conversation with Arpad Koknya, deputy general director in charge of the Central Plant's manufacturing operations, revealed certain problems in the planning and manufacturing process:

We have a stupid quality-control system that works well for simple, small things, but for complicated subassemblies like ours, it doesn't work so well. It can really cause big problems if the assembly is produced in a number of steps.

The system is a mixture of worker self-inspection and staff quality-control inspection. The worker says whether his own part is good or not, while the Quality Control Department looks at the entire subassembly when it's complete. Many of our workers sign off that their work is up to standard, but it isn't, and we don't find out about it until it shows up in the final assembly or, even worse, after its been delivered. We should really punish these guys, but the present employment situation (shortage of labor) doesn't allow us to do this. The quantitative bonus system we use in parts production adds to this problem.

Parts scheduling also causes problems. Each month our department sets up a parts shortage list (PSL). The PSL contains a list of final products and all the missing parts, along with the part identification number required to complete that product. This list is a key input into the parts-manufacturing operation. Items on the PSL get higher priority on the production schedule. Unfortunately, the computer can't handle the six-plus-one-digit code number very well, so a lot of part searches kick out "Out of Stock" messages even though they're really in stock. Too often we're making parts we don't need on a high-priority basis, which slows up our regular production.

Creating a production plan for assembly operations isn't complicated, but coordinating the production is difficult. Because of how sales orders come in, we only have to deliver about 20 units per month in the first part of the year, but about 60 to 100 units a month in the last part. Workers get very overworked by the end of the year; sometimes our best workers get sick from stress. But life isn't so easy for management either. These swings in production cause headaches for everybody. If the Sales Department could just forecast sales better, we'd have fewer problems down the line.

Exhibit 8 provides information on inventory levels for Csepel.

### **Nyirbator Plant**

The Nyirbator Plant was originally created to manufacture parts for all Csepel products, under the government's plan to bring industrial economic development to the country's rural areas. Currently, the plant produced the company's basic drilling machines and parts for all other machine types. The original labor supply was drawn from unskilled agricultural workers, who had to be intensively trained in company-run technical training programs. Over the years, Csepel had been a strong supporter of the city's technical school, which was now the firm's major source of skilled labor. In 1989 the plant employed about 740 people, and it generated sales of 649.1 million forints. The plant's manufacturing flow is shown in Exhibit 9, and its organization in Exhibit 10.

Managers at the Nyirbator Plant believed they were unnecessarily constrained by Csepel management. The drilling-machine plant's director of Economic Matters, Janos Fazekas, described several issues of contention:

First of all, our plant has to manufacture Csepel's low-profit items. As bad as that is, many times we get urgent orders by FAX from the Central Plant, which forces us to shut down our machines to supply them. We argue about these things all the time.

We want to be more independent and to have more power in these discussions with Production Control and Planning. These departments consider us to be their slaves and don't consider our specific bottleneck problems, and they continue to bother us with their special orders, which overuse our special machines.

Also, headquarters' sales operations are very slow in processing domestic orders. We could do a faster job on these sales if we could set up our own sales department.

Nyirbator's Engineering director, Istvan Szatmari, thought his department should be free to pursue new-product designs for the facility:

In recent years, we've brought in new engineers for new-product development, but all their time is spent in operations. They want to design new tools but can't. We're also in conflict with the Central Plant's R&D operations, because they won't give us the freedom to operate on our own.

The Nyirbator Plant was approximately 250 kilometers from headquarters. The telephone service at the plant was spotty, and the internal auditing controls lax. The Nyirbator managers occasionally took advantage of these conditions to evade Csepel's control. In one instance, they were able to buy a nonauthorized Xerox machine by listing it as a production part.

## HEADQUARTERS OPERATIONS

Except for Istvan Rakoczy, the head of the company's computer services, Csepel's headquarters staff had been promoted after long service in production. Hajnoczy, the managing general director, exemplified their pace and management style. Two or three mornings a week, beginning just after the shift opened, he toured the plants' shops with Koknya. These rounds, which were conducted at both plants, could last up to three hours and occurred more often if problems were plaguing a particular production run. Hajnoczy was very familiar with the plant operations and knew many employees on a first-name basis. Should he see something that appeared to be wrong, he would immediately order a change in either the production method or the order's schedule.

Hajnoczy was closely involved with many plant activities. During a two-hour afternoon conversation, he was interrupted many times by short telephone calls from plant personnel and brief conferences with his secretary. He also had to sign a number of technical orders and a request for computer supplies. Several lengthy telephone calls dealt with decisions about where pieces of shop equipment should be placed for a shop-floor layout change that was underway.

Although some employees appreciated the accessibility of top management and their intimate working knowledge of plant operations, others thought they showed too much concern for production and the bonuses attached to on-time production deliveries at the expense of other company functions. The head of the Central Plant's Sales Department, Gabor Nagy, commented:

Sometimes our general manager gets orders on his own when he's out in the field . . . and when he comes back, he simply gives these orders directly to the Production Department. This is bad for us in Sales, because we can't tell how effective we've been. We don't know if we got the order because of him or because we had been developing the same customer over the past few months. By doing things this way, we can't tell why the sale was ever made. . . . Top management's manufacturing bias is the company's major problem; it keeps us from being flexible.

Nagy was also concerned about Technoimpex, Csepel's foreign-trading firm. Lately, Technoimpex had broadened its product line and de-emphasized machine tools.

As a result, Csepel now employed service representatives in Romania, West Germany, and the United States to boost sales and service quality. In countries where Csepel had no representatives, it used Austria's Intertrade, a steel and machine-tool specialist.

## LOOKING TO THE FUTURE

For Istvan Rakoczy, head of Organization and Computing, exciting years were ahead:

I've recently convinced top management they should buy the MAS-MCS [Management Accounting System-Management Control System] integrated software package from the British software firm Hoykens. It's being introduced at the Hungarian firms VIDETON, BHG, and SZIM, and it's a system that can manage the MIS [management information system] problems for a company our size--production planning, all the paperwork controls, operations scheduling, and operations finance.

We bought a used IBM 4361 from a German firm late last year. We are installing 70 work stations at the Central Plant, as well as some in Nyirbator. It's the first time we've tried to implement a real integrated management system. It'll cost the company nearly 100 million forints, but it should be completed in 1991. If this implementation is successful, I'd like to make the department into a separate money-making operation. This would allow us to serve Csepel, keep our own people busy, and help them earn more money.

For Peter Toth, general manager of Economic Matters, the future was a bit more cloudy. The order book was low (particularly for domestic clients), prices were rising overall, the government was cutting support for CMEA exports, and optimal production lot sizes had not been established. Exhibit 11 contains three scenarios developed by Toth after consulting top management. The scenarios, ranging from "pessimistic" (A) to "optimistic" (C), made assumptions regarding the growth of the economy and Csepel's market penetration. Toth's suggestions for improving 1990's company performance entailed the following:

- dismiss 15 percent of all personnel (about 200 employees);
- raise the salaries of all remaining personnel by 20 percent;
- reduce costs in general, including the stock level of various finished goods;

- investigate opportunities for new ruble exports;
- maintain the company's traditionally good relationships with its creditors;
- accelerate the rate at which products are delivered to customers;
- find a joint-venture partner.

Exhibit 1

THE CSEPEL MACHINE TOOL COMPANY

Organization Chart

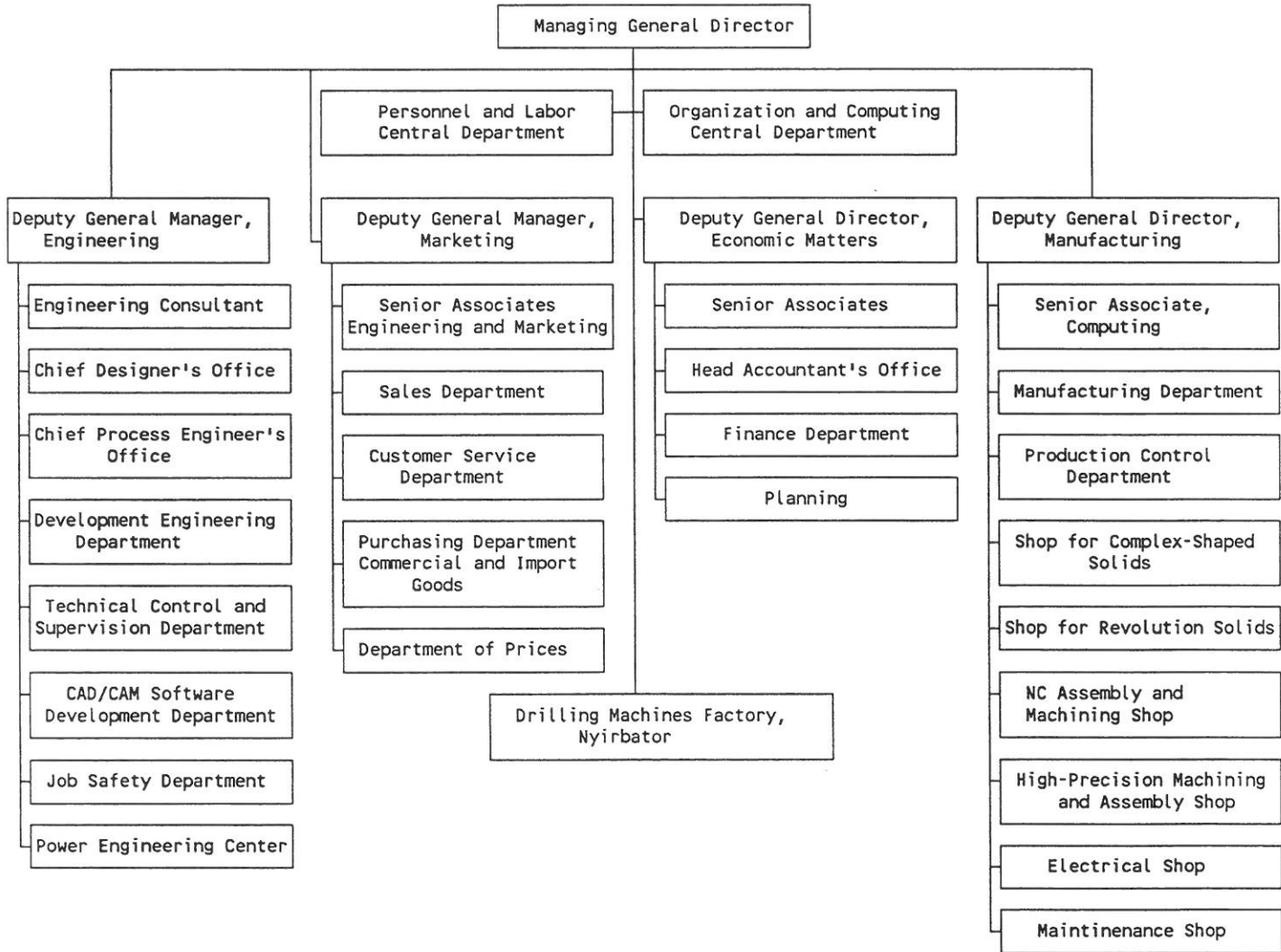
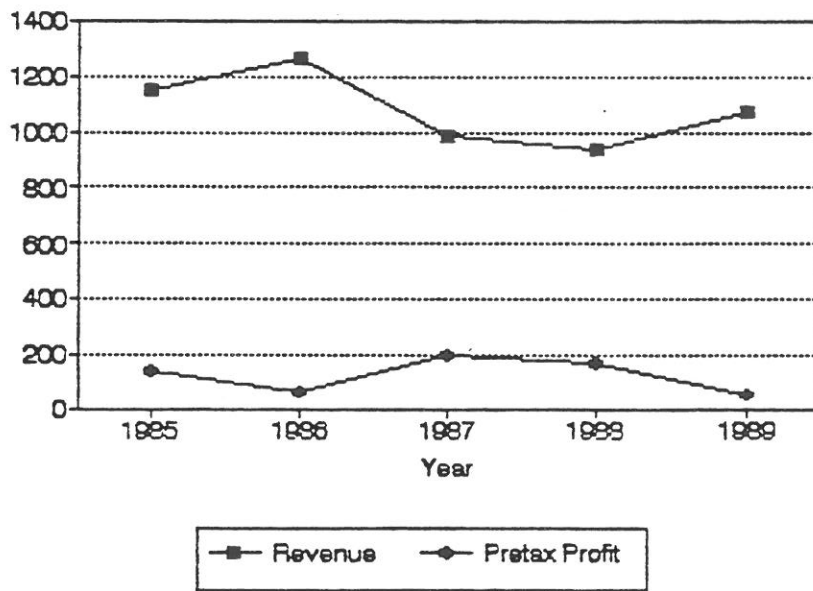


Exhibit 2

THE CSEPEL MACHINE TOOL COMPANY

Sales and Profits, 1985-1989  
(millions of forints)





## Exhibit 3

## THE CSEPEL MACHINE TOOL COMPANY

Income Statements  
(unaudited; in thousands of forints)

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Revenues					
Domestic	484.7	605.8	814.2	567.0	542.5
Exports					
CMEA* ruble market	352.8	466.4	694.7	981.4	1,058.9
Hard currency	<u>1,151.0</u>	<u>1,263.6</u>	<u>982.2</u>	<u>898.1</u>	<u>1,016.9</u>
Total	1,988.6	2,335.8	2,491.1	2,446.5	2,618.3
Direct manufacturing cost	<u>1,044.4</u>	<u>1,173.7</u>	<u>1,277.8</u>	<u>1,294.7</u>	<u>1,385.8</u>
Operating profit	944.2	1,162.2	1,213.3	1,151.8	1,232.5
Overhead cost					
Factory overhead	351.2	478.0	478.4	282.0	352.6
Admin. overhead	325.5	293.8	299.2	505.8	689.8
R&D expense	37.3	27.1	81.2	55.7	18.7
Customer service	11.3	16.2	12.5	22.1	17.0
Land rent	4.0	3.7	0.0	0.0	0.0
Miscellaneous	<u>53.4</u>	<u>64.9</u>	<u>70.4</u>	<u>97.1</u>	<u>8.1</u>
Total	782.7	883.7	941.7	962.7	1,086.2
Additional expenses	156.3	129.8	107.4	62.9	137.2
Other income					
Export support	123.0	16.0	60.7	0.0	0.0
Ministry support	2.1	35.7	79.1	129.2	35.1
R&D subsidy	5.0	0.0	51.2	35.7	5.9
Vendor penalties	6.1	2.4	2.4	0.0	3.4
Other	<u>2.5</u>	<u>5.7</u>	<u>3.0</u>	<u>0.0</u>	<u>8.3</u>
Total	138.7	59.8	196.4	164.9	52.7
Profit before taxes	143.9	208.4	360.6	291.1	61.8
Taxes	<u>109.6</u>	<u>133.1</u>	<u>151.4</u>	<u>49.3</u>	<u>.3</u>
Profit after taxes	34.1	75.3	209.2	241.8	61.5

\*Council for Mutual Economic Assistance.

## Exhibit 4

## THE CSEPEL MACHINE TOOL COMPANY

Balance Sheets  
(unaudited; in millions of forints)

	<u>1988</u>	<u>1989</u>
<b>ASSETS</b>		
Current assets		
Cash	1,139	3,230
Bank account	32,646	16,276
Additional accounts	13,896	-32,949
Bonds	-0-	-0-
Domestic buyer	203,731	192,807
Foreign buyer	<u>666,332</u>	<u>978,162</u>
Total	917,744	1,157,526
Employee fund	657	-0-
State budget fund	<u>-0-</u>	<u>2,882</u>
Total	870,720	1,173,851
Inventories		
Goods in process	192,216	216,533
Finished goods	<u>36,315</u>	<u>23,362</u>
Total	229,687	239,895
Raw material	428,644	678,293
Purchased stocks	<u>123,201</u>	<u>99,229</u>
Total	551,845	777,522
Total	781,532	1,017,417
Contingency fund	-0-	-0-
Other active accounts	257,231	45,158
Temporary account	<u>-0-</u>	<u>-0-</u>
Total	257,231	45,158
Shares held	6,000	228,000
Assets held	-0-	-0-
Foreign investments	<u>6,000</u>	<u>228,000</u>

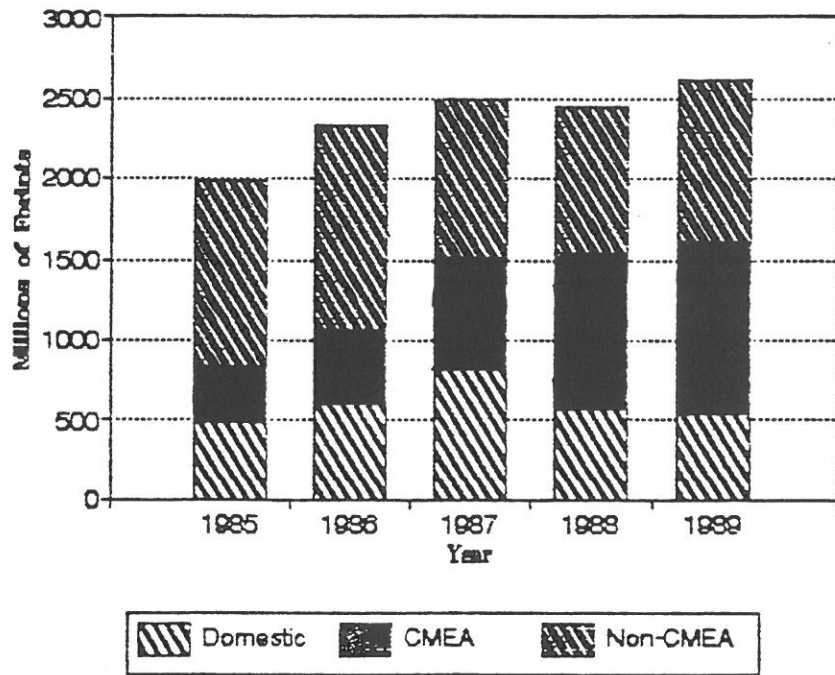
## Exhibit 4 (continued)

	<u>1988</u>	<u>1989</u>
Fixed plant and equip.	928,097	1,091,681
Less depreciation	735,634	786,716
Plant additions	<u>22,559</u>	<u>82,249</u>
Net book value	215,022	387,214
 Total assets	 2,177,030	 2,838,030
 <b>LIABILITIES</b>		
Accounts payable	-0-	840,399
Domestic deliverer	812,413	188,014
Foreign deliverer	89,070	221,510
Investment deliverer	24,962	12,935
Factoring	30,000	113,810
Creditors	308	36,144
Salaries payable	10,511	17,933
Soc. sec. payable	21,747	34,077
Prepaid taxes	- 125,762	- 33,389
Other accounts	<u>200,270</u>	<u>262,972</u>
Total	1,063,519	1,694,405
 Paid-in capital	 835,000	 835,000
Retained earnings	<u>- 99</u>	<u>323,344</u>
Total	834,901	1,158,344
 Income tax liability	 - 35,910	 - 53,613
Profit account	- 3,716	- 22,428
 Profit	 <u>318,236</u>	 <u>61,489</u>
 Total liabilities	 2,177,030	 2,838,197

Exhibit 5

**THE CSEPEL MACHINE TOOL COMPANY**

Sources of Sales, 1985-1989



## Exhibit 6

## THE CSEPEL MACHINE TOOL COMPANY

## 1989 Product Mix and Product Prices by Geographical Market

Machine Type	Model Number	Product Price (in thousands of forints)			CMEA Countries	Annual Production	Life-Cycle Position	Competitive Strength
		Hungarian Market	U.S. Dollar Market					
Radial drilling machines	RF-50	747.7	577.5	577.9	200 for	All very late	All weak	
	RFh-75	1,449.4	1,116.4	909.6	entire			
	RFh-100	2,015.7	2,056.1	1,558.2	group			
CNC machining centers	Yasda	n.a.*	23,951.4	n.a.	30 to 40	Early	Average	
	MK-500	11,683.4	9,460.0	12,072.9	35 to 55			
	MVI6	10,903.6	n.a.	n.a.	10 to 15			
	MVII0	11,989.6	13,294.9	n.a.	6 to 8			
CNC lathes	SDNC 610	8,951.5	10,581.9	6,566.2	35	Relative early	Strong	
	1000				to			
	SDNC 610	n.a.	4,742.4	8,464.1	50			
High-precision systems	RS-100	5,516.3	9,258.8	n.a.	15 to 25	Very early	Average	
	TCFM-100	1,616.2	n.a.	2,047.2	25 to 30			
High-precision systems	FKP-326-10	7,315.5	10,851.5	7,259.4	35 to 40	Mature	Weak	
	UP-1	15,726.0	n.a.	n.a.	5 to 10			
Special-purpose systems	PTC-71-180	n.a.	n.a.	4,431.7	10 to	Mature	Weak	
	SMC-71-180	n.a.	n.a.	5,539.8	15			

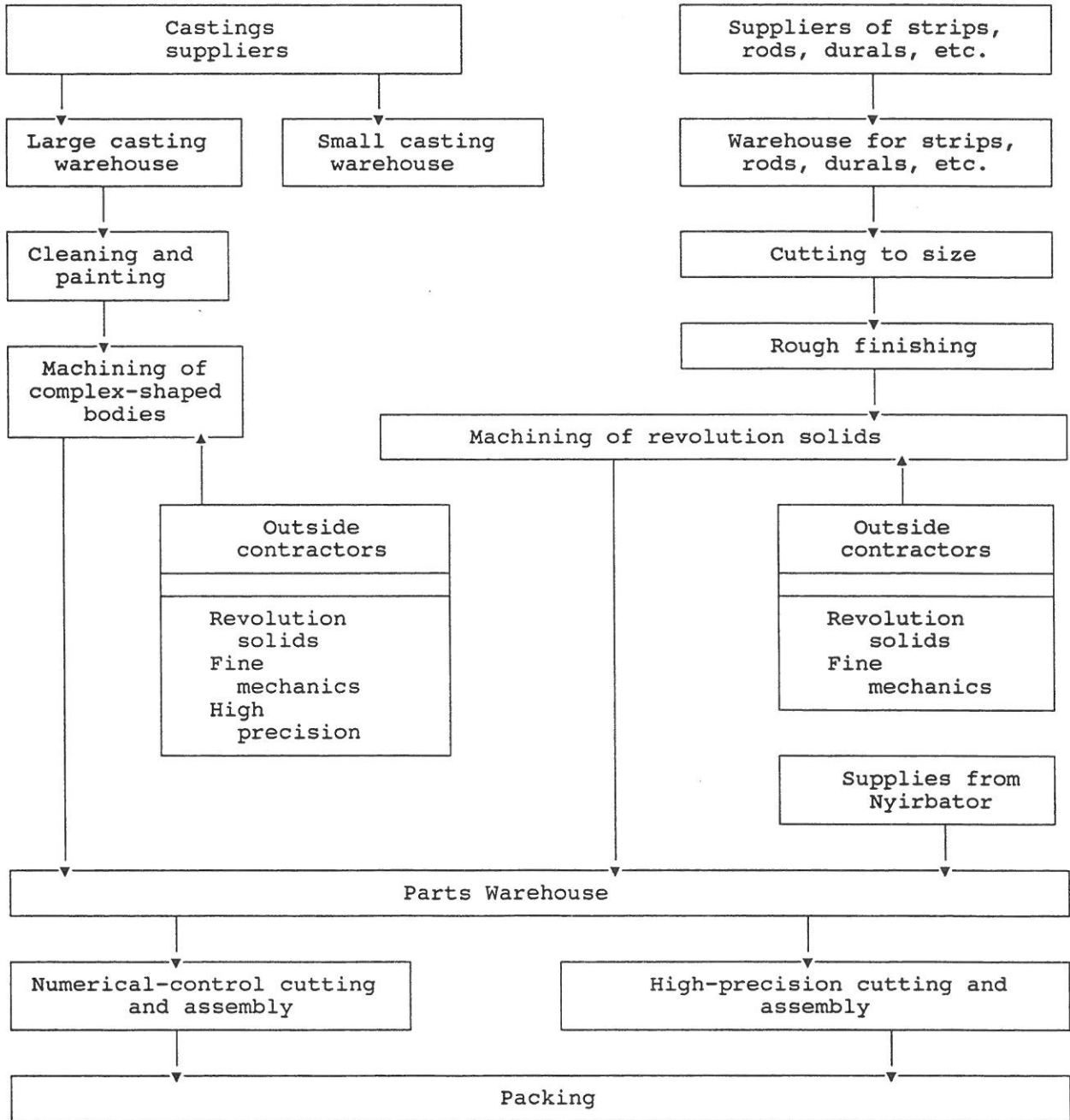
\*Product not available in this market.

Source: Company internal records and consultant's estimates.

Exhibit 7

THE CSEPEL MACHINE TOOL COMPANY

Central Plant Manufacturing Sequence



Note: About 5.0 percent of the company's 24,000 parts and subassemblies were manufactured in the Central Plant. The plant handled parts requiring extreme accuracy and/or state-of-the-art technology.

Exhibit 8

**THE CSEPEL MACHINE TOOL COMPANY**

Inventory Levels  
(in thousands of forints)

<u>Inventory Type</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Purchased stocks and raw materials	450.6	678.6	610.9	551.8	777.5
Goods in process	185.5	139.8	171.6	192.3	216.5
Finished goods	<u>15.5</u>	<u>17.4</u>	<u>31.8</u>	<u>36.3</u>	<u>10.0</u>
Total	651.7	635.2	814.3	780.4	1,017.4

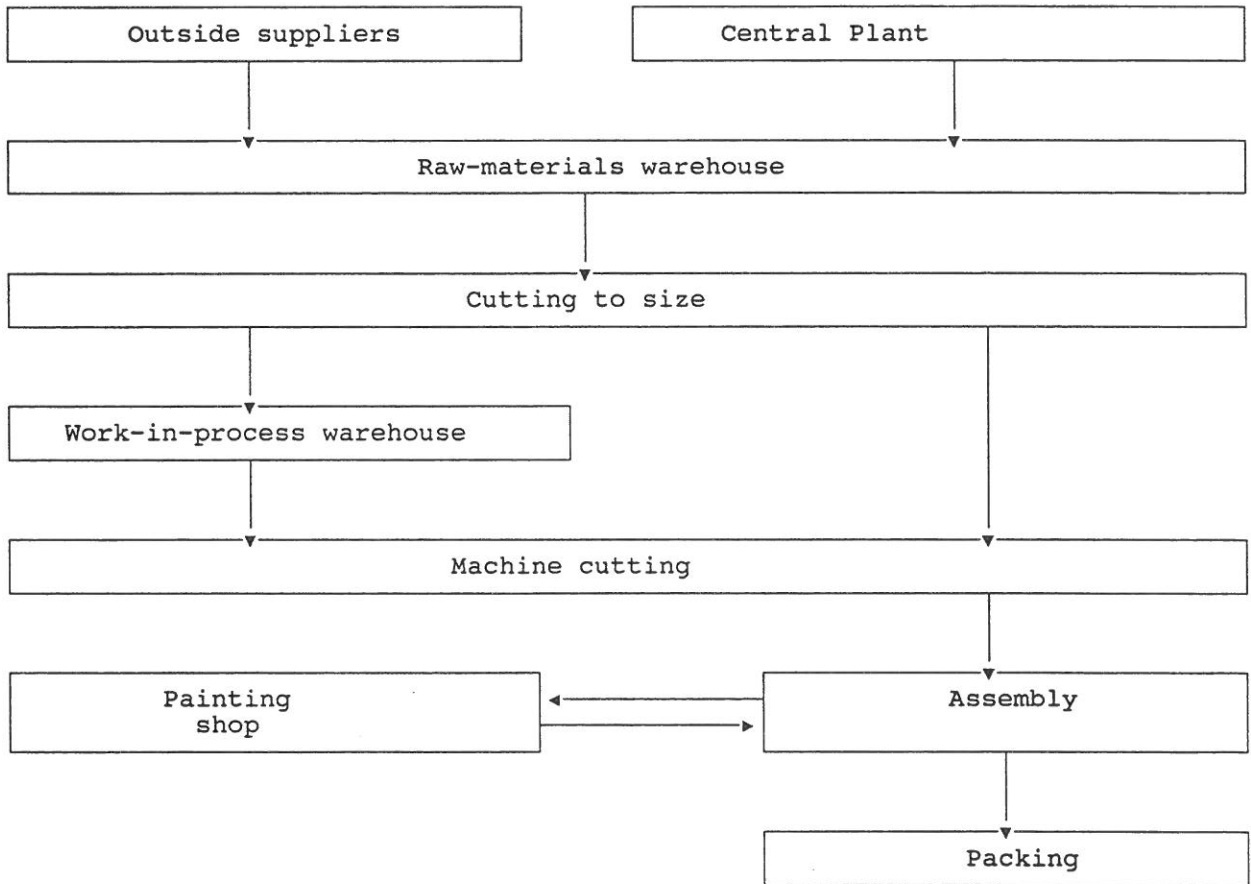
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Source: Internal company records.

Exhibit 9

THE CSEPEL MACHINE TOOL COMPANY

Nyirbator Manufacturing Sequence



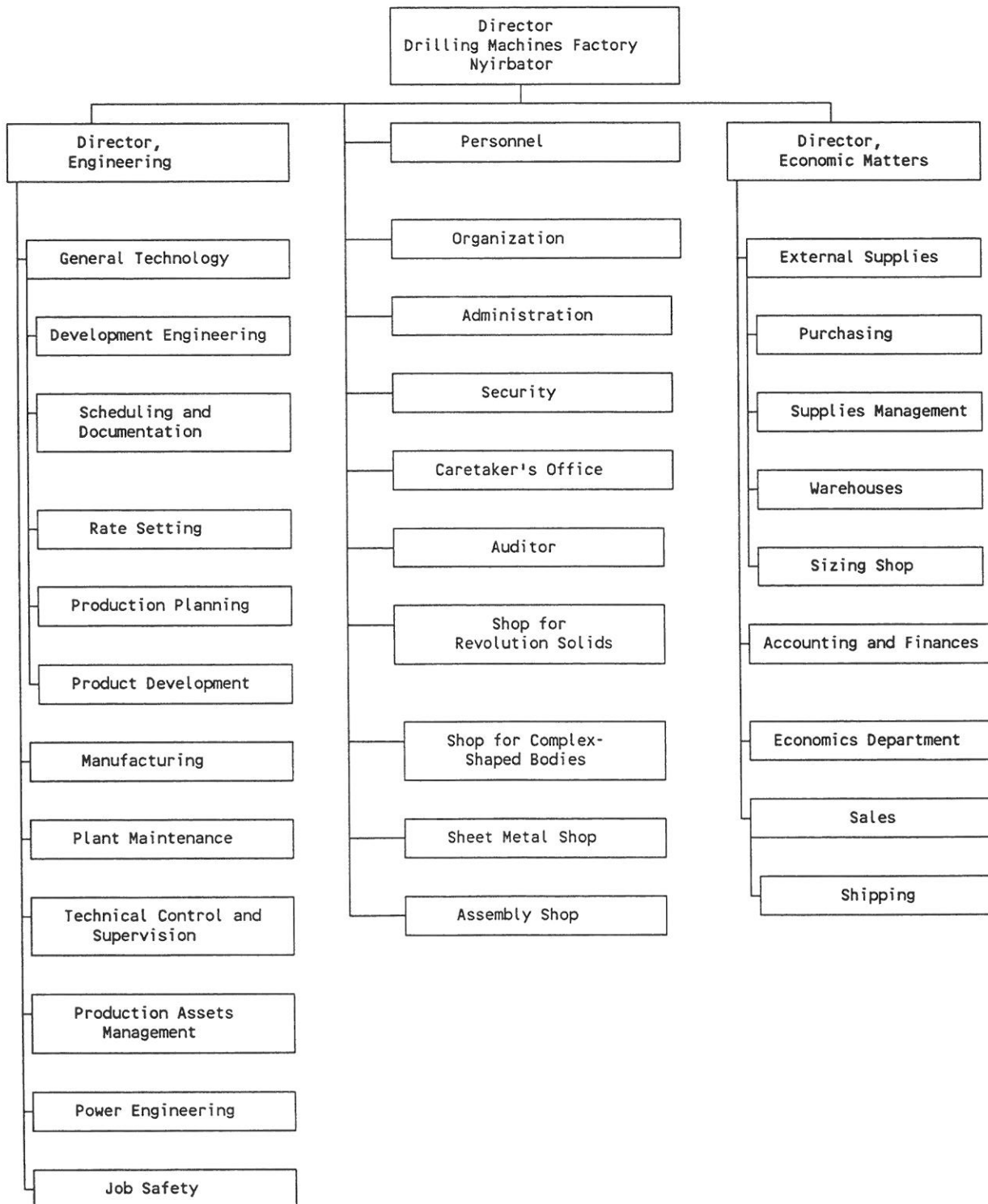
Notes: Almost 90 percent of Csepel's parts and subassemblies were manufactured in this factory. The process technology was simpler than that used in the Central Plant. Nyirbator's products were easier to assemble than those produced in the Central Plant, but their unit value was significantly lower. Except for high-precision parts, the plant was self-sufficient.



Exhibit 10

**THE CSEPEL MACHINE TOOL COMPANY**

Organization Chart for Nyirbator Plant



## Exhibit 11

## THE CSEPEL MACHINE TOOL COMPANY

1990 Pro Forma Income Statements Under Three Scenarios  
(in millions of forints)

	<u>A</u>	<u>B</u>	<u>C</u>
Revenues			
Domestic	407.0	430.0	450.0
Exports			
CMEA ruble market	648.0	231.4	130.0
Hard currency	<u>993.2</u>	<u>1,428.0</u>	<u>1,610.0</u>
Total	2,048.2	2,089.4	2,190.0
Manufacturing costs			
Direct	1,124.1	1,145.2	1,182.6
Overhead	<u>900.0</u>	<u>900.0</u>	<u>900.0</u>
Total	2,024.1	2,045.2	2,082.6
Other income			
U.S. dollar support	0.0	0.0	32.2
Ruble export	- 86.3	- 30.0	- 13.0
Profit before taxes	- 55.6	34.2	66.6
Less taxes	<u>0.0</u>	<u>17.1</u>	<u>33.3</u>
Profit after taxes	-55.6	17.1	33.3

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Source: Company internal forecast.

## TAURUS HUNGARIAN RUBBER WORKS

The management of Taurus Rubber Works had developed a new strategy in 1988 to respond to the changing business environment in Hungary. By 1990, however, the basic implementation of the company's diversification strategy had still not been accomplished. As director of the Corporate Development Division, Gyula Bosnyak recognized a critical need for his department to provide strategic leadership to the company in the new environment.

In early 1988, the Hungarian government had passed the Corporation Law, which put all state-owned firms on notice to privatize and recapitalize. As Hungary's state-owned rubber industry works, Taurus was thus faced with a number of issues. Not only did it have to deal with the mechanics of going public, it also had to obtain the ideal mix of debt and equity to ensure solid growth for a company in a stagnant economy and a low-growth industry.

The top managers of Taurus were concerned about the route they should follow in their attempts to invigorate the company. They accepted that Taurus had to maintain or improve its international competitiveness and that it had to diversify away from its traditional dependence on its noncompetitive, highly vulnerable manufacturing of truck and farm-equipment tires. Bosnyak had viewed the mandatory changes as an opportunity for Taurus to deal with its working-capital problem and begin serious diversification efforts.

After two years of deliberation and unsuccessful attempts at effecting change, Bosnyak was now sorting through his company's strategic options before making his recommendations to the vice president of the Technical Rubber Products Division and the company's newly elected president. To clarify the firm's options and its competitive threats, he set out to review industry conditions and the moves made by competitors in the tire industry during the last decade.

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This case was prepared by Joseph Wolfe of the University of Tulsa and the International Management Center (IMC), Budapest, Hungary; Gyula Bosnyak of Taurus Rubber Works; and Janos Vecsenyi of IMC. Revised by Professor Leslie E. Grayson, University of Virginia. Copyright © 1991, by the Darden Graduate Business School Foundation, Charlottesville, VA.

## THE CHANGING BUSINESS ENVIRONMENT IN HUNGARY

At the conclusion of World War II, Hungary signed a long-term agreement with the Soviet Union that gave the Soviets close control of Hungary's domestic economy and the Communist Party command of Hungary's political system. The Communist Party, or its successors, remained the only functioning political entity in Hungary until 1990, when the first freely elected parliament was placed in power.

From 1948 to 1968, Hungary's economic system mirrored that of the Soviet Union. It was a centralized economy characterized by a rigid, top-down approach to macro- and microeconomic planning intended to ensure economic growth at a predetermined rate. The state-owned companies received hundreds, even thousands, of performance targets every year. Managers had no control over these targets; therefore, they strove to meet only those performance criteria on which they were measured. The result was the limited ability of individual companies and the overall economy to react to changes in the global environment.

Between 1968 and 1980, the several reforms that were attempted to create an economy driven by market forces were met with opposition from staunch communist authorities. Not until 1980, when Hungary's gross domestic product and investment growth had stalled while consumption continued to grow at a brisk 10 percent annual rate and foreign debt increased to \$10 billion, was the government forced to implement economic reforms.

During the 1980s, numerous reforms were relaunched--to increase Hungary's international competitiveness, to service the foreign debt, and to generate hard currency. In order to establish a more realistic value for Hungary's nonconvertible currency than in the past, the government attempted to maintain the forint's value close to the black market rate through periodic devaluations. Other programs included the delegation of responsibility to employees to encourage decentralized management, creation of secondary financial markets, and the enactment of several laws that favored foreign direct investment. In addition, the Bankruptcy Law, introduced in 1986, laid the groundwork for more competitive and efficient companies by requiring all ineffective operations to declare bankruptcy and allowing reductions in employee levels. To further international trade, the government established reciprocal trade agreements with 25 countries.

These well-intentioned reforms failed to create a robust economy, however. As of 1990, Hungary was in a noncompetitive trading position, Hungarians were saving little, and banks lacked the investment capital needed to improve productivity and raise the standard of living. Government borrowing had increased foreign debt to more than \$19 billion. Most of this money went to finance consumption, fund ill-conceived investments, and service foreign debt--all of which impeded the government's ability to make

important investments. To compound these economic woes, Hungary was wrestling with labor shortages, rampant alcoholism, and high suicide rates.

## THE TIRE INDUSTRY

The tire industry was the major user of the world's rubber supply. Originally, the industry depended on natural rubber produced from trees in tropical countries. Synthetic rubber was developed in the 1930s, however, and in 1990 accounted for 70 percent of the world's rubber consumption.

The tire market was mature. The world market for rubber products was predicted to grow by only 2.7 percent annually between 1987 and 1992 (see Exhibits 1 and 2). With this maturation had come the internationalization of rubber firms, industry consolidation (driven by the large economies of scale needed to compete effectively in the market), and diversification of some major players into other industries.

Pressures on tire manufacturers included uncertainty over oil prices, unending price cutting, and chronic overcapacity among producers. Unable to raise prices as industry costs increased, producers had little choice but to cut costs to make money. Softness in the automobile market created considerable downward pressure on the prices auto makers were willing to pay for new tires, while competition in the replacement market forced companies to cut prices so deeply that profits were thinner in 1990 than they had been in decades.

The number of major international tire manufacturers was down from nine in the mid-1980s to seven: Bridgestone Corporation (Japan), Yokohama Corporation (Japan), Sumitomo Corporation (Japan), Continental Gummi-Werke AG (Germany), Goodyear Tire and Rubber Co. (U.S.), Michelin et Cie. (France), and Pirelli (Italy). Exhibits 3 and 4 detail the companies' sizes relative to Taurus, their relative market shares, and their profitability.

Bridgestone, the largest Japanese manufacturer of tires, pursued an aggressive growth strategy during the 1980s that culminated in its purchase of Firestone, America's troubled second-largest tire manufacturer, for \$2.6 billion. That move was controversial but was seen as essential by Bridgestone's top management to increase its market share in the United States. The firm planned to quadruple the output of its La Vergne, Tennessee, plant to supply the American market. Bridgestone was also seeking to gain market share in Europe and had a strong presence in Asia, the rest of the Pacific area, and South America, where Japanese trucks and cars were heavily marketed.

Continental was known as a premium-quality tire producer and held the number two position in European sales. It had purchased General Tire from GenCorp in June

1987 for \$625 million. That year it also entered into a \$200 million joint venture with Toyo Tire & Rubber Company and Yokohama Rubber Company to manufacture tires installed on Japanese cars shipped to the American market and truck and bus tires for cars made in the United States.

Cooper, a relatively small company, specialized in the replacement-tire market. Nearly half its sales were in private-label merchandise. Cooper had recently expanded capacity by 12 percent and planned to increase it another 10 percent by late 1990. About 60 percent of the firm's sales were in car tires, with the remainder in truck and bus tires.

Goodyear was the largest manufacturer of tires in the world until 1988, and it remained the largest U.S. tire firm in 1990. It was the only top-tier maker not to have merged in the last decade. It had yet to recover from a 1986 takeover attempt, however. To fight off the pursuit, Goodyear had sold its highly profitable aerospace division and took on over \$3 billion in debt, largely to finance a stock-repurchase plan.

During the 1980s, Goodyear diversified into the chemical, plastic, aerospace, and oil-pipeline businesses. Despite this diversification, 86 percent of sales and 76 percent of profits still resulted from the automotive products business. Sales growth had come from African and Latin American tire sales, where the company held a dominant market share.

Goodyear was expanding production capacity in Canada and South Korea by 12,000 tires a day per plant. The added capacity would come on line in 1991. The company was hoping to sell off its oil-pipeline business for \$1.4 billion, however, to reduce the \$275-million-a-year interest payments on its \$3.5 billion of debt.

Michelin overtook Goodyear as the world's biggest tire manufacturer when it purchased Uniroyal/Goodrich (merged in 1986) for \$690 million in late 1988. The purchase resulted in a 44.5 percent increase in sales for Michelin, although profits fell 11.1 percent. Michelin had also entered a joint venture with Okamoto of Japan to double Okamoto's capacity to 24,000 tires per day. Michelin's strength was in the truck-tire segment of the market.

Pirelli was known as a premium-tire manufacturer. Its initial attempts to enter the U.S. market by purchasing Firestone ended in frustration, but in 1988 it purchased the Armstrong Tire Company for \$190 million to gain a U.S. foothold. Armstrong's \$500 million annual sales were equally divided between original- and replacement-tire sales. By 1990 Pirelli was looking to other European companies for merger opportunities.

## TAURUS

The first rubber factory was established in Hungary in 1882. Prior to World War I, the Hungarian rubber sector held a .6 percent global market share, as the factory's rubber balls, toys, asbestos-rubber seals, and Palma heels gained a worldwide reputation for quality.

During World War I, however, the Hungarian rubber sector declined dramatically. Export sales dropped to a level between 15 percent and 18 percent of total production, factory equipment deteriorated, and global market share fell to .3 percent. Annual sales growth for the sector dropped to 1.5-2 percent a year, and only the rubber yarn and latex product lines were internationally competitive.

After World War II, the Hungarian government pursued a policy of extensive growth for its nationalized firms. From 1950 to 1970, the rubber sector's employment and gross fixed assets increased approximately 6.2 percent and 15.7 percent a year, respectively, and annual production increased 12.5 percent. Although growth was realized, inefficiencies occurred. Labor-utilization rates were low, and productivity ratios lagged 1.5 to 3 times behind that obtained by comparable socialist and advanced capitalist countries. While domestic sales and sales to CMEA (Council for Mutual Economic Assistance) countries appeared to support the sector's activities, little attention was paid to rationalizing production or product lines. The nationalized rubber firms produced products ranging from bicycle and automobile tires to rubber toys, boots, and raincoats.

As a result, the Hungarian government restructured its rubber industry. In 1963 Budapest's five rubber manufacturers (PALMA, Heureka, Tauril, Emerge, and Cordatic) were merged into the National Rubber Company. In addition to establishing locations in Vac, Nyiregyhaza, and Szeged, the new company centralized purchasing, cash management, R&D, and investment decisions. In a break from conducting affairs through centralized planning, the company pioneered the use of strategic planning.

In 1973 the National Rubber Company changed its name to Taurus Hungarian Rubber Works. In 1990 it operated rubber processing plants in Budapest, Nyiregyhaza, Szeged, Vac, and Mugi, as well as a machine- and mold-making factory in Budapest.

As shown in Exhibit 5, Taurus was organized into four divisions and a number of subsidiaries. Exhibit 6 summarizes the sales generated by each division in 1988 and 1989, as well as the assets and personnel dedicated to each operation. Exhibits 7 and 8 provide Taurus's full financial position. Corporate sales had increased annually to 20.7 billion forints by 1990, with a growing global emphasis:

Total Company Sales (in millions of forints)					
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Exports	4,055	4,517	5,349	6,843	7,950
Domestic	<u>9,979</u>	<u>11,174</u>	<u>12,255</u>	<u>12,056</u>	<u>12,716</u>
Total sales	14,034	15,691	17,604	18,899	20,666

Taurus's Tire Division manufactured bias-ply, all steel radial and textile radial tires for commercial (nonpassenger) vehicles. In 1988 truck tires accounted for 34 percent and farm tires for 20 percent of the division's total sales. Approximately 58 percent of the Tire Division's sales volume was exported, and the following countries composed the largest purchasers (in millions of forints):

United States	351.7
Algeria	298.2
Czechoslovakia	187.3
Germany	183.5
Yugoslavia	172.0

The Tire Division had recently expanded operations for its all-steel radial truck tire and anticipated that eleven new types of Taurus tires would enter the market in the near future. Two tire introductions were completed in 1988 and three were completed in early 1990. Through a licensing agreement with an American tire manufacturer, the division was also in the process of developing a new "supersingle" tire for the market.

Taurus's Technical Rubber Division manufactured and marketed rubber hoses, air springs, conveyor belts, waterproof sheeting, and camping gear. In 1988 the PALMA camping-gear line held a 15 percent global market share, and the rotary hose line held a 40 percent global market share. The division's sales volume was distributed as follows:

Large-bore, high-pressure hoses	6.7%
Rotary hoses	27.1
Hydraulic hoses	14.7
Air springs	5.3
Conveyor belts	14.3
Waterproof sheeting	13.9
Camping goods	18.0%



The demand for high-pressure and large-bore rubber hoses depended on offshore drilling activity; Taurus projected that demand for air springs would increase as the rubber air-spring technology gained acceptance with vehicle manufacturers. In 1988 the division's largest customer was the Soviet Union, with purchases of 380,000 forints.

In addition to outside sales, Taurus's Machines and Molds Division manufactured products to be used in-house as part of the company's overall manufacturing operations. In 1988 70 percent of the division's total sales were exported. Overall sales volume was distributed as follows:

Technical rubber molds	24.0%
Polyurethane molds	17.0
Machines and components	25.0
Tire-curing molds	34.0%

The Taurus Trade Division conducted CMEA purchases and sales for the company and performed autonomous distribution functions for other firms. Taurus expected this division to continue to function as Taurus's purchasing agent while increasing its outside trading activities.

## **IMPLEMENTING THE TAURUS STRATEGY OF STRATEGIC ALLIANCE**

Immediately after returning from his company's top-management conference, Bosnyak began collecting materials to confirm the tentative decisions that had been made at Lake Balaton. Based on secondary data collected and assembled into Exhibits 9 and 10, he could see the general rubber industry had fallen from a better-than-average industry growth performance in the 1960-1970 period to one that was far inferior to the industrial average during the 1980-1987 period. He also saw that other industries, such as data processing, aircraft, medical equipment, and telecommunication equipment, had obtained sizable growth rates from 1977 to 1987. Moreover, he was extremely aware of the increasing concentration occurring in the tire industry and most major rubber companies' diversification moves. The rubber industry's tires segment had obviously passed into its mature stage. For 1987, Bosnyak listed the various strategic alliances shown in Exhibit 11. The diversification activities of Taurus's major tire competitors in 1989 are shown in Exhibit 12.

Within the domestic market, various other Hungarian rubber manufacturers had surpassed Taurus in the growth rate as they divested their low-profit lines and adopted new ones with greater growth rates. Taurus's market share of the Hungarian rubber goods industry had slowly eroded since 1970, and this erosion increased greatly in the decade of the 1980s because of entry by a number of small startup rubber companies encouraged by Hungary's new privatization laws. While the company's market share

stood at about 68.0 percent in 1986, Bosnyak estimated Taurus's share would fall another 4.0 percent by 1992. Exhibit 13 shows the figures and estimates he created for his analysis.

With the aid of a major consulting firm, Taurus had recently conducted the in-depth analysis of its business portfolio shown in Exhibit 14. The company operated in a number of highly attractive markets, but the firm's competitive position needed to be improved for most product lines. Accordingly, the firm's emphasis was to be on improving the competitiveness of the company's current product lines and businesses. With 1991 in mind as the target year, Taurus was to implement two types of projects: (1) software for quality-assurance programs, management development, and staff-training efforts and (2) a management information system and hardware for upgrading the agricultural-tire compounding process and the infrastructures of various plants.

Fundamental to Taurus's desire to emphasize growth was the following newly enunciated strategy reported in the 1988 Taurus Annual Report, p. 3:

The decade of 1990 is predicted to be a busy stage of the rubber sector worldwide.

There are strong factors of concentration in traditional manufacturing business(es) and particularly in tire operations. The role of substitute products is growing in several areas. On the other hand, the fast end-of-century growth of industrial sectors is expected to stimulate the development of sophisticated special rubber products. In the face of these challenges, TAURUS bases its competitive strategy on the following:

A continuous structural development program has been started aimed at increasing the Company's competitive advantage, with scope to cover a range from manufacturing processes, through quality assurance, to the reinforcement of strengths and elimination of weaknesses.

Efficiency is a prerequisite of any business activity. The Company portfolio must be kept in good balance.

Associated with profitability, the Company keeps developing its sphere of operations, determining the direction of diversification according to the criteria of potential growth and returns.

Our pursuit of competitive advantage and diversification must be supported by a powerfully expanding system of strategic alliance and cooperation.

As formally stated, the company was seeking strategic alliances for certain business lines rather than growth through internal development, which had been its previous strategy. Internal development possessed lower risks because it extended the company's current areas of expertise; it built on the various product lines already in existence and the present customer base, and it used the company's store of management knowledge. Internal development possessed a number of impediments, however, to Taurus's current desires for accelerated growth. Paramount was the tendency of internal development to focus management so much on current activities that it did not pay attention to new areas, some of which were also outside current managers' areas of expertise.

Now ranked thirtieth in size in the rubber industry, Taurus determined that it should seek cooperative, strategic alliances as its competitors had in forming the new international combinations with their enormous financial strength, strong market positions, and diverse managerial assets. In seeking these affiliations, Taurus decided to be open and responsive to any type of reasonable alternative or combination that might be offered. Alliances could include participating with companies currently in operation or the creation of new, jointly held companies, whether related or unrelated to the rubber industry. The only solid criteria for accepting an alliance would be its profitability and growth potential.

Hungary's business climate was thought to be the most congenial, if not the most profitable, in Eastern Europe in terms of foreign investment. The Foreign Investments Act of 1988 gave Hungary a most liberal foreign-investment environment. Foreign investors were assured freedom from adverse discrimination, compensation in original currency in the event of nationalization, the right to own up to 100 percent of a firm, and the ability to transfer dividends and up to 50 percent of wages abroad. Reciprocal trade agreements had been established with several countries to encourage international trade.

In addition, to allow the market to determine investment and capital formation, the Hungarian government had encouraged the creation of several secondary financial markets. In 1982 Hungary joined the World Bank, and in 1984, it became the first communist country to establish a secondary bond market. To spur financial competition and improve capital efficiency, 8 commercial banks were established in 1987.

Also in 1988 the Hungarian government introduced the first progressive income tax and value-added tax in an East Bloc nation. These taxes were designed to shift the tax burden away from businesses to individuals so that enterprises would ultimately increase investment and raise productivity. In 1989, after establishing a stock market, the Hungarian government issued shares in some state-owned companies.

In pursuing strategic alliances, Bosnyak noted that Taurus's bargaining position differed greatly among the various business lines in its portfolio. As an aid to

understanding its bargaining strategy with potential allies, the businesses were placed into one of three categories as follows:

<u>I</u>	<u>II</u>	<u>III</u>
Truck tires	Rotary hoses	Farm tires
Hydraulic hoses	Waterproofing sheets	Specialty hoses
Belting	Machines and molds	Camping goods
		Air springs
		Precision goods

Category I types were those where Taurus's bargaining position was relatively weak, as it had little to offer a potential suitor. Category II types were those where Taurus could contribute a sizable "dowry" and had much to offer a potential ally. Category III types were those businesses with mixed or balanced strengths and weaknesses.

The problem now was how to restructure the company's current divisions to make them into rational and identifiable business units to outside investors as well as to serve Taurus's own needs for internal logic and market focus. Which product lines should be grouped together, and what should be the basis for their grouping? Bosnyak saw several different ways to do this. Products could be grouped on the basis of their capital requirements. They could also be grouped by markets served or trade relations that had already been established by Taurus. Depending on how Bosnyak defined the company's new strategic business units (SBUs) he knew he would be making some major decisions about the attractiveness of the company's assets. He also would be defining the number and the nature of Taurus's potential strategic alliances. As he explained,

If I create an SBU which manufactures hoses, then a good joint-venture partner might be someone who manufactures couplings for hoses; this would be a match that would be good for both of us, and it would be a relatively safe investment. If, on the other hand, I create a business which can use the same hoses in the offshore mining and drilling business, and this is a business that is really risky but one that could really develop in the future, what do I look for in partners? I need to find an engineering company that's carrying out large mining exploration projects. For every type of combination like this I can create, I have to ask myself each time, "What are the driving questions?"

In reviewing the company's portfolio, Bosnyak immediately saw three new SBUs he could propose to Laszlo Geza, vice president of the Technical Rubber Division. One SBU would serve the automobile industry through the manufacture of rubber seals and grommets that provided watertight fits for car windows; V-belts for engines and engine

components such as air conditioning, power steering and electrical units; and special engine seals. Another unit would serve the truck and bus industry by manufacturing the bellows for articulated buses and air springs for buses, heavy-duty trucks, and long-haul trailers. The last newly created SBU would target the firm's adhesives and rubber sheeting at the construction and building industry. Here the products could be used to waterproof flat roofs, as well as serve as chemical-proof and watertight liners in irrigation projects and hazardous-waste landfill sites.

Although top management knew "the house wasn't on fire" and that a careful and deliberate pace could be taken regarding the company's restructuring, Bosnyak wanted to make sure the proposals he was about to make to the Technical Rubber Division were sound and reasonable. Moreover, the success or failure of this restructuring would set the tone for Taurus' future diversification efforts.

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Exhibit 1

**TAURUS HUNGARIAN RUBBER WORKS**

Predicted Changes in Rubber Demand by Geographical Area  
(in thousands of metric tons)

	<u>1987</u>	<u>1992</u>	<u>Change</u>
North America	3,395	3,432	1.09%
Latin America	788	944	19.80
Western Europe	2,460	2,953	20.04
Africa & Middle East	259	324	25.10
Asia & Oceania	3,060	3,541	15.72
Socialist countries	<u>4,057</u>	<u>4,706</u>	<u>16.00</u>
Total	14,019	15,900	13.42%

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Source: Greek, p. 26.

Exhibit 2

**TAURUS HUNGARIAN RUBBER WORKS**

Predicted Demand for Rubber in Socialist Countries  
(in millions of metric tons)

	<u>1987</u>	<u>1992</u>
East European		
Synthetic	2.90	3.30
Natural	<u>.40</u>	<u>.37</u>
Total	3.30	3.67
Asian Socialist		
Synthetic	.30	.43
Natural	<u>.46</u>	<u>.61</u>
Total	.76	1.04

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Source: Derived from data presented in Greek, pp. 25-26.

## Exhibit 3

## TAURUS HUNGARIAN RUBBER WORKS

Selected Company Sales and Profits  
(in U.S. dollars)

	1984		1988	
	Sales (billions)	Profits (millions)	Sales (billions)	Profits (millions)
B. F. Goodrich (U.S.)	3.40	60.6	n.a. <sup>1</sup>	n.a.
Bridgestone (Japan)	3.38	65.1	9.30	310.2
Cooper (U.S.)	.56	23.9	.73	35.0
Firestone (U.S.)	4.16	102.0	n.a. <sup>2</sup>	n.a.
GenCorp (U.S.)	2.73	7.2	.50	n.a. <sup>3</sup>
Goodyear (U.S.)	10.24	391.7	10.90	330.0
Michelin (France)	5.08	(256.5)	8.70	397.4
Pirelli (Italy)	3.50	72.0	7.01	172.1
Taurus (Hungary)	.26	11.5	.38	9.0
Uniroyal (U.S.)	2.10	77.1	2.19	11.8

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<sup>1</sup>Merged with Uniroyal in 1987.

<sup>2</sup>Acquired by Bridgestone in 1988.

<sup>3</sup>Acquired by Continental in 1987.

Sources: Akron Beacon Journal, January 13, 1986, p. B8; "Powerful Profits Around the World," Fortune, Vol. 120, No. 3, July 31, 1989, pp. 292, 294; Gary Levin, "Tire Makers Take Opposite Routes," Advertising Age, Vol. 60, No. 6, February 6, 1989, p. 34.

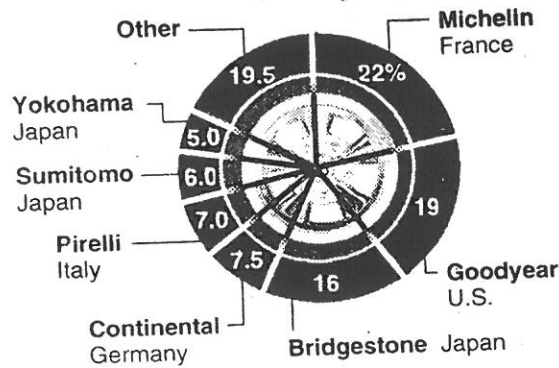


Exhibit 4

TAURUS HUNGARIAN RUBBER WORKS

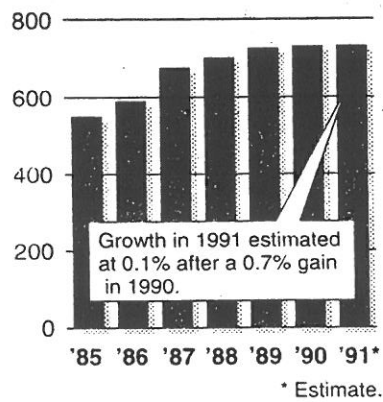
Competitors in the Global Tire Market

Market Shares



Sources: Goodyear Tire and Rubber Company, Harco Consulting

Worldwide Sales of Passenger Car and Truck Tires; Total Value in 1990: \$47.5 billion (in millions of units)

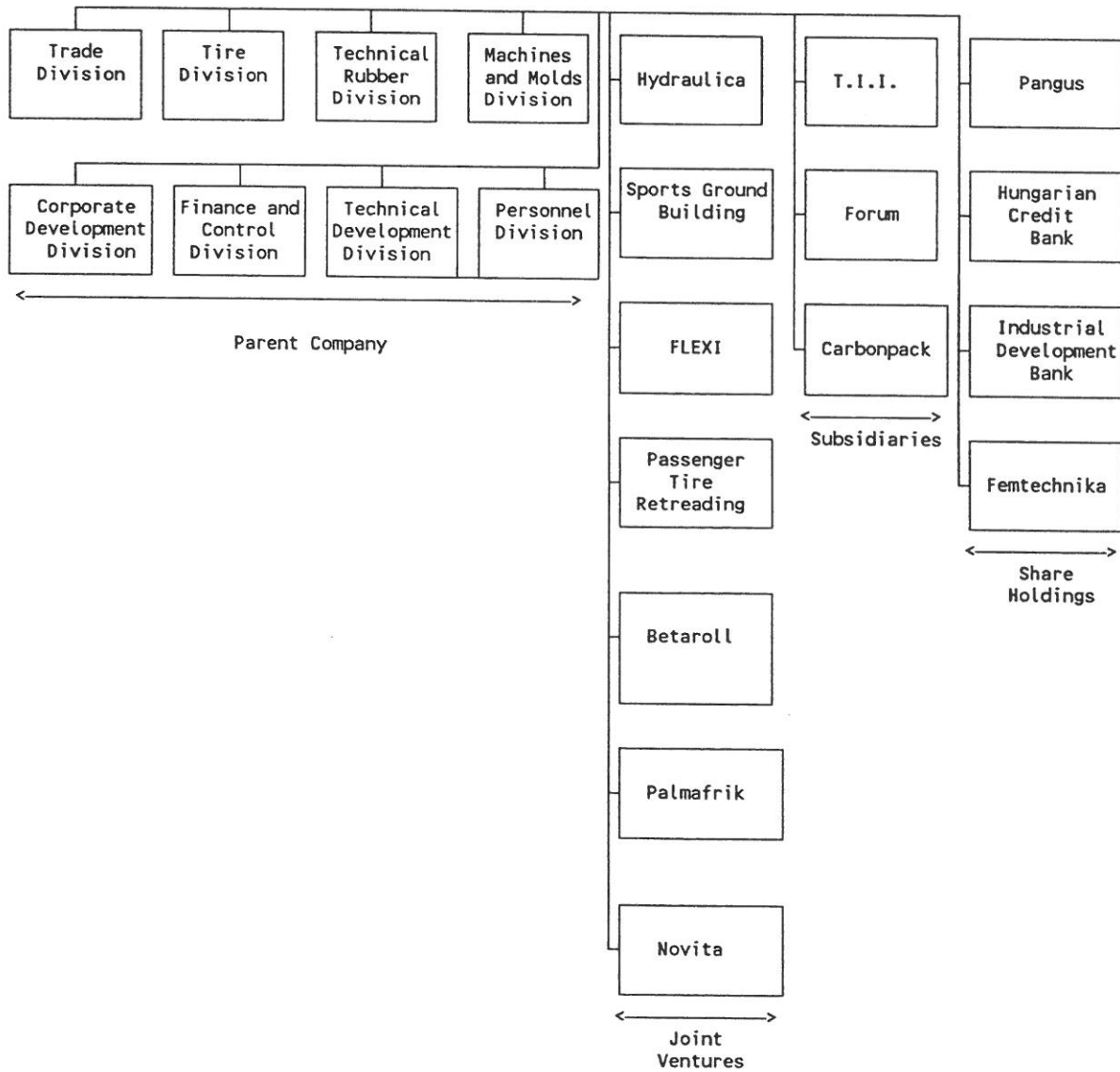


Source: The New York Times, February 3, 1991, p. F5.

Exhibit 5

**TAURUS HUNGARIAN RUBBER WORKS**

Taurus Organization Structure



## Exhibit 6

## TAURUS HUNGARIAN RUBBER WORKS

Selected Division Performance Information  
(in millions of forints)

	<u>Tires</u>	<u>Technical Rubber</u>	<u>Machines &amp; Molds</u>	<u>Trade</u>
<u>1988</u>				
Revenues	6,591	6,484	212	5,612
Assets				
Gross fixed assets	5,201	2,756	268	--
Net fixed assets	2,934	1,199	123	--
Inventories	1,024	601	100	--
Employees	3,987	3,912	557	208
<u>1989</u>				
Revenues	8,547	7,183	242	4,694
Assets				
Gross fixed assets	5,519	2,787	292	--
Net fixed assets	3,016	1,120	135	--
Inventories	1,126	545	104	--
Employees	4,021	3,851	552	198

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Note: Machines and molds sales include output used in house.

## Exhibit 7

**TAURUS HUNGARIAN RUBBER WORKS**

Taurus Income Statements for 1987-1989  
(in millions of forints; year end December 31)

	<u>1987<sup>1</sup></u>	<u>1988</u>	<u>1989</u>
Basic activities	10,637.7	12,193.4	14,918.6
Nonbasic activities	<u>6,270.0</u>	<u>6,705.5</u>	<u>5,747.0</u>
Total revenues	16,907.7	18,898.9	20,665.6
Direct costs	12,022.1	13,095.0	13,819.6
Indirect costs	<u>4,235.6</u>	<u>4,963.3</u>	<u>5,714.8</u>
Production & operating costs	16,257.7	18,058.3	19,534.4
Before-tax profit	650.0	840.6	1,131.2
Taxes	290.0	386.0	491.4
After-tax profit	360.0	454.6	639.8

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<sup>1</sup>1987 data adjusted for better comparability to reflect the effects of tax changes initiated in 1988.

Sources: 1987 and 1988 data from 1988 company Annual Report; 1989 data from internal reports.

## Exhibit 8

## TAURUS HUNGARIAN RUBBER WORKS

Taurus Balance Sheets for 1987-1989  
(in millions of forints; year end December 31)

	<u>1987<sup>1</sup></u>	<u>1988</u>	<u>1989</u>
<b>ASSETS</b>			
Cash, bank deposits, & receivables	2,491.1	3,157.0	3,763.2
Inventories	2,749.6	2,803.8	2,888.3
Other current assets & capital investments	<u>577.4</u>	<u>739.7</u>	<u>938.6</u>
Current assets	5,818.1	6,700.5	7,590.1
Property	2,480.7	2,772.0	3,008.6
Machines & equipment	4,718.2	6,202.6	6,357.9
Fleet	46.3	46.4	48.6
Other	<u>27.9</u>	<u>25.9</u>	<u>25.6</u>
Fixed-asset value	7,273.1	9,046.9	9,440.7
Accumulated depreciation	3,977.0	4,303.8	4,687.7
Unaccomplished projects	<u>541.4</u>	<u>272.2</u>	<u>541.6</u>
Total fixed assets	3,837.5	5,015.3	5,294.6
Total assets	9,655.6	11,715.8	12,884.6
<b>LIABILITIES</b>			
Short-term loans	1,531.7	1,684.3	1,444.0
Accounts payable	922.7	1,378.5	2,072.8
Accrued expenses	95.8	141.4	151.6
Provisions for taxes	(274.1)	195.0	34.7
1989 long-term debt service	267.0	129.9	314.3
Other liabilities due within 12 months	<u>58.0</u>	<u>5.4</u>	<u>242.1</u>
Total current liabilities	2,601.1	3,534.5	4,259.5
Provisions & noncurrent liabilities	61.4	335.1	.4
Long-term loans	725.4	1,453.1	1,815.7
Equities & funds reserves	5,907.7	5,938.5	6,169.2
Current-year after-tax profit	<u>360.0</u>	<u>454.6</u>	<u>639.8</u>
Total equity & funds	6,267.7	6,393.1	6,809.0
Total liabilities	9,655.6	11,715.8	12,884.6

<sup>1</sup>1987 data adjusted for better comparability to reflect the effects of tax changes initiated in 1988.

Sources: 1988 company Annual Report for 1987 and 1988 data; 1989 data from internal company reports.

Exhibit 9

**TAURUS HUNGARIAN RUBBER WORKS**

Average Annual Growth Rates

	<u>Rubber Sector</u>	<u>All Industry</u>
1960-1970	8.3%	6.8%
1970-1980	4.0	4.1
1980-1987	<u>1.7</u>	<u>4.3</u>
Average	5.0%	5.1%

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Source: Internal Taurus report.

Exhibit 10

**TAURUS HUNGARIAN RUBBER WORKS**

10-Year Growth Rates for Selected Industries, 1977-1987

	<u>Annual Growth Rate</u>
Data-processing equipment	21.0%
Transistors	17.0
Aircraft	16.0
Medical equipment	15.0
Measuring & control equipment	13.5
Electronic games	13.2
Telecommunication equipment	12.9
Metal-processing equipment	10.4
Synthetic fibers	7.8
Steel	7.4
Building materials	7.3
Fertilizers	7.0
Agricultural equipment	4.5
Coal	3.2
Passenger cars	2.5
Crude oil	0.5

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Source: Internal Taurus report.

Exhibit 11

**TAURUS HUNGARIAN RUBBER WORKS**

Strategic Alliances in 1987

Goodrich (U.S.) and Uniroyal (U.K.) operating as a joint venture.

Pirelli (Italy) acquired Armstrong (U.S.).

Firestone (U.S.) acquired by Bridgestone (Japan), which had another type of alliance with Trelle Nord (Sweden).

General Tire (U.S.) acquired by Continental Tire (Germany), which, in turn, operated in cooperation with Yokohama Tire (Japan). Continental also owned Uniroyal Englebert Tire.

Toyo (Japan) operating in cooperation with Continental Tire while also operating a joint venture in Nippon Tire (Japan) with Goodyear (U.S.).

Michelin (France) operating in cooperation with Michelin Okamoto (Japan).

Sumitomo (Japan) operating in cooperation with Nokia (Finland), Trelle Nord, and BTR Dunlop (U.K.).

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Source: Corporate annual reports.

## Exhibit 12

**TAURUS HUNGARIAN RUBBER WORKS**

## Major Rubber-Company Diversifications, as of 1988

	<u>Nontire Sales (%)</u>	<u>Major Diversification Efforts</u>
Goodyear	27	Packing materials Chemicals
Firestone	30	Vehicle service
Cooper	20	Laser technology
Armstrong	n.av.	Heat transmission equipment
General Tire	68	Electronics Sporting goods
Carlisle	88	Computer technology Roofing materials
Bridgestone	30	Chemicals Sporting goods
Yokohama	26	Sporting goods Aluminum products
Trelleborg	97	Mining Ore processing
Aritmos	n.av.	Food processing
Nokia	98	Electronics Inorganic chemicals

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Sources: Corporate annual reports for citations of diversifications. Source for nontire sale volume is Bruce Davis, "No Clear-Cut Winner in Tire Crown Fight," Rubber & Plastics News, August 21, 1989, p. 18.



Exhibit 13

**TAURUS HUNGARIAN RUBBER WORKS**

Distribution of Rubber-Goods Production  
Among Taurus and All Other Hungarian Rubber Manufacturers

	<u>Percentage of Market</u>			
	<u>1970</u>	<u>1980</u>	<u>1986</u>	<u>1992 Est.</u>
Taurus	95.0	80.0	68.0	65.0
All others	5.0	20.0	32.0	35.0

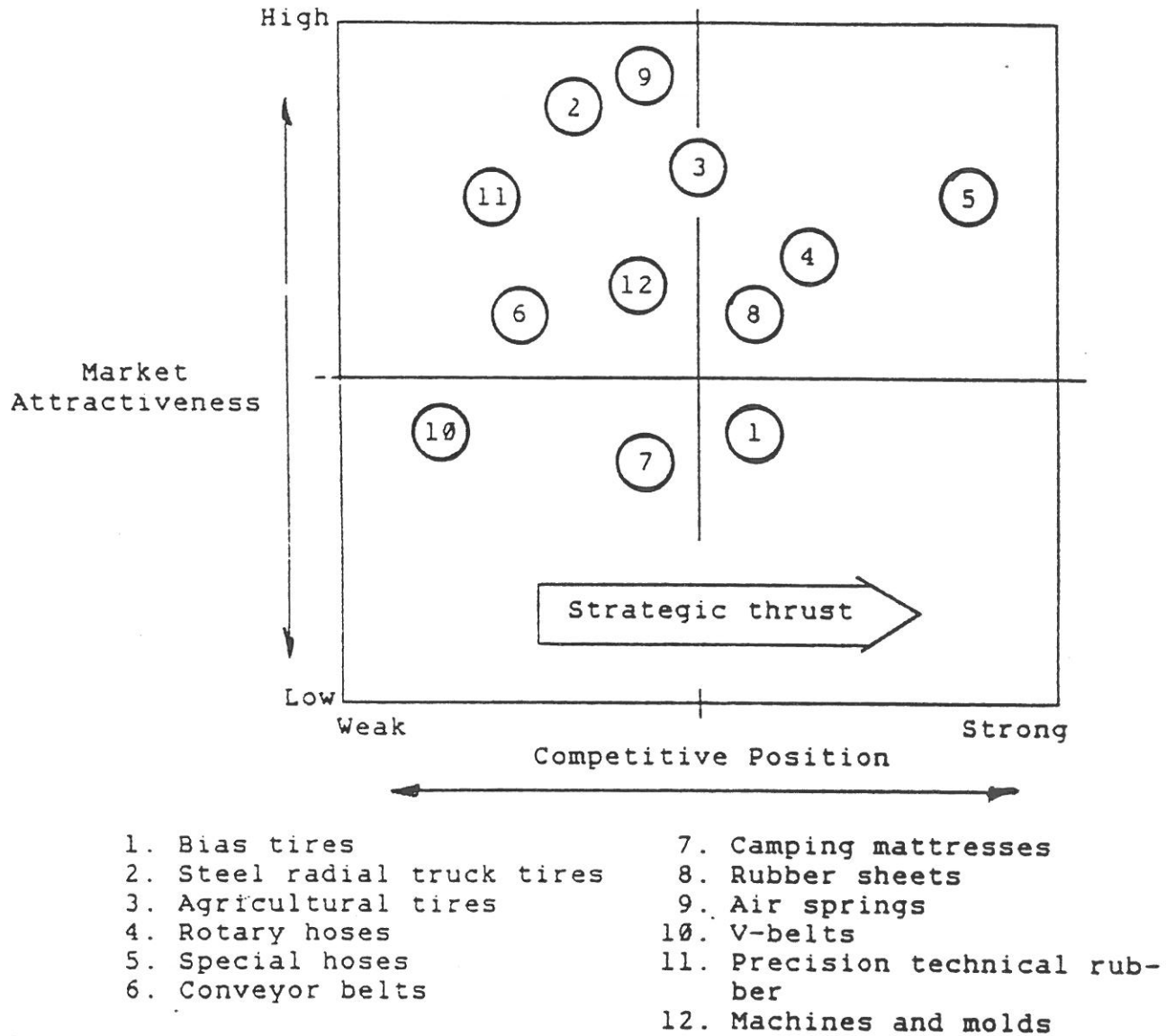
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Source: Internal company data for years 1970 to 1986 and case writer's estimate for 1992.

Exhibit 14

TAURUS HUNGARIAN RUBBER WORKS

The Taurus Portfolio



Source: Company documents and consulting group's final report.

## TRENMOS (A)

As Jeff Zeiger relaxed on the Caribbean beach in August 1989, he thought about Moscow nearly 5,000 miles and whether he was going back. Zeiger had spent the past six months in Moscow working to open what (he had hoped) would be the first American restaurant in the Soviet Union, TrenMos. The frustrations had been tremendous, and his life in Moscow was a far cry from what he was accustomed to in the United States. Moreover, he questioned whether the USSR was ready to accept the Western business practices he was trying to introduce. Feeling confused and needing time to clear his head, Zeiger followed the advice of his former boss and took a vacation in the Caribbean. He hoped to sort out his goals and priorities. He hated to leave a job undone, but the idea of returning to the day-to-day frustrations of Moscow was not appealing. A decision had to be made, however, and quickly.

### Background

Jeff Zeiger's father, Shelley, was born in 1935 in a part of the Ukraine that had belonged to the Soviet Union before World War II. In 1944, as Ukrainian Jews, Shelley and his family were forced into hiding to escape the threat of Nazi extermination. The Zeigers spent the next two years in a shelter 11 meters underground where they could neither stand upright nor see the sun. Each day a family friend secretly lowered half of his rationed food down to them by way of a handmade pulley attached to his chimney. Finally, in the chaos of the war's final days, the Zeigers were able to escape and make their way from Poland to Czechoslovakia to Austria to West Germany and ultimately America.

By 1973, Shelley Zeiger owned and was successfully operating two wholesale liquor companies in Trenton, New Jersey. In the course of doing business, he noticed that the sales of his brown liquors such as bourbons and scotches were declining while the white liquors such as vodka and gin were growing. Thus he began to consider ways he could capitalize on his white-liquor business. Shelley Zeiger's cultural ties to the Soviet Union prompted him to look toward his birthplace for potential new opportunities. He envisioned importing Stolichnaya vodka from the Soviet Union and using his current suppliers to distribute the product nationwide.

In 1973, Stolichnaya was an unknown brand of vodka in the United States with annual sales of only 7,000 cases. Today, Stolichnaya is the number two imported vodka in the US with sales in 1989 of over a million cases.<sup>1</sup> Shelley Zeiger had found a tremendous business opportunity and the partnership gave him a chance to explore his Ukrainian heritage.

Shelley Zeiger visited Moscow for the first time in February of 1973 and met with the general director of Soyuzplodimport, the Ministry of Whiskey, Wine and Beverages. The meeting was cordial, but only three weeks before, Donald Kendall, president of PepsiCo, had made a similar trip to Moscow and signed an agreement with the Soviet government to trade Pepsi syrup for Stolichnaya vodka.

Although the general director was unable to help Shelley Zeiger tap the Russian vodka source, he hated to see Zeiger leave empty-handed. After all, Zeiger could supply the government with much needed hard currency, and unlike so many foreigners, he could speak excellent Russian. Therefore, the general director suggested that Zeiger speak with a friend of his, Director Ganjko of the Fragrance Department of Soyuzchimexport (the Ministry of Fragrances, Oil and Chemicals), to explore other potential business opportunities. Later that week, Zeiger met with Ganjko to discuss the possibility of purchasing Soviet fragrances and selling them in the United States. Zeiger's interest grew when he learned that these fragrances were natural and contained no synthetic ingredients. Believing that a consumer movement was underway in the United States toward natural products, Zeiger bought \$7,000 worth of Russian fragrances. He knew nothing about the fragrance business but decided to trust his intuition. Besides, fragrances did contain alcohol, which was in line with his existing business. Back in the United States, Shelly Zeiger's wife Marion began selling the fragrances out of their home. From fragrances, their USSR import business expanded to include amber and other semiprecious stones. Zeiger Enterprises was the holding company for both Shalmar Imports and G. A. Westfall, and had net sales of over \$3 million. Shalmar Imports traded solely with the Soviet Union, while Westfall imported gifts from both Eastern and Western European countries. The company had continued to center around the trading of Soviet and European products, but the focus had shifted away from fragrances to more traditional items such as black painted boxes and matryoshka (nesting) dolls.

In addition to their trading companies, the family had formed Zeiger International, the parent company for the family's joint-venture businesses with the Central (formerly Leninsky) District Food and Catering Trust in Moscow. TrenMos was part of Zeiger International. The Zeigers' businesses employed over 100 people in 1989 and were headquartered in the family's hometown of Trenton, New Jersey. (See Exhibit 1 for an organizational chart.)

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Patricia Winters "Eastern European Spirit is Toast of U.S." *Advertising Age*, Vol. 61, August 6, 1990, p. 32.

## The Sister City Agreement

Legislation regarding foreign investment in the Soviet Union was at the time changing on what seemed like a daily basis. As of 1989, all registered Soviet organizations had finally received permission to engage in foreign trade. In order to do business in the Soviet Union, however a foreign entity was strongly encouraged to establish a partnership with a Soviet counterpart.

Having served on the US/USSR Trade Economic Council since 1974, Shelley Zeiger believed that, while many Soviet organizations were interested in forming joint ventures, they were apprehensive about joining forces with an American partner. This attitude was understandable considering the 30 year heritage of the Cold War. Shelley Zeiger believed this basic distrust would not be overcome until the Soviets understood the philosophy of capitalism. An opportunity to contribute to such understanding, while broadening the outlook of his community arose in 1985. In 1983, Shelley Zeiger had been elected chairman of the Trenton Chamber of Commerce. Although Trenton was rich in history, new businesses were not clamoring to move there. Zeiger hoped that his many international dealings would enable him to make Trenton businesses more "global" and because most of his international experience involved the Soviet Union, he turned to his contacts in Moscow. He believed that developing economic and cultural ties between the two cities could be an important step toward globalization.

In 1985, Zeiger organized a delegation of 16 prominent Trentonites to travel to the USSR. The group included Trenton's mayor, a state senator, the publisher of the leading city newspaper, and the city council president. He then asked his Soviet colleagues to arrange a comparable Soviet delegation: the mayor of Moscow, the Chamber president, and the Minister of Culture.

The two-week visit to Moscow began with a formal meeting of the two delegations, Americans on one side of the table and Soviets on the other. They began sharing information about the hardships, accomplishments, and assets of the two cities. According to Shelley Zeiger, each city was proud of its historic sights and their enterprises but was also frustrated by municipal problems such as poor sewage and water-treatment systems. Throughout the discussion, Zeiger emphasized that, although Moscow and Trenton were 4,670 miles apart, their cities had much in common. Therefore, he proposed that Moscow and Trenton create a formal relationship to enable the two cities' leaders to share business and cultural insights with one another. The mayor of Moscow was interested. Shelley Zeiger recalled their conversation:

So, the mayor asked, How many people do you have in Trenton?"  
We could cheat a little, but we couldn't come up with 11 million (the population of Moscow). We had about 96,000. So, I tried to preface that [Trenton] is very historical, but it didn't help. He said, "you know, Moscow is really 32 cities (each district contains

300,000 plus people) and maybe we can work this out with one of the districts."

Zeiger suggested that the Central District, which includes the Kremlin and Red Square, as the heart of Moscow, would be an appropriate partner for Trenton. The mayor agreed to consult the district's mayor, Vladiflav Novozhilov and Zeiger was delighted. He proposed a pact that would allow the two "cities" to share information in problem areas, to exchange students, politicians, and press, to share medical information, and to develop trade and business.

Over the next two years, Shelley Zeiger arranged for Trenton to sponsor local performances of the Moscow Ballet, the Kirov Ballet, and the Georgian State Dance Company. He believed showing the Moscow politicians that this relationship could work favorably and that there was no need to hide, worry, or delay formalizing the agreement was important. Two years later, a remarkably quick turnaround by Moscow standards, Sergei Goryachev, the newly elected mayor of the Central District, traveled to Trenton to present the Sister City documents (see Exhibit 2). At this time, the first Soviet/US Sister City Agreement was signed by the leaders of the heart of Moscow and those from, as Zeiger called Trenton, the "heart of the US."

During their visit to the United States, Goryachev and his group had an opportunity to sample American culture. One highlight was their first taste of pizza. Each member of the delegation ordered seconds, and Shelley Zeiger immediately recognized a demand. He quickly proposed that they inaugurate their economic relationship by selling pizza in Moscow.

### **Astro Pizza**

Not a man to waste time, Shelley Zeiger had an agreement with Roma Foods by 1988 to send a pizza truck to Moscow. Zeiger planned to sell hot, freshly made pizzas and cold sodas directly from the truck. The fact that there were no laws or guidelines to structure an American/Soviet joint venture in Moscow did not deter him. He and Goryachev decided to create their own rules. Under the agreement that resulted, Zeiger Enterprises would receive 49 percent of the truck's profits and the Soviet government 51 percent.

Zeiger wanted to be sure the truck was operational before the April 13, 1988, US/USSR Trading Council meeting in Moscow. He transported the pizza truck to Helsinki along with the driver and mechanic. Driving directly into Moscow, they received a number of curious looks but no hassles. Two days before the conference, Zeiger previewed his Astro Pizza truck outside the American Embassy in Moscow by giving pizza away to diplomats desperate for American food. The following day, the truck parked outside a church in downtown Moscow and handed approximately 850 Russians their first taste of pizza.

On April 13, Zeiger officially debuted Astro Pizza in the USSR, with his truck parked on the Lenin Hills in front of Mikhail Gorbachev's alma mater, Moscow State University. Here

Zeiger announced the "true beginning of Perestroika" in front of a massive crowd, which included over 300 members of the press. Zeiger recalled, "We had people from all over the world.... They were coming out of the woodwork. It was mind boggling."

Watching the pizza operation, Zeiger noticed that the Soviet cashier was silently grabbing rubles from the people and abruptly stuffing them into a bag beside her. (They had forgotten one thing, the cash register.) Despite the throngs of people struggling to purchase a slice or two, he asked the cashier to step aside for a moment and explained, "In America, when we take someone's money, they become a valued customer. We treat our customers with respect by acknowledging their business with a 'thank you' and a smile." The Russian woman said that, with thousands of people in line, there was no need or time for courtesy or smiles. Nevertheless, Zeiger insisted, and the woman returned to her job, whispering "Spacibo" (thank you) between clinched lips. She slowly became more comfortable and cheerful, however, and the mood of the crowd began to change. At times, Zeiger found himself with a "thank you war" on his hands. He remembered people's expressions as they received their first taste of American pizza and customer service:

"That's when I knew I had brought a little bit of America to the Soviet people. I also realized I had beaten Kendall from Pepsi. It had taken me 12 years. I told him, "You got me on the Stolichnaya, but I got you on the pizza."

Astro Pizza trucks continued to roll around Moscow in 1989. Four days a week, they served pizza to the Soviet people for rubles, and on the remaining three days, they serviced expatriates for hard currency.

Soon after launching Astro Pizza, Shelley Zeiger recognized that the Soviets were not only ready for American cuisine, they were demanding it. In order to meet their demands and to find an outlet for the rubles piling up from Astro Pizza, he decided to establish more permanent operations - a restaurant. Little did he know what was ahead of him. He had laid the ground work, but now he was entering a much riskier venture and one that required an investment of over \$350,000 for building improvements, furniture, and equipment. He needed to develop a strong operational partnership, find a building, renovate it, and hire and train a large number of employees. Moreover, the restaurant, TrenMos would present different operations problems from a mobile pizza truck. They would need to turn over tables quickly and provide excellent service -both very "un-Soviet" concepts.

## **Mission**

Shelley Zeiger's vision was to offer a restaurant to the Soviet people that provided food and service equivalent to that in the West with prices in line with the Russian economy. The ruble income from the restaurant could be used to compensate Soviet employees and provide funds for supplies. This approach seemed appropriate to Zeiger considering his long-term goals of growth within the Soviet Union. To succeed in this mission, he would have to supplement

ruble sales with dollar sales. Unlike McDonalds, his operation was too small to think in terms of a 20-year return-on-investment horizon. TrenMos needed to repatriate profits in the near term. Dollar revenues would be used to compensate Western employees and purchase imported goods. In addition, Shelley wanted to offer the Soviet citizens, who had no access to hard currency, the same opportunity as Westerners.

Zeiger had visions of eventually using the rubles to invest in Soviet real estate. For the time being, however, he found that even a simple effort such as getting a bank account was incredibly difficult. The Soviets had no concept of or need for working capital; they did not understand the need to have cash on hand.

Recognizing all the challenges the new venture faced, Zeiger realized that he would need strong leadership in the restaurant's local manager, and he set out to convince his son Jeff to spearhead the project.

### **Jeff Zeiger**

Jeff Zeiger had gotten his start working for his father's hotel, the Capital Plaza, in Trenton. He was highly motivated and worked well with older people. As his father recalled:

I gave him free rein: he would make up the menu, he would work with the buyers, he would set up the room, etc. He was even mopping the floors. He quickly learned that, in order to succeed in business, you need to know everything. That way you understand everyone's job who is working for you.

Jeff Zeiger went on to attend the Cornell University School of Hotel Administration. He lost interest, however, and even though his father was disappointed, he quit school after only two years. He then went to work for Sheraton as a night manager and later moved to the Hyatt, where he managed the hotel restaurant. While Jeff Zeiger was at the Hyatt, his father approached him about the TrenMos opportunity.

Jeff Zeiger was uncertain; he had never really wanted to go to the Soviet Union. His father convinced him, however, that running the first American restaurant in the Soviet Union would be a great opportunity. It began to sound romantic. Jeff Zeiger would handle all front-room operations, public relations, and advertising. Bernard Derroisne, a French chef, would work with Zeiger to handle the back-room operations. The Russian partner would handle all relations with the Soviet government.

### **TrenMos Start Up**

During the setup and operation of the Astro Pizza venture, Shelley Zeiger had taken care of all operations and had organized everything directly through his friend Sergei Goryachev, the mayor of the Central District. Dealings were simple because Astro Pizza required no building



space and used only imported ingredients. The Russian partner, General Director Mussa Karkhov, who had been assigned from the Central District Food and Catering Trust, offered little input. Karkhov's role would change, however, with the advent of TrenMos. He would be expected to work the Soviet system by establishing strong government relationships, expediting paperwork, and guaranteeing timely order and arrival of supplies. He would also be in charge of locating an appropriate building for the restaurant.

The early stages of setting up TrenMos progressed smoothly. Because of Shelley Zeiger's connections in the Central District, he was able to expedite the process of locating and leasing a building and obtaining a registration agreement and number. This process, which normally took up to two years, took only six months.

Shelley and Jeff Zeiger soon began to face the challenges of being one of Russia's first joint ventures however. A multitude of problems plagued the efforts to get TrenMos up and running. Even after careful instruction, the construction crew installed the air-conditioning system incorrectly to pump the cool air outside and the warm air inside. Workers were so poorly equipped and trained that Jeff Zeiger found one crew member cutting a metal pipe with a wire, a process that would have taken nearly the entire day.

Another example of the frustrations involved the seemingly simple installation of the parquet floor. After waiting a long time for the wooden tiles to arrive Jeff Zeiger then learned that the appropriate adhesive had not been ordered. Once the adhesive finally arrived, he could not find workers. By the time he found the workers, they were drunk. In the end, he settled for a piece of scrap carpeting that did not match the decor or atmosphere of the restaurant. Karkhov was more than satisfied with the carpet, but Zeiger was extremely disappointed.

In addition, serious operational problems with the heating system made it clearly inadequate, at least by Western standards. Customers would have to wear their coats while eating. Karkhov's attitude was: "The customers will just have to drink more. What's the big deal? They wait in lines for three to four hours for food; they can handle the cold." Karkhov and Jeff Zeiger clearly had disparate opinions about what it would take to successfully open TrenMos. Jeff Zeiger wondered if their basic definitions of success were perhaps different.

For Karkhov, earning a profit was unrelated to running an efficient business. He believed that his ability to manipulate the system would determine his personal monetary gain. For instance, in the restaurant business in Moscow the maitre d' customarily told customers that no tables were available even when the restaurant was empty. A tip of \$10-\$20 would persuade the maitre d' to however, find an open table. Karkhov made clear to the Zeigers that he expected to receive a considerable amount of his income from participating in this practice which clearly was not the way the Zeigers had planned to run their business.

Because of the problems that became apparent during setup, the Zeigers were worried about what would happen when the restaurant opened: Was the whole system like this? Do we have any chance? Even if we could somehow bring in a new Russian partner, would a new

person have any more success than the current one? What about the supply situation; without being able to buy the same food every day, how could he set up a menu?

In addition, for Jeff Zeiger personally, life in Moscow was tough. Simple things such as toilet paper and water, were difficult to get, and his social life was nonexistent. He had learned to speak Russian by taking long (15-ruble) taxi rides and exasperating trips to the farmers' market, but could he ever learn to put up with Russian life?

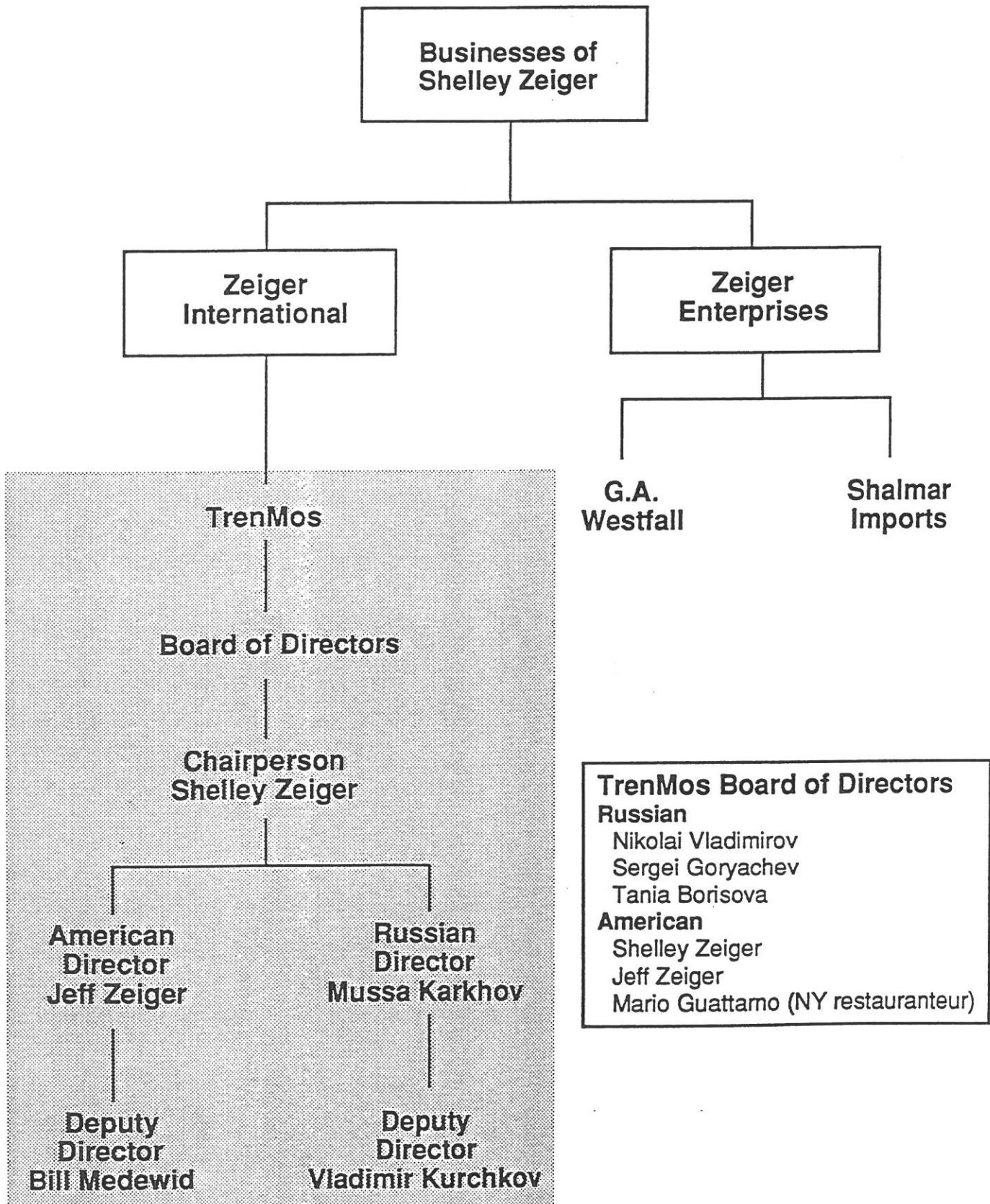
### **The Decision**

The TrenMos joint-venture team had planned to open the restaurant on July 4, 1989, but by August, little progress had been made. The situation seemed hopeless so Jeff Zeiger decided to fly back to the States, and while he was still uncomfortable with his decision to leave Moscow, he asked for his job back at the Hyatt. His former boss responded, "Go think about it for a week or so in the islands, and then I will accept your decision." So here he was, sipping on his pina colada, lost in thought.

**EXHIBIT 1**

**TRENMOS (A)**

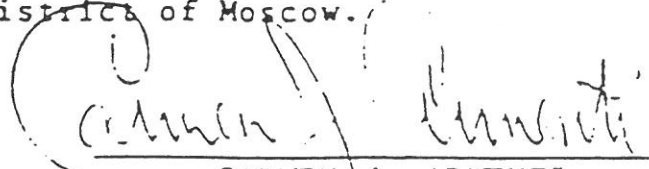
**Organization Chart as of August 1989**



**EXHIBIT 2**

**TRENMOS (A)**

RESOLVED, by the City Council of the City of Trenton that the Mayor and City Clerk shall be and are hereby authorized to initiate all appropriate and lawful measures to institute and maintain channels of communication as will further the good will and mutual respect established by our delegation and to do all other things necessary and appropriate to establish and maintain a sister-community relationship with the Lenin District of Moscow.



CARMEN J. ARMENTI  
President of City Council

Attest:



EUGENE E. KALINOWSKI  
City Clerk

## TRENMOS (B)

Jeff Zeiger chuckled to himself as he lugged a 55-pound sack of potatoes across Moscow's Central Market. Doing business within the archaic Soviet system still amazed him; nonetheless, he was happy about his purchase. The potatoes were unusually large by Moscow standards and could be added to the menu as a hearty American-style side dish. As he shifted the potatoes to the other shoulder, he reflected on the considerable progress TrenMos had made.

Only a year earlier, Zeiger had decided to give TrenMos and Moscow another chance. He could not turn his back on the opportunity to run Moscow's first Soviet-American restaurant. He returned to Moscow with a newly found optimism that was in large part the result of a change in management that occurred while he was away: TrenMos's board of directors had voted to dismiss Mussa Karkhov.

For the first three months that Zeiger was back in Moscow, TrenMos was without a Soviet partner, but Jeff and Shelley Zeiger had begun talks with Sergei Goryachev, the former mayor of the Leninsky (Central) District, about becoming their new partner. Having dealt with Shelley Zeiger for over 15 years, Goryachev understood capitalism better than Karkhov, and he recognized the Zeiger's need for service and efficiency. In addition, he would be able and willing to use his government contacts to expedite TrenMos's future requests for equipment and licenses. In January 1990, Goryachev joined the Zeigers as a TrenMos partner.

While Goryachev's open mind and knowledge of the system were enormously helpful, running the restaurant on a day-to-day basis was still difficult. The restaurant was open and operating, but several important issues remained unresolved. For instance, what was the best way to manage currency needs? While Jeff Zeiger and Goryachev believed serving Soviet citizens was important, the business needed hard currency in order to remain viable. Consequently, they decided to charge all patrons rubles for lunch, but dinner would be primarily a hard-currency meal. Lunch prices were less than dinner prices, and the partners hoped ruble lunches would open up TrenMos to many. In addition, at dinner times, from those Soviets who could afford the meals (ranging from \$9-\$20/person) but did not have access to hard currency, rubles were accepted.

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This case was prepared by Donna C. Ackell, Beverly M. Brown, and Jeffrey K. White under the supervision of Mark Eaker, Professor of Business Administration. Copyright © 1992 by the Darden Graduate Business School Foundation, Charlottesville, VA.

Another important area that required attention was training and compensation. Zeiger and Goryachev worked together to train their Soviet employees about the importance of cleanliness and service. They taught them to treat every customer with respect and even to wipe each glass until it sparkled. In order to reinforce desired behavior, the partners set up an ingenious incentive plan.

Under Soviet law, Russians were unable to hold foreign currency without going through a lengthy, complicated authorization process. Yet foreign currency was very valuable to Russians; it could be used to purchase goods from the beriozkas (state-owned stores that accepted only hard currency) which were filled with items otherwise unavailable to Soviet citizens. The partners thus wanted a system that would allow employees to earn hard-currency tips and be able to use them. In order to reward their workers while still complying with Soviet law, they established employee accounts at the beriozkas. Each employee's share of the hard-currency tip money was credited to an account at the store. Employees would then select the items they wanted, and the account would be charged.

In addition to these hurdles, Zeiger also had to handle the problems of obtaining sufficient quantities of quality food. Meat had to be ordered from the state months in advance, and even then, the authorities could not guarantee when it would be delivered. While this system worked for state-run establishments less concerned with freshness than TrenMos, the state system was not acceptable to Zeiger and Goryachev. They decided to obtain their food from the private farmers' markets surrounding Moscow. These markets, unlike the barren state stores, were generally well stocked. Unfortunately, the goods were up to seven times more expensive, and the supply was utterly unpredictable. Therefore, Zeiger and his chef, Bernard Derroisne, began visiting the markets on nearly a daily basis. Zeiger used his limited "street Russian" to bargain with villagers for food, and Derroisne made up the day's menu as they went from booth to booth.

The strategy the partners chose proved very successful, and TrenMos turned a ruble and hard-currency profit after only seven months of operation. According to Zeiger, the keys to their success were flexibility, understanding, and dedication. In addition, buying for rubles and selling for dollars never seemed to hurt their bottom line.

Although operating TrenMos was far from dull, Jeff Zeiger was already thinking about how he could invest the ruble profits TrenMos was generating. The political atmosphere in the USSR was becoming increasingly unstable, but the Zeigers recognized the opportunities that Russia's changing attitudes toward a free-market economy also offered. What would the changes mean for joint ventures? The possibilities seemed endless - real estate, more restaurants, other retail endeavors, or even casinos. Zeiger was wondering what components of the TrenMos concept were expandable, when his thoughts were suddenly interrupted by a Siberian farmer's market display: Fresh Wild Boar. What luck he thought. Derroisne could prepare his famous "Texas Wild Boar" that evening.

### TRENMOS (C)

By early 1991, Jeff and Shelley Zeiger had begun seriously to consider expanding their restaurant business in Russia. They were not sure, however, what type of restaurant would be most successful. Could the Soviet economy support a chain of up-scale restaurants? Was this form really what the market demanded, or should they turn their attention to more affordably priced ventures? Should they concentrate on Moscow, or should they look outside the capital? In order to choose the best strategy, the Zeigers decided to open a series of test restaurants with different menus, atmospheres, and locations.

Unfortunately, just as they were about to open their first new restaurant, the August coup attempt occurred. This event threw their thinking into a tailspin. How could they operate a growing business in such a hostile and unpredictable environment? Another joint venture, the Moscow Radisson Hotel, which was to be the first four-star hotel in Moscow, had been dissolved one week before the coup; could this happen to them? Was this environment too risky for expansion?

They decided to move forward with one test restaurant, The TrenZag, a small café, opened on a limited basis in September 1991 in Zagorsk, a city approximately 50 miles north of Moscow. Although Zagorsk was a tourist town, the partners found neither the demand nor the dollars necessary to run a successful venture. The café was unsuccessful and ceased operations in late fall.

The Zeigers then decided to concentrate efforts on Moscow. Their second Moscow restaurant, TrenMos Bistro, opened March 31, 1992. The TrenMos Bistro was strategically located in the business district across from the Kremlin. It introduced the concept of a relaxed, American, happy-hour restaurant and bar, similar to a TGI Friday's or a Bennigans, for Moscow business people. On the basis of the two restaurants, TrenMos in 1992 was a highly successful joint venture, and it fared well through the storm of Soviet political upheaval.





## HUNGARY IN 1990

In 1990, Eastern Europe beckoned to Western capitalists as a place to expand. Decades of Soviet domination had suddenly ended as Communists were swept from power in 1989 and 1990 in Albania, Bulgaria, Czechoslovakia, East Germany,<sup>1</sup> Hungary, Poland, and Romania.<sup>2</sup> Citizens of these nations had become fed up with low wages, poor standards of living, inadequate housing, and the absence of modern health care. They yearned for the benefits of democracy and a free market.

While new governments sought to unravel the socialist bureaucracy and foster entrepreneurship, Western government officials applauded, and Western companies looked for business opportunities. According to a 1990 poll co-sponsored by The Wall Street Journal, one-third of corporate chief executive officers in the United States, Asia, and Western Europe had plans to build or buy factories in Eastern Europe between 1990 and 1995 (Exhibit 1). In 1989, when the Berlin Wall was still standing, only 5 percent of such executives had similar five-year plans.

Hungary offered probably the most attractive environment for foreign investment in all of Eastern Europe. A land-locked country about the size of Indiana, Hungary had earned a reputation as an innovator among the countries behind the Iron Curtain. It was the first Communist country to establish a secondary bond market (in 1984). It had joined the World Bank in 1982. It had a stock market and permitted foreign investors to own up to 100 percent of Hungarian firms. Hungarian law also allowed significant profits to be taken out of the country in the form of dividends. A European business magazine described Hungary's business climate as "the most congenial if not the most profitable" in Eastern Europe (Exhibit 2).

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<sup>1</sup>East Germany merged with West Germany in October 1990.

<sup>2</sup>Yugoslavia was Communist but not in the Soviet sphere.

In 1990, Hungary held its first free parliamentary elections in over 40 years. The result was the first totally non-Communist government in Eastern Europe. Hungary's new president, Aprad Goncz, was a translator of literature who had little economic experience but was respected as an intellectual. Among the executives who told The Wall Street Journal that they planned to invest in Eastern Europe, 68 percent planned to invest in Hungary--more than in any Eastern European country except East Germany.

Still, obstacles to economic progress abounded. Like the rest of Eastern Europe in 1990, Hungary was neither capitalist nor socialist. It functioned somewhere between the two systems. Political freedom had opened the door to progress and opportunities for growth and development, but the bright promise was not assumed. Hungary might prove to be one of the greatest investment opportunities in the latter part of the 20th century, or it could become a quagmire in which Western capitalists would struggle and fail. The newly elected government was determined to foster the former, but the weight of history and existing economic circumstances seemed to favor the latter.

#### **The Path to Soviet Domination: 1914 to 1947**

The assassination in 1914 of Archduke Ferdinand, Hapsburg heir to the Austro-Hungarian throne, sparked the outbreak of World War I. At the conclusion of the war, four years later, the Treaties of Brest-Litovsk dismembered the Hapsburg monarchy. In late 1918, a Hungarian republic was officially formed, and Hungary gained independence for the first time since 1699. For the next two decades, a series of right-wing governments ruled the country.

Hungary joined the Tripartite pact with Germany, Italy, and Japan in November 1940 and, late the next year, formally declared war on the Soviet Union, Great Britain, and the United States. After a series of military defeats, Hungary made peace overtures to the Allies, but in 1944, German forces occupied the country. A right-wing puppet regime was installed, and more than 450,000 Hungarians were deported to German extermination camps. When Soviet troops invaded in the fall of 1944, Hungary was forced to sign an armistice agreement with the Allies in Moscow and became a Soviet puppet state.

#### **The Planned Economy: 1948 to 1968**

Under Soviet military occupation, Hungary restored full diplomatic relations with Moscow and signed a long-term agreement with the USSR that allowed the Soviets close control of Hungary's domestic economy. More than one million Hungarians became card-carrying members of the Hungarian Workers' (Communist) Party, which won control of the country's political institutions in a series of elections between 1945 and 1949.

The Communist government expropriated agricultural estates in 1945 and subsequently consolidated them into state farms. Under a Three-Year Plan introduced in 1947, the government nationalized nearly 600 industrial firms. In the fall of 1949, Hungary approved the constitution of the Hungarian People's Republic.

Hungary's economic system from 1948 to 1968 mirrored that of the Soviet Union. It was a centralized economy characterized by a rigid top-down approach to macro- and microeconomic planning. The Hungarian Council of Ministers set output targets, drawn up by a Central Planning Office, that were intended to ensure economic growth at a predetermined rate. Each state-owned company received hundreds or even thousands of performance targets every year.

Performance targets fell into four broad categories: physical output goals; input goals regarding material and parts specifications, as well as supplier references, labor quotas, and wage allowances; financial guidelines for profits, maximum allowable debt capacity, and production costs; and strategic instructions covering introductions of new products and technology and various capital investments to be made over the course of the year. While all plan elements were mandatory, some carried greater weight than others.

Hungarian managers were supposed to report actual results during and after each planning period, but managers often masked the true results and capabilities of their firms. If they performed too well, they would be given higher targets, which would be impossible to meet if supplies were not delivered as scheduled. In addition, managers strove to meet only those performance criteria on which they were measured. If output were measured in raw units, managers would make sure a large number of units was produced, regardless of quality. If aggregate value was the measure, managers would produce goods containing large amounts of expensive inputs.

Managers had no control over targets; altering numerical goals required that a company negotiate its way through multiple levels of the bureaucracy. This situation limited the ability of individual companies and the overall economy to react to changes in the environment. Managers were also limited in their ability to set prices for products and services. Centrally administered prices precluded companies from performing economic evaluations of capital investment or independently assessing the best mix of exports and imports.

In 1956, Hungary experienced its first public opposition to Communist rule. A new government, backed by local revolutionary

councils, announced that Hungary was pulling out of the Warsaw Pact<sup>3</sup> and becoming neutral in the Cold War. Soviet tanks rolled into the country and brutally crushed the revolt. In the aftermath, the Soviets installed Janos Kadar as general secretary of the Hungarian Workers' Party. Kadar ruled the country for nearly 30 years.

#### **A Slow March Toward Capitalism: 1968 to 1990**

In 1968, the same year that Warsaw Pact nations invaded Czechoslovakia to crush governmental steps there toward reform, the Hungarian government introduced its own reform, the New Economic Mechanism. The short-lived NEM was to create a planned economy that would be driven by market forces. Profit maximization was to become the highest goal of all state-owned enterprises, and the Central Planning Office was to be reduced in size and scope.

In 1973, however, Hungary suffered economic problems as a result of the first oil shock, and government authorities reasserted the primacy of central planning to maintain investment, consumption, and growth in gross domestic product (GDP). Although never formally withdrawn, the NEM was seriously curtailed. The government re-established centralized control of more than half of the investment in the economy. The government also began borrowing heavily from the West. Rather than investing in industries that would generate competitive trading products, the government poured money into the declining steel, coal, heavy-engineering, and chemical sectors--all areas in which Hungary was not globally competitive.

By 1980, GDP and investment growth had stalled, while consumption continued to grow at a brisk 10 percent annual rate. The government had accumulated more than \$10 billion in foreign debt, most of which had been spent on outdated technology, imports, and consumption.

In the 1980s, numerous reforms in the Hungarian economy were relaunched in efforts to generate hard currency, service the foreign debt, and increase Hungary's international competitiveness. The strategy was to create market functions in allocation of credit and to improve individual firms' access to export markets.

One of the first reforms was to establish a realistic value for Hungary's currency, the forint, which had been overvalued by about 20 percent in the late 1970s. Although the forint was not convertible, the government attempted in its reforms to maintain

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<sup>3</sup>A 1955 mutual-defense treaty that strengthened the Soviet Union's power over the satellite countries of Albania, Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and Romania.

its value at a rate close to the black market rate through periodic devaluations.

In an effort to allow the market to determine investment and capital formation, the government also encouraged the creation of several secondary financial markets. In 1987, eight commercial banks were established, which spurred financial competition and improved capital efficiency. In 1989, the Hungarian government established a stock market and issued shares in some state-owned companies.

Beginning with the Company Council Law, introduced in 1984, the autonomy of managers to make decisions for their companies also increased. To aid flexibility, the law allowed a considerable part of a firm's profits to be retained for investment, rather than being reallocated to money-losing firms. This law also gave managers greater responsibility than before in setting production goals, in deciding product mixes, and in marketing efforts. Managers were no longer to be appointed by governmental officials; they were to be directly or indirectly elected by the firm's employees. During 1985 and 1986, many companies established elected councils to facilitate the transition to decentralized management.

The Bankruptcy Law, introduced in 1986, required all companies to publish operating results and to make their statements available for public inspection. Ineffective operations were expected to declare bankruptcy. To aid workers displaced by factory closings, the government founded the State Rehabilitation Office. Thus a country whose doctrines previously stated that workers were never to be idle began to offer unemployment benefits.

The Foreign Investments Act of 1988 established in Hungary one of the most liberal foreign-investment environments in Eastern Europe. Foreign investors were assured freedom from adverse discrimination, compensation in original currency in the event of nationalization, the right to own up to 100 percent of a firm, and the ability to transfer abroad dividends and up to 50 percent of wages. Certain key industries--electronics, automobiles, telecommunication services, and machine tools--were guaranteed complete tax exemption. To encourage international trade, reciprocal trade agreements were established with 25 countries.

Some large firms were broken up, but others remained intact. Csepel, one of Hungary's largest industrial conglomerates, was divided into 13 autonomous companies, ranging from a bicycle venture to an education-and-development company. Other large firms successfully lobbied for additional capital and tax breaks, which allowed them to survive in their original, inefficient, states. The percentage of all active workers in the private sector increased by less than 3 percent between 1980 and 1988, when it

stood at 6.1 percent.

In 1988, the Hungarian government introduced the first progressive income tax and value-added tax in an East Bloc nation. These taxes were designed to shift the tax burden away from businesses to individuals, so that enterprises would ultimately increase investment and raise productivity. The immediate effects of these reforms, however, were to increase inflation and lower living standards.

Hungary's relatively liberal political and economic environment, as well as various tax allowances and duty concessions, had attracted more than 200 joint-venture investors by February 1990. On this dimension, Hungary outshone its trading partners in the Council for Mutual Economic Assistance.<sup>4</sup>

#### **State of the Hungarian Economy in 1990**

The well-intentioned reforms of the 1980s failed to create a robust Hungarian economy. Real growth in GDP stalled in the 1980s (Exhibit 3). At the same time, inflation climbed to 14 percent, as compared with the 6 percent level that prevailed in the early 1980s. Real wages declined. Investment, as a percentage of GDP, fell from 27 to 22 percent.

Hungary's trading position, always humble, deteriorated. In 1973, Hungary's share of total world exports was 0.8 percent, and in 1985, it was 0.4 percent. The Soviet Union, accounting for about 25 percent of all trade, remained Hungary's major trading partner. Hungary's main exports were agricultural products, machinery, and semifinished manufactures, not high-valued-added items.

Consumption grew rapidly in Hungary in the 1980s. Hungarians evidenced more demand for consumer goods than did the citizens of other Eastern European countries. Most families had television sets, almost a third of which were color. By early 1988, nearly half of all households owned an automobile. However, the average Hungarian worker had to work many more hours than his or her Western counterpart to earn the wages needed to purchase such goods. An automatic washing machine, for example, "cost" a Hungarian worker five times as many work hours as a West German worker (Exhibit 4).

In this consumption-oriented economy, Hungarians saved little. Banks lacked the capital to lend for investment needed to improve productivity and raise the standard of living. Instead, the

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<sup>4</sup>The Soviet-dominated East Bloc investment-and-trading coordinating group.

government borrowed from other countries. Most of this money went to finance consumption or fund ill-conceived investments. Foreign debt increased to more than \$19 billion--\$1,800 per capita--and the country's debt-service ratio almost doubled from 33 percent in 1981 to 64 percent in 1988. Servicing the debt impeded the government's ability to institute important investments in new technologies, manufacturing-process improvements, equipment, or machinery.

Hungary's economy was anemic in 1990. Its projected 1990 per-capita GDP, for example, was nearly one-seventh that of Austria's and one-eighth that of Germany's (Exhibit 5). Evidence was scant that Hungary was capable of competing with Western companies in producing and marketing products for exports. The Hungarian Chamber of Commerce reported that

the overwhelming majority of the machines used in industry are obsolete, and the proportion of machines and equipment to be written off is very high (23.0 percent). Worst of all, the trend is increasing.

A review by the Hungarian government estimated that about 60 of Hungary's largest companies would either have to declare bankruptcy or lay off substantial numbers of workers. The report estimated that about 1 million workers, 20 percent of the work force, were underemployed in subsidized operations.

The level of foreign investment in Hungary was paltry by Western standards. The 200 joint ventures in place in early 1990 had a combined value of \$300 million. Spain and Turkey, in contrast, received \$7.2 billion and \$3.0 billion, respectively, in joint-venture investments during 1988 alone. Critics of Hungary's government argued that, if the government sincerely wanted to attract foreign investment, it needed to reduce bureaucracy and grant foreigners the right to liquidate their investments fully.

Hungary lagged even in those areas in which it had invested the most, such as communications. The Hungarian telephone system was severely overburdened. Although the country possessed more telephones per capita than either Poland or the Soviet Union, its system of 152 phones per 1,000 persons was vastly inferior to Austria's (492 phones per 1,000) and West Germany's (621). Misdialed and disconnected calls, poor fidelity, and understaffed manual exchanges plagued the system. The World Bank in 1990 supported both a \$70 million upgrade of the network and the installation of a cellular system by USWest and the Ericsson Company. In addition, despite its goal of achieving energy independence and its successful operation of four nuclear power plants, Hungary imported more than half its total energy needs, mostly from the Soviet Union.

Hungary also had problems in human resources. Its population of 10.6 million had been declining since 1985, and the size of the work force fell 3.4 percent in the 1980s. Unfortunately, the population was expected to continue to decline at an annual rate of about 0.15 percent despite the government's attempts to reverse the trend by legislating liberal maternity-leave benefits, reimbursed child care at work-place centers, tax relief for families with three or more children, and generous prenatal and obstetrics allowances.

One method for increasing the effective size of Hungary's labor force would have been the retraining and movement of underutilized workers from inefficient, highly subsidized, low-growth industries. The government was less than vigorous in enforcing the 1986 Bankruptcy Law, however, with a resulting modest degree of worker redeployment from money-losing factories.

A shortage of skilled labor stimulated investment in education. Schooling was compulsory through age 16, and more than 95 percent of all students completed eighth grade. About 7.9 percent of the adult population possessed a university degree. The country contained 58 state-supported colleges and universities.

Because most Hungarian factories operated only single 8-hour shifts beginning at 6 a.m., a growing number of workers availed themselves of the opportunity to moonlight in the afternoons and evenings. Western observers remarked that many Hungarian workers seemed excessively tired from working their multiple jobs or, alternatively, lacked dedication to their principal employer. Some believed that the labor force had begun to work itself to the point of psychological and physical exhaustion. The life expectancy of the average Hungarian male had declined from 67 to 63 years of age in just 8 years. In addition, the country had the world's highest reported suicide rate. The number of alcoholics jumped from 224,000 in 1980 to approximately 489,000 in 1987, and psychiatric patients made up the second-largest group in occupying hospital beds in 1987.

### **Challenges for the New Government**

On April 8, 1990, the newly formed government was the inheritor of many challenges, not the least of which was to maintain the stability of the government. Harsh economic medicine might stimulate revolt in a population accustomed to the previous 40 years' low inflation; subsidies for rent, food, medicine, and utilities; full employment; job security; and an egalitarian wage structure. The alternative future, capitalism, offered no such certainties. With 20 percent of the population living in poverty and unemployment rising, maintaining the faith of the people would not be an easy task, but one factor working in the government's favor was that, unlike the leaders of other Eastern European



countries, the Hungarian government did not have to worry about internal ethnic struggles; 96 percent of the country was Magyar or Hungarian.

Hungary had three major tasks to carry out in order to achieve an efficient free-market economy. First, large injections of foreign capital were needed to improve infrastructure and modernize plants. Second, the remaining shackles of bureaucratic centralization had to be cast off. Third, and most important, attitudes had to change.

Despite a decade of reforms, the Hungarian people had yet to develop such capitalist attitudes as risk-taking, initiative, and enlightened self-interest. For decades, they had lived and worked in a planned economy run by bureaucrats that downplayed efficiency and emphasized equity. They did not understand the most fundamental tenets of a free market. One Western company, General Electric, learned this lesson after it bought a majority interest in a Hungarian light-bulb company in early 1990. At a meeting outside Budapest, a GE manager lectured his new staff about the importance of controlling inventory and receivables to maximize profit. "What means profit?" a Hungarian engineer asked. The American explained. Then came another question: "Why profit?"

Managers were just beginning to learn to respond to market forces and customers. The autonomy of managers to make investment decisions for their companies had increased substantially, but the vast majority had no experience in meeting the rigors of the market place. With a few exceptions, the concepts of entrepreneurship, pay-for-performance, cost control, strategic investment, and productivity remained alien.

Could foreign investors play the role of catalysts and economic missionaries in Hungary? To realize a return on their investments, they would have to devise systems and structures to encourage workers and managers to abandon attitudes and habits of the past 40 years. At a minimum, people would have to come to think of a job as a responsibility rather than a right. What steps could foreign investor/managers take that would not jeopardize the fragile opening allowed them?

Exhibit 1

HUNGARY IN 1990

Investment Plans in Eastern Europe

Results of a survey of chief executive officers in the United States, Europe, and the Pacific Rim countries:

- Do you plan capital spending projects in Eastern Europe during the next five years?

Executives saying yes in 1989: 5%  
Executives saying yes in 1990: 34%<sup>1</sup>

- If you plan to invest, where do you plan to invest?<sup>2</sup>

East Germany	87% <sup>3</sup>
Hungary	68
Poland	55
Czechoslovakia	47
Yugoslavia	13
Romania	8
Bulgaria	1
Albania	0%

- What are Eastern Europe's chances of becoming a major economic power in the next five years?

Very unlikely	29%
Somewhat unlikely	52
Somewhat likely	17
Very likely	2%

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<sup>1</sup>158 responses were received from CEOs in 1990. Survey jointly conducted by The Wall Street Journal, Booz-Allen & Hamilton, Inc., and Nihon Keizai Shimbun, Japan's leading business newspaper.

<sup>2</sup>Executives surveyed in 1990.

<sup>3</sup>Before reunification.

Exhibit 2

HUNGARY IN 1990

Comparative Business Climate Assessments in Early 1990

- Bulgaria The surprise package. Bulgarians ousted their dictator with little ado and have a flourishing Green movement.
- Czecho-slovakia Difficult to call this one yet. Czechs are highly skilled and innovative, the infrastructure is relatively good, and basic services work well. Ventures with large Western companies are already underway, but no framework exists for native entrepreneurs.
- East Germany [Before reunification] The safest bet in the East. West German cash is flowing, the people are skilled, and some modern infrastructure is in place. Provided the people don't go overboard politically, it is of definite interest.
- Hungary The most congenial if not the most profitable. Small companies are flourishing, privatization is underway, and a multiparty system exists. Budapest is the liveliest city in the East, but the rural areas are backward and very poor.
- Poland The switch to multiparty democracy is complete. Cash flows from the United States and West Germany are increasing. Poles are natural merchants but have no infrastructure. Rising expectations and an environmental crisis mean this one is still a toss-up.
- Romania Anyone's guess. The dictator is dead, but will a free system develop successfully? Not for the faint-hearted, but it may be an opportunity for those with traditional links.
- Soviet Union Joint ventures are surging, major companies including the Big Blue, IBM, are moving in. But will the Communist party give up its leading role? Political and social instability looming.

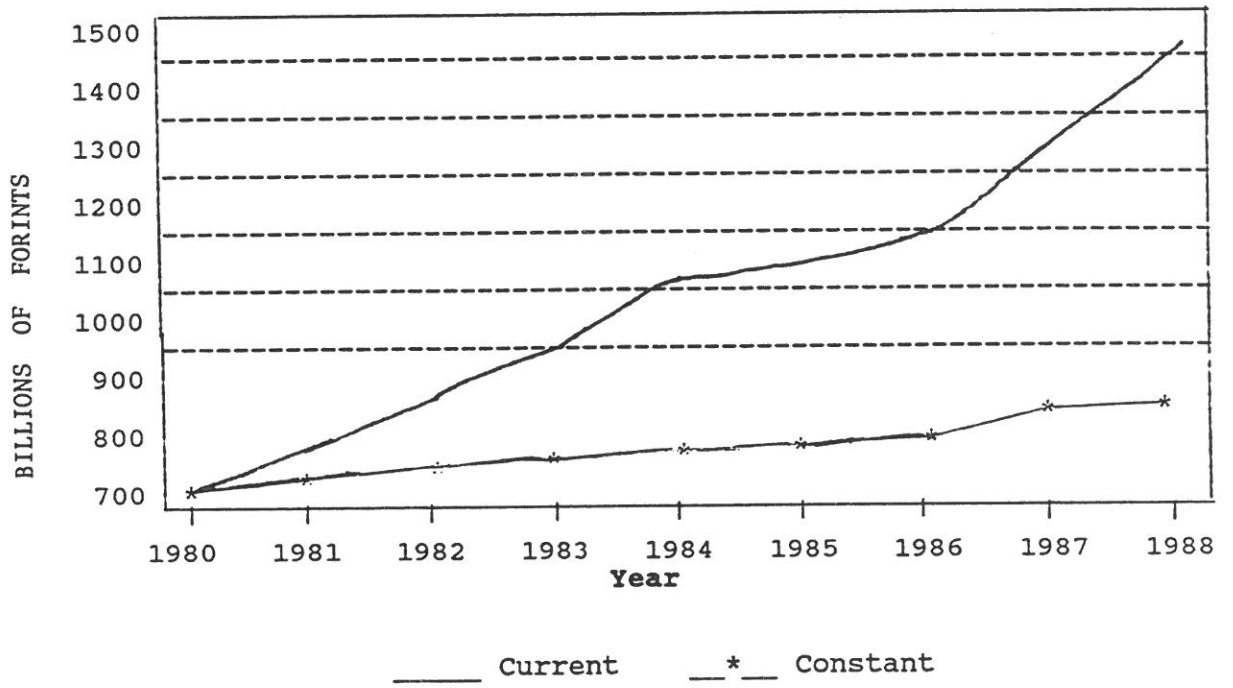
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Source: "The Economic Pulse Rate," Austria Business & Economy, Vol. 2: No. 3, January 1990, p. 9.

Exhibit 3

HUNGARY IN 1990

Gross Domestic Product



## Exhibit 4

## HUNGARY IN 1990

## Comparative Income Data

## A. Work Hours Required for Selected Consumer Goods, 1985

<u>Consumer Good</u>	<u>U.K.</u>	<u>W. Germany</u>	<u>Hungary</u>
Automatic washing machine	80	83	404
Automatic dryer	43	72	433
Color television	--	88	927
Personal computer (Commodore 64)	33	--	1,053
VCR	159	125	2,133

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Source: Heti Vilaggazdasg, Vol. 431, September 5, 1987, p. 51.

## B. Hours of Work Per Worker, 1986

<u>Country</u>	<u>Hours</u>
Hungary (per month)	144.7
South Korea (per week)	54.7
Poland (per month)	151.0
United States (per week)	40.7
Japan (per week)	46.0
Austria (per month)	142.1
Spain (per week)	38.6

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Source: 1987 Yearbook of Labor Statistics (Geneva: International Labor Office, 1987), pp. 675-678.

Exhibit 5

HUNGARY IN 1990

Projected 1990 Per-Capita GDP for Selected Countries  
(in dollars)

<u>Country</u>	<u>Per Capita</u>
Hungary	2,458
West Germany	19,560
United States	19,536
Austria	16,703
Italy	14,420
Great Britain	14,232

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Source: "The Economic Pulse Rate," p. 22.

**FOREIGN DIRECT INVESTMENT IN THE COMMONWEALTH  
OF INDEPENDENT STATES:****UNDERSTANDING VALUES AND BELIEFS  
AS THE KEY TO SUCCESS**

Foreign companies are eager to do business with the new Commonwealth of Independent States, the union formed at the beginning of 1992 by 11 of the former Soviet republics. For foreign companies, the breakup of the Soviet Union could eventually become a big plus. "Decentralization means chaos in the short term. But in the long term it's better," says Donald Kendall, former chief executive officer of PepsiCo and a longtime business partner of the Soviet government. The environment for investment will remain uncertain, however, for a long time. On the other hand, Kendall adds, "If U.S. companies wait until the problems are solved, somebody else will get the business."<sup>1</sup> Five years from now, conditions may be more predictable, but by then, first movers will have established advantageous positions with both consumers and their business partners. These early movers will have not only the benefit of prime positions, but also a significant jump on the learning curve for survival and growth in this unique environment, and they will have earned the support of the now-emerging generation of reformers and entrepreneurs.

Foreign investors were initially drawn to the Soviet Union in the late 1980s by its huge potential market of nearly 300 million people and Mikhail Gorbachev's promises of reform. In 1987, Gorbachev introduced a joint-venture law that gave foreigners the right to own up to 49 percent of businesses with Soviet partners, and, by 1990, more than 2,500 such agreements had been signed. Although many of the ventures are now successful and profitable, more than half have failed. According to several foreign businesspeople and

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<sup>1</sup>See Paul Hofheinz, "Let's Do Business," *Fortune*, September 13, 1991, p. 64.

lawyers working there, the Soviet Union was an investment opportunity for only the bravest and most patient.<sup>2</sup> The ventures were continually frustrated by the slow pace of economic and legal reform; the continual struggle between local, regional, and central authorities; and frequent backtracking as Gorbachev tried to assuage the hard-line Communists.

As of early 1992, the Communist Party is, of course, dissolved, along with some of the meddlesome apparatchiks (civil servants and managers of state-owned enterprises) it supported that extended like an octopus into every corner of the empire. Some apparatchiks are still around, however. They have changed colors, and many of them will be part of the emerging entrepreneurial class. Disbanded also is the KGB as a controlling and reactionary force. Yet, even though the country has changed dramatically since the attempted coup in August 1991 (and the rules, undoubtedly, will continue to change), the potential business partners, employees, and consumers are still the same people.

Thus, for foreigners who conducted business in the U.S.S.R. and for those who plan to enter the Commonwealth market, success depends greatly on an understanding of the people--their culture, beliefs, and values. Success, even survival, requires the drive and commitment to work within the system as it changes. For this reason, the experiences and attitudes of Americans who initiated joint ventures in the Soviet Union during the nearly seven years of Gorbachev's rule can serve as a useful guide for how to conduct business in the new Commonwealth.<sup>3</sup>

#### **Replacing a Collapsed Belief System<sup>4</sup>**

Neither Russia nor any of the other former Soviet republics has a tradition in or any appreciable knowledge of how democracy works or how to operate in a free-market economy. Moreover, the history of Russians dominating other nations, while being dominated within their own country, is a difficult background for devising and successfully implementing a new, voluntary association of the republics. A long period of confusion,

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<sup>2</sup>See Eleanor Randolph, "A Tough Place to Do Business," *The Washington Post*, July 30, 1991, p. A10.

<sup>3</sup>Many nationalities are represented in the Commonwealth of Independent States. Nevertheless, because the businesses considered in this paper currently operate only in Moscow, many of the individuals involved in them are ethnic Russians. For simplicity, therefore, the former Soviet managers and employees of these joint ventures are often referred to here as "Russians."

<sup>4</sup>This section was based on notes provided by John A. Armitage, a retired Foreign Service Officer and Diplomat-in-Residence Emeritus at the University of Virginia, Charlottesville, 1991.



disorder, and acute hardship await the Russians. Changes will bring many starts and stops along the way with unknown consequences for the economy, the governments, and the relationships among the new states.

The greatest difficulty for the Russians, however, is that their belief system has collapsed, and it is very unclear to them what is to replace it. The belief system that the Russian people lived under for centuries of Tsarist rule and for the 70-odd years of Communist rule held that the rights of the state are primary. The state was accorded all political power in order to assure law and order at home and security from its external enemies. The monopoly of centralized political power was also justified because the state was responsible for the welfare of all the people. Under Communist rule, this responsibility entailed the assurance of jobs for all, pensions, education, medical care, cultural and sports facilities, and a constantly, if very gradually, improving standard of living. This egalitarian provision for all people buttressed the belief in Communism as the most just, productive, and equitable society in the world, one of which its people could be proud.

The place of individuals and their rights came last. Their duty was to accept the opportunities offered by the state and to seek fulfillment by learning and doing well what the state assigned them. Russian men and women accepted this role and lived with it for decades. They may not have liked all of it, but they learned how to work the system:

- They did as little as they could to get by, because they were not rewarded for superior performance.
- They were taught to be suspicious of those who tried to get ahead or to do better.
- They avoided taking any risks or assuming responsibilities, because the government rewarded conformance rather than innovation or individuality.
- They were prone to equate enterprise--or capitalism--with black marketeering, obtaining scarce goods and selling them for outrageous prices.

Where do the Russian people turn now that this belief system has been discredited and discarded? Presumably, all democratic peoples would like them to adopt a belief system that the fundamental rights are those of the individual--to life, liberty, and the pursuit of self-fulfillment and happiness. Possessing these rights requires a person to respect the same rights of others, to assume responsibilities commensurate with the rights, to exercise self-discipline to replace the discipline denied the state, and to take and exercise the initiatives that help society. In the economic area, democratic people believe in the right of the individual to own property and develop it into productive enterprise in competition with others, and they believe that this system will produce quality goods at affordable prices.

In democratic politics, governmental bodies must become responsible to the people under laws defining and limiting the government's authority.

Foreign investors need to understand the extreme differences that currently exist between these two belief systems and to develop business relations with people in the Commonwealth that take these differences into consideration. In particular, they must keep in mind that democratic beliefs in North America and Western Europe have evolved over centuries and have entailed conflicts both within and between countries. Such beliefs are not necessarily easily adopted or even widely desired. Democratic maxims have been validated by the benefits and security they have provided as people have worked to improve their operation, but they have also been mortally challenged by the forces of racism and nationalism, Naziism, and fascism. In addition, to a people accustomed to state protection, democratic theory can seem heartless and frightening. Change is underway for the Russian people, but the foundation of their beliefs and behavior has deep roots and cannot be changed overnight. It may require decades.

#### **Developing Effective Business Relationships**

A study of the elements of success for three joint-venture restaurants in Moscow--McDonald's, Pizza Hut, and Tren-Mos--was performed by a group of students and professors from the Darden Graduate School of Business, University of Virginia, during a trip to the Soviet Union in May 1991. The following is a description of these US-Russian ventures:

- **McDonald's.** The first Russian McDonald's restaurant opened on January 31, 1990, at Moscow's Gorky St. and Pushkin Square. Seating 700 people indoors and another 200 outdoors, it is the largest McDonald's in the world. The restaurant is the first in a joint-venture contract that provides for an initial 20 McDonald's restaurants in the city.
- **Pizza Hut.** The first two Moscow Pizza Huts opened on Gorky Street and Kutozovski Prospekt in September of 1990. The opening culminated five years of negotiation and built upon the existing relationship between PepsiCo and the U.S.S.R. Pizza Hut adapted its menu somewhat to accommodate Russian tastes by including fish-topped pizza, borscht, and pickled cabbage among its regular fare.
- **Tren-Mos.** A January 23, 1992, article in *The Wall Street Journal* featured three successful joint ventures in the former Soviet Union--one of which was the Tren-Mos Restaurant, run by Jeff Zeiger. Zeiger, a 21-year-old Cornell Hotel School dropout, started the restaurant in May 1989 as an extension of his family's export/import business in the Soviet Union and a sister-city agreement between the Lenin District in Moscow and the Zeigers' hometown of Trenton, NJ. Tren-Mos was the first joint-venture restaurant in the Soviet

Union to offer continental cuisine in an upscale setting. The restaurant, located on Komsomolski Prospekt, seats 120 and employs 70 people, including a French chef. In the summer of 1991, two additional Tren-Mos restaurants were opened in and around Moscow.

In each case, the U.S. companies were able to develop effective business relationships in the Soviet Union because they took great pains, from the beginning of the negotiating process, to understand the Russian people and their beliefs and to incorporate this understanding into their business plans. Because Americans historically have not had an established set of business relationships or a solid understanding of the Russian people, these successful companies turned to their Soviet partners in order to gain insight and support. Forming a strong partnership based on trust, mutual respect, and a clear understanding of each side's strengths enabled them to work within the Soviet system, while also enhancing their ability to introduce and integrate Western efficiencies and business practices. In essence, the joint-venture teams attempted to bring together the best of both worlds.

The managers of McDonald's, Pizza Hut, and Tren-Mos were asked to compare and contrast their experiences in Russia to those in the United States or Europe. They identified a multitude of similarities and differences, but while the issues they covered were broad and varied, four critical factors continually surfaced in the discussions:

- Establishing decision-making authority.
- Battling inefficiencies.
- Managing consumer perceptions.
- Hiring and motivating Russian workers.

### **Establishing Decision-Making Authority**

The Russian members of a joint venture generally operate within the traditional Soviet model, in which the authority to run an enterprise is concentrated in a single general director. They are not trained in the participative management techniques prevalent in the West. As a result, Russian workers become confused when they receive directives from both Western and Russian managers. Moreover, many Russian managers believe that they should have control over the business venture and often ignore the preferences and directives of their Western counterparts.<sup>5</sup> These differences in management style are com-

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<sup>5</sup>These observations were reported by Keith Rosten in his article, "Soviet-U.S. Joint Ventures: Pioneers on a New Frontier," *California Management Review*, Winter 1991, p. 98.

plicated by the fact that many Americans are insensitive to the political, economic, and cultural differences between the two countries. In these situations, the Russians are even more likely to dismiss their U.S. partners' input as irrelevant.

Americans, therefore, cannot blindly assume that their management decisions will be accepted and implemented. Rather, they need to understand the inherent differences in management style and clearly delineate lines of authority with their Russian partners in the original joint-venture documents. Because the Russian people are generally legalistic, they will abide by the provisions in the joint-venture agreement; but the agreement must be clear and unambiguous. Moreover, the presence of Western personnel, at least until the businesses are fully operational, is critical for Western partners to maintain some control over the operations of their joint ventures--unless they are content to be silent partners.

The Western managers of McDonald's, Pizza Hut, and Tren-Mos all recognized these potential problems and carefully developed acceptable lines of decision-making authority with their Russian partners. Each, however, chose a different strategy:

- In its joint-venture agreement, McDonald's negotiated firm control of the decision-making process for its restaurant's operations. Even now, about 30 Canadian and U.S. managers remain on site at the restaurant in Moscow or at the food-processing facility. Russian managers currently hold mid-level assignments and are responsible for issues such as public relations and product quality.
- During construction of the Pizza Hut restaurants and the first nine months of operation, Western Pizza Hut managers were constantly on site in Moscow. In the joint-venture agreement, however, Pizza Hut had agreed to transfer management of the joint venture eventually over to the Russians. Andy Rafalet, regional director of Pizza Hut's operations in Eastern Europe and the Soviet Union, believed that "to make joint ventures work, you have to give the local management team the responsibility for running the business. I will be called the deputy general manager. I will be like the coach, training the people around me." Adhering to their promise, in May 1991, all permanent Western Pizza Hut managers left. Since then, they have limited their involvement to telephone conversations and occasional visits to ensure that quality standards are being maintained.
- Jeff Zeiger of Tren-Mos split the decision-making authority with his Russian partner. Zeiger handles public relations, hiring, and training, while his partner manages food purchasing and preparation. Each partner has final authority in his specified areas but consults the other to ensure consistency and coordination.

## **Battling Inefficiencies**

While Americans cannot ignore government regulations and all businesses have considerable "red tape" with which to cope, the former Soviet Union's red tape makes the other infrastructures pale in comparison. Soviet inefficiencies exist because of the central planning of nearly all production--which requires numerous layers of government organization and exhaustive paperwork--coupled with low authority and accountability at nearly all levels. Problems multiplied in the late 1980s when the republics, major cities, and districts began battling the central authorities for control. Formation of the Commonwealth most likely will have positive consequences for joint ventures in the long run as decision making becomes more decentralized. For the next several years, however, the transition in control will continue to create confusion and delays. Moreover, the Russian people are by now so accustomed to these inefficiencies that many do not understand how to be innovative or to assume responsibility for ensuring a profitable, long-term business.

American businesses, therefore, need to be aware that the establishment of a joint venture can be fraught with delays and frustrations. Obtaining a business license, receiving approval for a selected site, locating experienced management, and completing renovations are all concerns that a new operation faces in the United States. However, the uncertainty and complications of completing these same tasks in the former Soviet Union are of a completely different nature, and of much greater magnitude. Many Americans have learned the hard way that what is promised may not be delivered. For example, Zeiger found that building renovations were not only running dangerously behind schedule but were also not being completed according to his specifications. His air-conditioning pipes were installed along the outside of the wall instead of inside it, and his "deep red" carpeting arrived a dirty brown shade. Unlike in the United States, he had little hope of recourse in Moscow. Often a manager must learn to live with these disappointments, as Zeiger did.

Inefficiencies resulting from the Soviet system also cause problems in the day-to-day operations of a joint venture. In particular, uncertainties about the availability of raw materials, other supplies, and machine parts add another dimension to the risk of doing business. A major cause of these difficulties is the country's underdeveloped and aging distribution system. The roadways are poorly kept and planned. The government still requires that nearly all goods pass through Moscow before being distributed to other parts of the country, which often adds weeks to the delivery process.

For many joint ventures, especially the smaller ones, the best defense against many of these obstacles is to rely on their Russian partners' personal contacts and relationships. Through these contacts, the business can often obtain supplies that are not available in the state-owned markets or stores. These relationships can only help so much, however. Both the U.S. and Russian partners must work together to develop a plan for securing consistent supplies and for dealing with inevitable shortages and problems.

Of the three restaurants analyzed, each chose, early in the negotiating process, to deal with these anticipated frustrations in a different way:

- McDonald's decided to take control of its daily operations through vertical integration. McDonald's opened its own processing plant outside of Moscow to produce almost 100 percent of its food. During the first two years roughly 85 percent of the ingredients were sourced domestically from farmers, who were carefully trained by McDonald's and provided with the necessary capital equipment. Beginning in early 1992, however, McDonald's started making the transition from preparing all of its own food to buying it, at less cost, from Russian companies.<sup>6</sup>
- In contrast, Pizza Hut managers source 75 percent of their supplies from the local economy. They wanted to work with potential local supply sources to improve these suppliers' quality and standards. "We are not food producers," explained Rafalet. "Our expertise is in restaurants." In a few areas, however, Rafalet has had no choice but to import products. For example, he located a farmer who was willing to provide mozzarella cheese, and Pizza Hut flew him to England to learn how the cheese was made and provided him state-of-the-art equipment. Nevertheless, the mozzarella produced was unacceptable; the milk quality was too low. Therefore, cheese had to be imported until a sufficient number of cows could be raised on a diet of mostly Western grain to provide quality milk.
- Tren-Mos also took a local approach to running its daily operations by sourcing approximately 95 percent of its fresh goods domestically from Moscow's five public markets. Because Tren-Mos is a small operation and cannot afford to train food producers and provide them with capital equipment, the restaurant is more exposed to the pressures of the inefficient economic system than either McDonald's or Pizza Hut. In addition, because Tren-Mos is so reliant on local supplies, it is subject to certain governmental requirements that importing companies are not. For example, Tren-Mos must inform the government of its meat requirements three months ahead of time, which limits the restaurant's flexibility.

Even with their careful planning and clearly stated strategies, the joint-venture restaurants still encounter problems. For example, Tren-Mos cannot accurately predict what types of food will be served each day, since the goods available in the market change constantly. In fact, for the first year and a half of operation, Zeiger had to change the menu

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<sup>6</sup>See Louis Uchitelle, "That's Funny, Those Pickles Don't Look Russian," *The New York Times*, February 27, 1992.

daily. The managers of these three restaurants quickly learned that flexibility was instrumental to success.

### **Gaining Acceptance by Consumers**

Once an organization decides how it will approach the hurdles posed by the inefficiencies in the Soviet system, and magnified by the collapse of Communism, it must turn its attention to issues that will affect its perception and acceptance in the marketplace. For the nearly 70 years that the Soviet government controlled the production levels, assortment, pricing, and distribution of all goods, "business" competition was virtually nonexistent. Consumers' preferences were ignored, and their choices were extremely limited, with most products being of poor quality. As a result, the concepts of marketing, advertising, and brand loyalty did not exist in the Soviet Union. American managers of joint ventures cannot depend on market-research firms or advertising agencies to help gather information on consumer preferences or to advertise their products. Moreover, they generally must rely on their intuition to set prices on their products.

A joint venture's currency and pricing decisions will have important implications for operations, finance, and public relations. As of early 1992, the ruble was not a convertible currency. Soviet law, which has not yet been changed, states that joint ventures cannot accept both foreign hard currency and rubles at the same time within one facility. This policy clearly makes it difficult for businesses to earn enough rubles to pay employees and buy domestic supplies and, at the same time, earn hard currency to repatriate profits and import supplies. Consequently, each joint venture must search for a system that best enables it to meet its operating and financial objectives.

Ongoing changes in the currency exchange rate have also complicated pricing decisions for the three restaurants. At the time the joint ventures were being negotiated, the official exchange rate set by the Soviet government was about 1.6 dollars per ruble, although most people believed that the ruble was worth far less. It was against the law for Soviets to hold hard currency, which, over the years, had led to the rise of a black market. During the 1980s, many Soviets were illegally purchasing hard currency on the black market at a rate of approximately 10 rubles per dollar. By 1990, Gorbachev had acknowledged that the ruble was artificially propped up, and he introduced a mixed exchange rate for foreigners. He set an official business rate of approximately 2 rubles per dollar and a tourist rate of 6 rubles per dollar. At the same time, however, the poor quality of Soviet goods was recognized around the world, and the black-market rate fell to nearly 30 rubles per dollar. This trend suggested that the Soviet government still had a long way to go before reaching an equilibrium between its fixed exchange rate and the "free-market" rate established by the black market. Indeed, by early 1992 the government had lowered the exchange rate to more than 100 rubles per dollar, and Soviet citizens were allowed to hold hard currency that they had legitimately earned. Despite these extreme changes in the exchange rate, managers of the three restaurants have tried to maintain fairly constant ruble and dollar prices after

allowing for inflation. As a result, over time, menu items sold in rubles have become much cheaper for foreigners to purchase, while imported supplies and equipment have become expensive relative to the earnings they produce in rubles.

Before opening their restaurants, the managers in this study tried to determine who, based on their income, would visit their establishments. Most Soviet workers earned about 250 rubles per month in the late 1980s. In contrast, black marketeers and some senior government officials earned 2,000 rubles or more each month. Moreover, a burgeoning middle class of entrepreneurs was earning high ruble wages. Knowing these divergences in income, the restaurant managers adopted a wide spectrum of currency and pricing strategies:

- McDonald's decided to accept only rubles at its first restaurant in Pushkin Square. Russian people, therefore, have free access to the restaurant, although the food is somewhat expensive by Soviet standards. An average meal costs approximately ten rubles or one day's salary for an average worker. McDonald's next restaurant, which is scheduled to open on the ground floor of its office building, will accept only hard currency, and prices will be somewhat higher than in the United States. Given the exchange rate in early 1992 of more than 100 rubles per dollar, these prices will make the restaurant virtually inaccessible to the average Muscovite, although private entrepreneurs probably will be able to afford a visit.
- Pizza Hut's first restaurant has a ruble take-out line and a hard-currency eat-in area. The second facility is subdivided into ruble and hard-currency sides, both eat-in. At opening, a large pepperoni pizza in the ruble restaurant cost 18.20 rubles, while it cost \$6.90 on the hard-currency side. Pizza Hut managers hoped to serve primarily Russians in the ruble restaurant and thought that foreigners and some successful private entrepreneurs would visit the hard-currency restaurant. At the tourist exchange rate in September 1990, an American student would pay more than twice as much money to eat in the hard-currency restaurant than he/she would pay to eat in one of the ruble restaurants. Why then would an American choose to pay in dollars? The answer was simple: Pizza Hut planned to maintain a standing line of at least 30 minutes in front of the full-service ruble restaurant. Therefore, foreigners would need to pay extra if they wanted quick service.
- Tren-Mos has taken yet another approach. The restaurant's managers devised a system that accommodates both hard currency and rubles: lunch service is generally for rubles, and dinner is for hard currency. The restaurant can, therefore, accommodate both Russians and foreigners within the same facility,



but at different times of the day.<sup>7</sup> The restaurant generates enough revenue in rubles to cover almost all expenses, so the dollar profit margin works out to 65 cents on every dollar taken in. One bar and one kitchen serve all guests, and all staff receive equal training regardless of the shift they work. Zeiger explained that he considers the equal treatment he shows the Soviet people to be fundamental to his success.

While all three joint ventures serve both Russians and foreigners, the perceptions of these restaurants may differ from this reality. The important questions are whether the Russian people care whether they have equal access to the services of joint ventures, and if so, how that will affect business in the short and long terms. To most Americans, a segregated restaurant would be completely unacceptable. Many Russians, however, apparently feel quite differently. Because they are not accustomed to the freedom of choice that Americans have, they have a positive reaction when given another option, such as a ruble side of a Pizza Hut restaurant. In other words, they currently see these new choices as privileges, rather than rights. Nevertheless, as the Russians learn more about democracy and free-market economics, and if the ruble becomes convertible, they will expect foreign companies to cater to their needs and provide equal access. At that point, public opinion may play a pivotal role in the success of a joint venture.

To establish strength in the market and develop brand awareness among customers, foreign companies naturally turn to advertising. However, while Americans perceive advertising as a conventional path to educating people on products and services, it is often met with resistance from Russian partners and exposes another key cultural distinction. Advertising was not only considered unnecessary in the Soviet Union, but was unwanted by the government. Although some joint ventures still have no reason to advertise, because demand for their well-known, foreign products exceeds supply, smaller joint ventures struggle with the best way to promote their products.

McDonald's and Pizza Hut rely heavily on name recognition, media publicity, and prominent locations to promote their restaurants. Tren-Mos, on the other hand, does not have this luxury and actively advertises--to foreigners only--by working with the concierges in several of the Western hotels. The concierges recommend Tren-Mos to the hard-currency visitors and pass out business cards in return for several complimentary dinners. Tren-Mos also advertises on Europa Plus, an English-speaking radio station, and has posted a sign at the airport. In addition, the restaurant's managers work with American magazines to ensure that the restaurant is mentioned in travel sections discussing Moscow. At this time, however, Tren-Mos still relies on word of mouth to inform customers of its lunch business in rubles. The managers of all three restaurants realize that brand loyalty--hence,

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<sup>7</sup>See Laurie Hays, "Some Americans Take the Steppes in Stride," *The Wall Street Journal*, January 23, 1992, p. B1.

advertising--will become more important as the economy develops and the Russian people are given more choices.

### **Hiring and Motivating Employees**

American business people must understand and make efforts to develop Russian workers. Leaders of a new joint venture must discover how the people can be motivated. To do so requires an understanding of how workers will view work, capitalism, and democracy.

While Americans and Russians share many of the same core values--friendship, family, and a desire for job satisfaction--the systemic differences between the two countries have resulted in distinctly different American vs. Russian views of the workplace. In the U.S. work place, 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. Russian citizens have never been given such responsibilities. As mentioned earlier, decision making in factories rested with the general director, and even he or she was told by the state specifically what to produce and how much. 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 the Soviet economic system are a pronounced aversion to risk taking, a lack of individual initiative, and little attention to efficiency.

Given these differences in work attitudes, the hiring and training of employees is a crucial decision for a joint venture. Unlike in the United States, lack of education among employees is currently not a problem in the Commonwealth. Moreover, employees are eager to leave their state jobs for more pay and a chance to work for a foreign company. The question is: Which workers will be able to adapt most readily to the idea that customer service, quality, and speed are of the utmost importance? The three joint-venture restaurants took somewhat different positions on these issues:

- When McDonald's opened its restaurant in Pushkin Square, nearly 25,000 Russians applied--many of whom had professional work experience and held advanced degrees. The restaurant managers, however, decided to hire mostly young people with little prior work experience for the approximately 600 positions available. McDonald's executives thought that, even though a more experienced labor pool existed, younger Russians had not yet been "spoiled by the system" and would be easier to mold.
- Pizza Hut also received a large number of applicants after placing a small ad in the *Moscow Communist Youth Daily*. Many of the applicants had worked

at McDonald's since its opening several months earlier. They viewed Pizza Hut's full-service restaurant as being more prestigious, and McDonald's had hired so many people that individuals were referred to by their number, not their name. Pizza Hut selected people who were as near to "street wise" as possible--that is, resourceful people with common sense. The 300 people who eventually were hired could only be termed eclectic. The 16 cashiers all had banking diplomas, many of the waitresses were young mothers with little or no academic training, and some of the kitchen staff had Ph.D.s in engineering.

- Because Tren-Mos was a much smaller venture, the managers hired the best or most promising workers from operations that were similar to theirs. In order to do this, Zeiger and his Russian partners combed the city's few existing cooperative (private) and state-run restaurants and chose workers who offered the most courteous service or possessed the greatest potential. While these workers generally were not accustomed to Western standards, Zeiger carefully trained them and provided continuous feedback on their performance.

Because each business venture in the Commonwealth is unique, it is difficult to say at this time that one of these approaches is superior to another. Much will depend on how the highly educated Russians who were hired will react to these jobs, which most Westerners consider menial. As the "glamour" of working for an American restaurant subsides, turnover of overqualified employees is likely to increase. As more foreign businesses enter the marketplace and present new opportunities to Russian workers, choosing employees for these establishments will become more like it is in any other country. The workers will be given choices and will consequently adjust their expectations and criteria of what constitutes a "good" job.

For all three joint-venture restaurants, hiring employees was only the "tip of the iceberg" when it came to developing a work force to meet Western standards. Almost all claimed that the crucial part of this process rested in training. The managers of all three restaurants stressed the same qualities they would in their U.S. operations: courtesy and efficiency. However, because of the lack of competition in the retail market, these traits have been difficult for new Russian employees to develop.

With the declining value of the ruble, Russian labor is extremely cheap when measured in dollars. And because the ruble is not yet convertible, most joint ventures have rubles to spare. Consequently, companies generally hire more workers than they would in the United States and expect less output per worker. Both McDonald's and Pizza Hut decided to absorb the cost of more employees rather than invest in additional training because of the difficulty that many of the new employees experience in adjusting to an American work style. At the Moscow McDonald's, new employees are trained for four weeks, which is less than they would receive at any other McDonald's site. The tradeoff is that the operating crew of 200 per shift is much larger than an American crew for the same

size restaurant. At Pizza Hut, training is also compressed into a shorter period. Both companies accept less than their international standards of service time and efficiency; the time standards at Pizza Hut are approximately half of those in Western countries.

In contrast, at Tren-Mos, Zeiger takes the time to communicate the importance of immaculate glasses, hot food, and strict attendance. He believes that, because Tren-Mos is an upscale restaurant, he cannot afford to take shortcuts on training and the quality of service. While he admits that the workers need much longer to adapt than American workers do, the result is the best and most Western-style service found in Moscow. Although these approaches are difficult to compare and judge, Tren-Mos has apparently followed what will be a more efficient and cost-effective long-run strategy.

As part of its training of workers, perhaps the most important element for a joint venture is deciding how to motivate its workers to adopt new standards and how to build loyalty. The idea of paying for performance, while commonplace in the United States, was not part of the Soviet system. Traditionally, Soviet workers will tell you, they have followed the "you pretend to pay us and we'll pretend to work" philosophy. Most joint ventures have found, however, that workers respond well to incentive plans, although they have to be structured somewhat differently than they are in the United States. For instance, Pizza Hut has a system with a base salary of approximately 250 rubles per month onto which the company automatically adds a 250-ruble bonus. Each time a worker fails to show up for work, comes in drunk, or performs inadequately, a certain percentage of the bonus is taken away. While this approach runs counter to the traditional U.S. bonus system, foreign managers explain that, because Soviet workers do not have a good grasp of the standard they should be striving for, the best approach is to set that standard and let each deduction be a lesson.

Another monetary issue that must be dealt with is the compensation of Russian employees for their hard-currency tips. Given the declining worth of the ruble, hard currency is extremely valuable to a Russian citizen. While foodstuffs and consumer goods are scarce around the country, they are plentiful at state-run hard-currency stores (called Beriozkas). The problem is that Russians cannot hold hard currency without specific documentation that they have earned it. One way Tren-Mos found to work within the constraints of the law while still benefiting its employees is to set up employee accounts at the Beriozka. Tip money is automatically deposited into these accounts as employees earn it. When the workers wish to purchase items, the store draws directly from these accounts. These accounts provide an added incentive for employees to provide excellent service to their customers, because they allow Russians access to previously unobtainable items.

A slight increase in pay generally does not motivate Russian workers, especially those who do not receive hard currency, at a time when there is little that Russians can purchase with their rubles. While the 500 rubles/month salary that McDonald's workers receive is roughly 60 percent higher than the average Muscovite's salary, these workers are already comparing the monthly salary, which is worth approximately \$5.00, with the salaries of

McDonald's employees in other countries. They cannot help but wonder why their pay is so much lower than a comparable Western worker's pay.

### **Applying Lessons in Future Business Relations**

Amid the transition from a centrally planned to a market economy and the growing turmoil in the country's economic situation, Western businesses continue to greet each day in Moscow as a new learning experience. For example, the Commonwealth has still not resolved questions about who owns assets and who has the right to sell them. Under the Soviet system, land and natural resources belonged to the state, as the ostensible representative of the people. Ongoing legislative developments, however, offer new flexibility to foreign investors. Foreign companies and Russian citizens can now form companies that may issue stock. In addition, foreign investors can establish their own companies in the Commonwealth, without Russian partners.<sup>8</sup> Therefore, while in the future joint ventures probably can expect to operate more freely than before, these and further legislative developments may persuade a foreign investor to establish its own enterprise (over which it has absolute control) or to purchase shares in an ongoing enterprise rather than work under the constraints of a joint venture.

Such changes will dramatically affect the structure of Western companies' future activities in the Commonwealth, but businesses will still need to confront the realities of inefficiencies that developed during the 70 years of Communist rule. They will need to establish appropriate decision-making authority, manage the perceptions of Russian consumers, and hire, train, and motivate Russian employees. Foreigners will still need to recognize that their Russian suppliers, customers, employees, investors, and partners are operating under an entirely different set of values. This divergence most likely will be a source of frustration and tension, but it can also create the possibility for creative approaches to help both parties achieve their goals, just as McDonald's, Pizza Hut, and Tren-Mos have done.<sup>9</sup>

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<sup>8</sup>For a discussion of these new laws, see Rosten, "Soviet-U.S. Joint Ventures," p. 93.

<sup>9</sup>Joint ventures in manufacturing and mining probably will encounter even more problems than the three restaurants discussed in this note, because the logistical, technological, and managerial complexities are greater in industry than they are in the service sector.



# FINANCE

## SCHWINN BICYCLE COMPANY (A)

In 1988, Tom Henderson drove up to the Csepel (pronounced Chap'el) Works near Budapest, Hungary. He was amazed at the size of these manufacturing facilities, which were about 15 kilometers south of Budapest. Csepel was also an extremely complex factory. It manufactured basic metal shapes in both copper and steel and finished products as diverse as bicycles and machine tools. It had apparently grown like Topsy over the past 70 years. Approximately 16,000 people were employed in the various businesses, which were mostly borderline in profitability.

Henderson was here to inspect the KKG bicycle-manufacturing facilities. Schwinn was contemplating a joint venture with this formerly state-owned but now for-profit company. It was not the first time Schwinn executives had discussed a joint venture with this Hungarian company, but it was Henderson's first involvement.

Schwinn Bicycle Company, a privately owned American manufacturer of premium-priced bicycles, produced over a million units a year and had sales in the hundreds of millions of dollars. In addition to bicycles, it marketed a complete line of accessories and parts, fitness equipment, and a clothing line.

Schwinn had been managed for 95 years by the Schwinn family and, in 1988, was run by Edward R. Schwinn, a fourth-generation family member, from corporate offices in Chicago, Illinois. Schwinn's primary strengths were the quality of its equipment and its distribution system. Its promotion material advertised Schwinn bikes as "The Winningest Bicycles in America" and was supported by world championships and 40 wins by the Schwinn/Wheaties Pro-Team in 1988. Distribution included 4 company-owned wholesale warehouses and 2,000 U.S. retail outlets. In addition to its U.S. operation, Schwinn sold products worldwide and had a joint-venture manufacturing operation on mainland China.

Schwinn had recently embarked on a new stage of globalization and was interested in gaining a European production facility. One of the company's major competitors, Derby International of Great Britain, had earlier implemented its global strategy by purchasing



bicycle companies in the United States, Canada, Austria, and Holland. Schwinn realized that the bicycle industry was becoming multinational, and if Schwinn wanted to remain competitive, it had to increase its presence overseas. In addition to the China joint venture, the company was currently involved in obtaining operations in Taiwan and Japan. Schwinn had no manufacturing or assembly operations in Europe, however, so it looked favorably on opportunities for operations in Eastern Europe. The company was especially interested in Hungary, because that country seemed to be actively pursuing business with the West and had a more aggressive and accommodating approach to joint ventures than did other Eastern European countries.

### **Hungarian Economy in Early 1988**

At the beginning of 1988, Hungary had serious economic problems to overcome, and few simple or quick-fix solutions were in sight:

- hard-currency debt of US\$18.7 billion
- during 1987, a balance-of-trade deficit in convertible currency of \$904 million, equal to 3.2 percent of gross domestic product
- an inflation rate of 15.7 percent, predicted to be 20 to 30% in 1990
- inefficiency and below-average quality in manufacturing
- overstaffed operations, which could lead to high unemployment following privatization
- political and economic uncertainties--fragmented political parties and changing laws and regulations
- a relatively stagnant economy, but some slight growth in 1987

Hungary also had a number of basic strengths, however, that would be helpful in resolving these problems:

- an enlightened government that was developing programs to support a market economy
- some experience with a two-tier economy, in which forints, the Hungarian currency, were exchanged for hard currency
- a trade surplus in its nonconvertible currency accounts, especially with the Soviet Union
- a good education system
- a conscientious and willing work force (many held two jobs, however) with low wages
- a population that was supportive of changes toward a free-market economy

The Hungarian economy, while centrally planned, had set an agenda for correcting its difficulties that incorporated Western-type actions. The plans included, but were not limited to, the following:

- privatization of state-owned companies
- foreign-investment incentives
- entrepreneurial incentives
- tax reform
- currency convertibility
- political and legal changes
- development of commercial banks and capital markets

These actions were very ambitious; each initiative involved many important decisions and had far-reaching complications. For example, privatization was much more complicated in a Communist state than in a Western country. No accurate financial histories, balance sheets, or income statements existed, and the concepts of the "time value of money" and "cash-flow analysis" were unknown. Under these circumstances, setting a value on the assets to be privatized was next to impossible. Assuming a value was determined, financing became the next problem. With no stock market, no capital market, a single state-owned and -managed bank, and a nationwide capital shortage, investment capital had to come from other countries.

Moreover, even if the problems of valuation and capital source were resolved, many uncertainties remained. The most significant involved ownership, product pricing, redundant workers, and monopoly enterprises. First, for most companies, who owned the assets and who should receive payment for those assets were both uncertain. In companies that had previously been handed over to joint worker-manager councils, this group believed they were the owners. In almost all cases, the privatized venture needed the capital to up-grade antiquated and poorly maintained facilities, but the government wanted the capital to pay down debt. No mechanism existed to decide. Second, product prices had always been set by the government. The bases for setting prices were social and political, seldom related to costs. The government would still control pricing, and, in spite of the inflation, there was no certainty the government would approve requests for price increases, especially for consumer goods that had always been subsidized. Third, as the Hungarian government acknowledged, most operating units employed 25 to 40 percent more workers than would be found in a competitive Western enterprise. Although no specific constraints to laying off the redundant workers existed, neither did unemployment benefits or plans for the government to initiate them. Potential managers worried about operational morale if workers were laid off without any consideration. Monopoly was another uncertainty. In communist Hungary, with its barely 11 million people, most businesses had been consolidated into one monopolistic unit. Csepel was the only manufacturer of bicycles in the country; there was one tire manufacturer, one electric wire and cable company, one truck company. If the goal of privatization was free enterprise and competition, what type of regulation would be enacted to control the monopolies?

Despite a new law, Hungary did not allow 100 percent ownership of enterprises by foreign investors--in fact, without specific, difficult-to-get approval, ownership of 50 percent or more was impossible. On the other hand, laws and regulations dealing with joint

ventures had been liberalized more in Hungary than in any other East Bloc country. Both profits and capital could be returned to the investors in the currency of investment without restriction. A company such as McDonald's could repatriate profits even if it did not generate hard currency.

The government had taken some specific actions that were likely to have a significant effect on the business climate for 1988 and later years. The government was forcing tight monetary conditions on the domestic market to drop the level of real household consumption. It was also pressing manufacturers to sell their products externally, especially into hard-currency markets. Tax reform included a value-added tax and a personal income tax and were introduced at the beginning of 1988. Consumer and producer price subsidies were terminated, which caused an overnight 8 percent increase in prices. The government had begun restructurings of government-owned companies, and bankruptcy laws were tightened. Imports from East Bloc countries were stimulated to increase supplies to the domestic market and reduce the current Hungarian trade surplus. Exhibits 1-4 provide additional economic data.

The government had announced very specific goals for 1988, of which the major ones were:

- to establish sustainable macroeconomic equilibrium as a forerunner of a convertible currency
- to cut the deficit of its current account to US\$500 billion from US\$846 million in 1987
- to enforce tight conditions on the domestic markets that would reduce domestic-market growth and the level of real household expenditures
- to increase exports of manufactured products to convertible-currency areas
- to implement tax reform
- to cut subsidies a sizable amount, to stabilize exports, and to increase imports from Russia and other Eastern countries where Hungary had earned trade surpluses for the last few years

### **KKG: The Hungarian Bicycle Industry<sup>1</sup>**

KKG had been the sole manufacturer of bicycles in Hungary for more than 50 years and was protected with a 30 percent tariff on imports. The company experienced a number of name changes and a number of different owners during this time because of the changing economic philosophies of the governments. In 1948, the company produced motorcycles along with 90,000 bicycles. By 1975, bicycle production had increased to 250,000 units, and

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<sup>1</sup>The source of industry information is the case "Manufacturing Bicycles in Hungary," UVA-G-366.

a three-pronged restructuring occurred: motorcycle production was closed down because it had been losing money, an operation manufacturing machines for the garment industry was incorporated into the factory, and a plan to increase capacity to 500,000 bicycles was initiated.

The following table shows bicycle production and demand for bicycles in Hungary. As can be seen, production never reached the planned 500,000-unit capacity.

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	<u>1975</u>	(thousands of units)		
		<u>1980</u>	<u>1983</u>	<u>1985</u>
Bicycle production	254	374	260	244
Exports	112	151	1	0
Imports	252	207	212	200
Domestic sales <sup>1</sup>				

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<sup>1</sup>Data not corrected for changes in domestic inventory.

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KKG stopped exports to Western Europe after 1980, primarily because of the upward valuation of the forint from 60 per dollar at the time of the plan to 37 per dollar in 1980. In addition, Iraq and Iran were large importers of KKG bikes, and war cut off the demand from those countries.

In 1983, KKG became a commercial for-profit organization when the government turned the factory over to independent company management. With the loss of most state subsidies, the company then had to increase prices, which reduced sales volume. In spite of some state subsidies, the bicycle operations produced no profit. Indeed, the existence of bicycle production really depended on the sale of garment machinery, which was stable and profitable. More than 75 percent of these garment machines (95 percent of the exports) were exported to Russia.

The quality of Hungarian bicycles was acceptable but not equal to that of Western products. Units weighed about 10 percent more than comparable Western products and were made from lower quality components. Many domestic models lacked reflectors, a hub gear-shift system, rim brakes, and other equipment that were standard on most Western bicycles. Styling variations of Hungarian bicycles, which included color stripes, choice of

colors, and the quality of finish, were well below international standards, and durability of the units was no better than that of Western products.

KKG had fallen behind in the process technology used in competitor plants in other countries. In addition to low labor productivity of the manufacturing processes, the plant was poorly laid out and organized. For example, at a West German company, preassembly and assembly required 26 and 55 minutes, respectively; at KKG, the same operations required 44 and 92 minutes.

Low productivity and excess personnel mandated by government policies against layoffs had resulted in staffing levels about 40 percent higher than a comparable Western plant. Excess workers and resulting low productivity meant that bicycles carried extra indirect costs of about 1,000 forints (Ft) per unit. (The official exchange rate was 60 forints for a dollar in 1988.)

Fixed costs were driven up by poor capacity utilization, long transport routes, unnecessary moving costs caused by decentralized workshops in the factory, and high heating and energy costs. In addition, domestic prices for raw materials and semifinished products used in production, such as steel bands and tubes, were higher than world prices; thus, most material costs were higher for KKG.

The company was unable to import cheaper parts and assemblies from Western companies because of hard-currency shortages. It might have benefited from production sharing with foreign firms, but the government had levied a protective tariff of approximately 30 percent that made imported bicycle parts cost more than the company's production. The following table illustrates original import costs relative to KKG's production costs:

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<u>Part or Assembly</u>	<u>Production Costs at KKG (Ft/unit)</u>	<u>Price on World Market (Ft/unit)</u>
Front hub	25.2	18.0
Rear hub	182.0	158.0
Saddle	130.0	100.0
Pedal	73.1	46.9

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Losses in bicycle operations amounted to Ft361 million in 1980 but decreased to Ft90 million in 1983 and stopped in 1985 after exports were discontinued. No exports meant no

convertible currency was generated, however, which was detrimental to the Hungarian economy.

In many ways, the firm's profitability was hurt most by the excessive economic regulation of the Hungarian state. The turnover tax levied on sales and the labor bill inflated domestic prices. In addition, the steady appreciation of the forint in the late 1970s had raised prices of Hungarian bicycles abroad. Under the economic reforms of 1980, domestic prices were subject to limits based on export prices and the cost of imported raw materials. Because of the reforms, the company was unable to pass along its high raw-material prices to domestic consumers. The result was that domestic prices were steady from 1980 to 1985 while material costs rose, squeezing margins. Bicycles were transferred to the "free price" category, but prices still could be changed only with the permission of the State Price and Material Bureau.

### **The Decision**

To help with its analysis of the KKG opportunity, Schwinn management had gathered some additional information on joint ventures in Hungary. Apparently a number of methods could be used to structure the joint bicycle business. One was to manufacture the products in a free-trade zone in Hungary. This method allowed materials and parts to be shipped in, with duty, but the duty would be returned on all assembled items shipped to convertible-currency countries. The 30 percent tariff on bicycles would remain on all imported parts used for bicycles sold in Hungary. A second method was to manufacture the bicycles in Hungary, sell the majority of them in Hungary and other East Bloc countries, and sell the balance of the production in Western Europe. In this method, the Hungarian government could give incentives either in the form of a 5-year tax holiday or a reduction in the 50 percent value-added tax.

Schwinn's analysis of the future in Europe, including the plans contemplated by Western European countries for 1992 and the apparent changes in the East Bloc countries' desires to trade with the West, indicated that the second structure might be better. The free-trade zone had short-term advantages and would be preferred under current conditions. If, however, trade between East Bloc countries became freer and was based on convertible currencies in each country, the experience of marketing in the East Bloc would be invaluable. Initiatives to implement currency convertibility within the East Bloc countries were in process, and convertibility within those countries was likely to occur sooner than convertibility with the dollar or other convertible currencies. Trading within these Eastern countries would open opportunities for a Csepel-Schwinn joint venture to increase volume and, thus, profitability.

Tom Henderson's task was to determine for Schwinn management the criteria to be used to make the go/no go decision, what additional data and analyses were needed to reduce the uncertainties, and, if the decision were to proceed, what the key negotiating issues were.

## Exhibit 1

## SCHWINN BICYCLE COMPANY (A)

Hungary: Gross Domestic Product  
(in billion forints)

	<u>Current Prices</u>		<u>Volumes (%)</u>
	<u>1987</u>	<u>1988</u>	<u>1988/1987</u>
Sources			
Industry	399.9	420.0	98.1
Agriculture	180.2	191.0	105.2
Construction	91.6	97.0	97.8
Other material and services	554.7	692.0	100.0
GDP total	1,226.4	1,400.0	100.0
Uses			
Personal consumption	778.5	858.9	95.7
Public consumption	126.3	155.0	102.8
Consumption, total	904.8	1,013.9	96.7
Gross fixed investment	303.5	304.0	94.3
Net increase in stocks	24.0	45.1	
Domestic use of GDP	1,232.3	1,363.0	97.7
Exports	464.4	529.5	106.3
Imports	470.3	492.5	100.6
Net exports	-5.9	37.0	
GDP total	1,226.4	1,400.0	100.0

Source: National Bank of Hungary 1988 Annual Report.

## Exhibit 2

## SCHWINN BICYCLE COMPANY (A)

Hungary: Balance of Payments in Convertible Currencies, 1986-1987  
(in million US dollars)

	<u>1986</u>	<u>1987</u>
Exports	4,136	5,078
Imports	-4,676	5,075
Trade balance	-540	3
Freight and insurance, net	-237	-308
Travel, net	199	368
Investment income, net	-829	-924
Government expenditure, net	-32	-52
Other current receipts, net	-54	-36
Unrequited transfers, net	74	102
Current balance	-1,419	-847
Medium- and long-term capital		
Assets, net	-311	-97
Liabilities	1,202	1,177
Inflows	3,802	3,108
Outflows	-2,600	-1,931
Short-term capital, net*	577	-1,137
Overall balance	49	-904
Monetary movements**		
Monetary gold (-increase)	(-14)	(324)
Foreign exchange (-increase)	(15)	(935)
Use of IMF resources	-50	-355

\*Includes errors and omissions.

\*\*Figures in brackets mean increases in assets.

Source: National Bank of Hungary 1988 Annual Report.



## Exhibit 3

## SCHWINN BICYCLE COMPANY (A)

Hungary: Balance of Payments in Nonconvertible Currencies, 1986-1987  
(in million US dollars)

	<u>1986</u>	<u>1987</u>
Exports	5,012	4,815
Imports	-4,995	4,713
Trade balance	17	102
Freight and insurance, net	-76	-81
Travel, net	167	170
Investment income, net	-28	-39
Government expenditure, net	4	6
Other current receipts, net	45	101
Unrequited transfers, net	4	3
Current balance	133	262
Medium- and long-term capital		
Assets, net	-64	-111
Liabilities	-174	-107
Inflows	59	60
Outflows	-233	-167
Short-term capital, net		
Assets	25	8
Liabilities*	10	72
Overall balance	-61	124

\*Includes errors and omissions.

Source: National Bank of Hungary 1988 Annual Report.

## Exhibit 4

## SCHWINN BICYCLE COMPANY (A)

Hungary: Gross Foreign Debt, 1983-1987  
(In million US dollars; end of periods)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
In convertible currencies	8,250	8,836	11,760	15,086	17,739
By original maturity*					
Short-term	2,123	1,421	1,705	2,422	1,954
Long-term	6,127	7,415	10,055	12,664	15,785
By type					
Financial loans**	6,712	7,220	10,089	13,355	15,776
Trade-related credits†	1,124	1,125	1,319	1,433	1,652
Intergovernmental credit	4	3	2	1	1
Other‡	410	488	350	297	310
In nonconvertible currencies	1,367	1,260	1,229	1,109	1,026
By original maturity					
Short-term	380	342	176	199	263
Long-term	987	918	1,053	910	763
By type					
Financial loans	331	341	212	228	290
Trade-related credits	30	24	-	-	-
Intergovernmental credit	948	863	1,009	873	728
Other	58	32	8	8	8
Total foreign debt	9,617	10,096	12,989	16,195	18,765

\* Short-term debt is defined as debt with a maturity of one year or less. Long-term debt is defined as debt with a maturity of over one year.

\*\* Syndicated loans, bonds and notes, bank to bank credits and deposits, and balances of nonresident banks.

† Including bankers' acceptances.

‡ Mainly down payment for Hungarian export and import documents in the process of settlement.

Source: National Bank of Hungary 1988 Annual Report.



### SCHWINN BICYCLE COMPANY (B)

The agreement between Schwinn and Csepel was signed in October 1988 after many months of negotiations. The new company, Schwinn-Csepel Bicycle Manufacturing and Sales, Ltd., was a Hungarian joint venture. The U.S. partners were Schwinn Bicycle Co. with 41.1 percent and Willie Bicycle Corp. of Bethlehem, Pennsylvania, with 9.9 percent; the Hungarian partners were the Institute for Energetics and the Csepel Works Machinery Factory for the Garment Industry and Bicycles with 9.0 percent and 40 percent, respectively. Because Willie Bicycle Corp. worked closely with Schwinn and was not involved in Hungary other than its investments, Schwinn had 51 percent control.

The joint venture's specifically authorized activity was the design, manufacture, assembly, and marketing of bicycles. It would make some parts, import some parts, and obtain other parts from Csepel, as the former company had done. The goal was to make bicycles for the Hungarian market, to export competitively to Western Europe, and, in the future, if an East Bloc convertible currency became a reality, to export to East Bloc countries.

During the negotiations, in addition to settling the percentages of control, the contribution by each of the parties was decided as follows:

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	<u>Csepel</u>	<u>Schwinn</u>
Machinery and equipment	90	10
Capital	0*	80
Technology and product know-how	40	60
Designs	30	70
Tools	80	20

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\*The Institute for Energetics supplied 20 percent of capital.

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Each item was given a value in dollars in order to allocate ownership, and the building was leased from Csepel by the joint venture. In addition to the equity supplied by Schwinn, debt capital was necessary. Based on a feasibility study presented by Csepel to Magyar Hitel Bank Rt, the Hungarian Credit Bank, Ltd., provided a credit line of 250 million forints<sup>1</sup> for use by the new company.

The management of the plant was to be Hungarian, but Tom Henderson, with the title of Director of European Operations, would be the American overseer and Schwinn representative at the plant. Quality control was to be under Schwinn's management, as were the design and specifications of the bicycles--especially those being exported with the Schwinn label. Management aspects such as monthly reports, personnel policies, manning, asset control, and manager succession were discussed and settled in the negotiations.

Prices on the bicycles for Hungarian consumption had been set by the Ministry of Material and Prices to be 8 percent above costs on January 1, 1989. Pricing was a serious problem, because Schwinn-Csepel would be selling as a private company into a controlled economy where the government was interested in protecting the consumer. With 20 to 30 percent annual inflation forecast for 1989 and 1990, the company would have to apply to the Ministry of Material and Prices constantly for price increases to stay even with inflation. Price controls applied primarily to consumer goods, so many of the Schwinn-Csepel's suppliers could raise prices without governmental approval. Prices were set on specific products. If Schwinn changed designs or made important quality improvements, it would have the opportunity to apply for prices on new products. (Higher prices on new products were easier to obtain than price relief for inflation.) Therefore, the implementation of design changes or cost reductions would be necessary if Schwinn-Csepel were to maintain profits.

The manufacturing operation was significantly changed after Schwinn became a partner. Equipment that was not involved in bicycle manufacturing was removed, and the production-flow lines were laid out according to Schwinn's design to gain productivity. Procedures to improve quality were also initiated. The plant changes were financed and carried out by the Hungarian partners as part of their contribution. During the negotiations, Csepel agreed to transfer redundant workers to other Csepel factories in the immediate area. This agreement allowed the joint venture not only to reduce the number of employees, but to select the better workers from the total pool.

The plant began shipping bicycles in early 1989 and was scheduled to produce 250,000 bicycles after the start-up period. After a year of operation, the plant was in the black, although the profits were small. The plant was running at an annual level of 200,000

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<sup>1</sup>60 forints = 1 U.S. dollar.

bicycles with a work force of roughly 400. This production level represented a productivity increase of between 15 and 20 percent. New painting lines and some automatic welding equipment had contributed to this labor saving and to quality improvement.

At this point, Schwinn believed that being there "firstest with the mostest" would allow it to retain its Hungarian market no matter what competition might arise in the future. Henderson was satisfied with the negotiating process and with the progress since the joint venture began operations, but he wondered how the progress to date would be evaluated by his superiors. He knew that Schwinn's executives were reevaluating a planned expansion in China because of that country's crackdown after Tiananmen Square. One option being considered was the expansion of his operation. The decision would involve the nature of the risks of doing business in each country.





## RODALE PRESS IN THE COMMONWEALTH OF INDEPENDENT STATES

Paul Wessel, the chief financial officer and Chuck McCullagh, vice president of Rodale Press and publisher of the company's *Bicycling* magazine, were leaving Pennsylvania on Monday for a November 1991 visit to the company's joint-venture operation in Moscow, which published a Russian-language farming magazine, *Novii Farmer* (Russian for *New Farmer*). Wessel, his hands behind his head and leaning back in his chair, was ruminating on the history of Rodale Press's business in the Soviet Union, or the Commonwealth of Independent States, as it was now known.

In the two-plus years since the deal had been initiated, unforeseen problems had arisen. Five issues of the bimonthly magazine had been published, but the sixth issue had been put on indefinite hold when Wessel and McCullagh learned that their Russian distributor was buying the magazines but not distributing them! Most of the magazines sat in a warehouse outside Moscow. The Russian editor of the magazine was also selecting articles for publication that were utterly beyond the scope of the magazine, and he seemed oblivious to Rodale's advice. As the political situation in Russia became increasingly unstable, moreover, support for the magazine among potential advertisers evaporated. Wessel wondered if the company would ever achieve its goals in Russia.

### RODALE PRESS

Rodale Press, a \$300-million, family-owned publisher of books, magazines, and newsletters, published 50 books a year on health, fitness, homes, and gardens. It also operated four book clubs. The company's magazine titles included *Prevention*, the nation's most widely read health magazine, which offered systemic ways to prevent illness and disease; *Organic Gardening*, a practical guide to organic-food growth and preparation methods; *Bicycling*, the world's largest English-language cycling publication; *Runner's World*, America's leading running magazine; *Men's Health*; *Backpacker*; and *American Woodworker*.

Funded in part by Rodale Press, the Rodale Institute, a non profit organization, conducted research and development in the areas addressed by Rodale's publishing businesses. The Rodale Institute developed methods of sustainable agriculture that were more productive, more profitable, and more protective of the land than current methods.

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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. Copyright 1992 by the Darden Graduate Business School Foundation, Charlottesville, Virginia.



At the Rodale Research Center, a 305-acre farm in Maxatawny, Pennsylvania, farmers, experts from major universities, the U.S. Department of Agriculture, and the U.S. Agency for International Development worked together on these techniques. The Rodale Institute also worked with governments, non profit agencies, and international organizations in developing countries to help them build self-reliance and economic independence through regenerative agriculture and improved use of resources. The findings of these collaborative efforts were disseminated to farmers everywhere through the Rodale Institute's *New Farm* magazine, books, workshops, and farmer field days. The Rodale Institute was one manifestation of a companywide mission that resonated throughout the Rodale Press. The company's brochure opened with this statement of the mission:

At Rodale Press, we have a vision of the world as it could be. A world where health is recognized as more than simply freedom from disease. Where individuals take control over their lives. Where people protect and enhance the environment. Where neighbors and nations are guided by the spirit of cooperation.

The company offered self-improvement classes for its employees, no-smoking policy applied to all buildings, and employees were encouraged to use the Energy Center, a fitness facility that provided not only exercise classes but also team sports. Rodale Press occupied 13 new and renovated buildings sprinkled in and around the rustic town of Emmaus in the hills of eastern Pennsylvania. Fitness House, the company's "cafeteria," was a renovated home decorated with beautiful artifacts selected by Ardie Rodale, the wife of the recently deceased Chairman Bob Rodale. There employees could select healthy flavorful meals, many of them vegetarian, served family style.

The company was founded in 1930 by J.I. Rodale, a forward-thinking man who saw the need for natural farming techniques to enable Americans to eat better than they were. In 1942 he launched *Organic Gardening*, and followed with *Prevention* in 1950. Many recognized Rodale's founder as the father of the modern natural-food and natural living movements in America. Bob Rodale, J.I.'s son, led the company from the time of his father's death in 1971 until his own death in 1990. Bob Rodale's personal contacts and interest in the former Soviet Union led to the launch of Novii Fermer.

The company's revered chairman had died in a car accident en route to the Moscow airport while actually working on this deal. The company's resolve to publish the first issue of *Novii Fermer* was strengthened by his passing. At the moment, however Wessel was questioning whether a commitment to pursue Bob's dream, however strongly felt, would be enough to overcome all the difficulties the project faced. Rodale's investment to date in the Russian deal including legal fees and the purchase of some equipment for the venture was about \$1.5 million.

## GENESIS OF THE DEAL

With the ascension of Mikhail Gorbachev in 1985 and his policies of glasnost (openness) and perestroyka (restructuring), American consumer businesses began to eye the Soviet market's 287 million people. In January 1987, the Presidium of the U.S.S.R. Supreme Soviet authorized the establishment of joint ventures between foreign companies and Soviet entities, such as factories and government organizations. Mikhail Gorbachev, who became president in 1985, envisioned that this joint cooperation would satisfy Soviet requirements for scarce industrial products, raw materials and foodstuffs; attract foreign technology, management experience, material and financial resources; and develop the export base of the country. When the law was first introduced, a foreign partner was entitled to a maximum of 49% ownership in a venture. Foreign companies, however, were not allowed to repatriate their profits; that is, they could not convert ruble profits into hard currency. Therefore, Western partner companies had to be willing to invest for what is, by American standards, the incredibly long term or establish some sort of barter arrangement to bring home profits in the form of salable goods.

The relationships leading to the Rodale joint venture started in August 1989. Yevgenii Gringaut, a Russian working at Vneshtorgizdat, the publishing house of the Soviet Foreign Trade Ministry, had an idea for not merely a magazine, but for a whole package, of primarily publishing businesses. Many Russians were predicting an explosion of privatized, independent, owner-operated farms and Gringaut wanted to ride this wave of interest in farming by teaching individual Russian farmers the American approach to agriculture. Because at the time the only way Russians could deal outside the official government ministries was in a joint venture, and because Gringaut wanted to focus on American farming, he needed as a partner an American farm-oriented publisher. Gringaut was attracted to Rodale's organic, regenerative approach to agriculture because he himself was a weekend gardener, a breeder of gladiolus. Coincidentally, his top ministry assistant and General director of the joint venture, Vasilii Senatorov, had met Bob Rodale, an ardent cycling enthusiast, while covering international bicycling events. He moved quickly to establish contact.

Gringaut wanted the magazine to be an American-style magazine with American editorial content and an American look and quality. A Russian-printed magazine would face considerable quality problems. Russian printers could not print in four colors, could not obtain high-quality paper, or adhere to deadlines. As a result, Gringaut had no choice but to propose that the venture print the magazine outside the Soviet Union. While the venture considered a printer in Yugoslavia, PTS eventually settled on printing the magazine in Helsinki, Finland. The Finns had long-time commercial ties to Russia. PTS also chose the Finnish printer because the employees spoke English, used the Western banking network, and were "more businesslike" than the Yugoslavs.

The magazine would generate ruble revenues. Operating expenses for the magazine, except for the printing, would be paid in rubles, but operating expenses were projected to be relatively small. Thus the magazine would have a big ruble profit and a big hard-currency deficit.

While a farming magazine was to be the centerpiece of the deal, it was not the whole deal. In Russia, any profitable deal required connections with hard currency or with tangible goods with which to barter for hard currency. Gringaut had a dacha in a village that adjoined the 50th Anniversary of the October Revolution State Farm in Kudinova, Noginsk, 40 miles east of Moscow. He and the farm director, Nikolai Geleti, had become friends. The state farm had political connections and could provide goods for bartering or paying employees of the joint venture. Moreover, the farm director, also stirred by the promise of capitalism, wanted to construct a sausage factory in which to process the farm's 60,000 pigs. Quality equipment for such a factory, however, would require hard currency amounting to several hundred thousand dollars. Gringaut decided to offer the farm director equipment for the sausage factory in exchange for the farm's participation in the joint venture. Employees of the joint venture would receive high-quality sausage from the factories and operation, perhaps at some point down the line, rights to some of the farm's land.

With American equipment and technology, the farm could produce quality sausage and salami. Half of the sausage production would be sold to the Soviet public for rubles. The remaining sausage would generate hard currency being sold in *Berioskas* (hard-currency stores) and to embassies and hotels catering to foreigners. For the first year of operation, the sausage plant was projected to make a dollar profit of \$1 million. The operating expenses of the sausage plant, including construction expenses, feed for the pigs, salaries, and utilities, would be denominated in rubles.

Thus the sausage plant would lose money in rubles, but generate a profit in dollars, whereas the publishing operation would make money in rubles and lose money in dollars. The idea was that the two operations would subsidize each other. Whatever fell between the cracks would be profit.

Gringaut also envisioned that the ruble profits would fund a tourism venture and that the venture's publishing services would be sold to other people just as on a Christmas tree. Gringaut would hang dozens of different businesses on the initial joint venture.

"Gringaut had explained it to Wessel as follows:

"Russian law is quite different from American law. In American law, there is a presumption that you can do anything except what the law prohibits. In Russian law, you can do only what the law specifically sanctions; that is, you cannot make a move until the law says you can. So if you want to do anything, no matter how elementary, it has to be written into your charter.

## THE DEAL TAKES SHAPE

Gringaut persuaded Bob Rodale to become involved in August of 1989. Wessel and McCullagh were brought in shortly thereafter. The two senior managers had the most international experience in the company. As chief financial officer, moreover, Wessel negotiated the financial and legal sides of all Rodale deals. The idea was for Wessel to negotiate the deal subsequently and leave the day-to-day running of the magazine to its operating staff, U.S. Editor George DeVault, Advertising Manager Tanya Tishin, and the Russians. McCullagh would assume the title of publisher. British by birth and well traveled, McCullagh was also known as Rodale's corporate troubleshooter. He was already in Europe during Wessel's first visit to Moscow in November, 1989 and he met Wessel there. Neither he nor Wessel spoke any Russian.

Rodale had no delusions about generating hard-currency returns any time soon. When Wessel was first evaluating the deal, he proposed to Bob Rodale three possible rationales for getting involved. One, Rodale Press could make some money; two, Rodale could help the Russian people improve their lives; and three, the people at Rodale could have some fun. Bob Rodale responded that Wessel had stated the right reasons, but in the reverse order.

Wessel met with Gringaut three times in November 1989 to negotiate details. Then he and McCullagh spent a week in Moscow in December 1989 finishing the agreement. The partners signed the agreement in late February 1990. Under normal circumstances, a joint-venture agreement required six months for authorization by the Russian government. Gringaut, however, had a contact within the Finance Ministry, a case officer who reviewed joint-venture agreements such as this one. During an accidental meeting with Gringaut, this contact told him that PTS needed to make some minor changes in the documents. Wessel recalled looking at the list of required changes, and thinking that they did not limit the scope of PTS's businesses at all. The authorities were apparently more concerned with the formalities of the documents than with how the documents would empower the joint venture. In May, the partners received one of the fastest government approvals in the history of joint ventures. Thanks to Gringaut's chance meeting. After registering in May 1990, the joint venture started hiring employees.

The charter specified a timetable of major activities. The pilot issue of *Novii Fermer* was to be published May 15, 1990. At that time, the joint venture would not exist, so Rodale would have to publish this inaugural issue. Gringaut and Rodale had very different ideas about the purpose of this first issue. Gringaut wanted to get a sense of the magazine's reception among Russian farmers; he thus wanted a pilot that represented the content, quality, and focus of the actual magazine. Rodale wanted to use the pilot as a tool to generate interest among U.S. advertisers.

Several staff people in Emmaus handled the project, and they created a pilot that was unrepresentative of the *Novii Fermer* that was to be. The pilot issue, printed in the United States, was of higher production quality than later issues. It was almost entirely in English and featured articles technically beyond Russian farmers' comprehension. Gringaut and the other Russian managers at PTS did not even want copies of the pilot. Advertisers, on the other hand, were excited about the pilot issue, but they had inflated expectations of the permanent magazine. (See Exhibits 2 and 3 for a copy of the letter Tishin sent to prospective advertisers and for the advertising rates.)

### THE START-UP OF OPERATIONS

Organizing the venture's operations and hiring staff took much longer than Rodale had anticipated. Office space in Moscow was in critically short supply. Moreover, because of a shortage of construction materials, PTS spent seven months repairing the offices they did obtain. The Russian partners spent four months looking for the secondhand furniture for the offices, which were located in a converted apartment building. Office necessities included a refrigerator, so that employees of PTS might purchase food in the morning on their way to work while food was still available in the stores.

Hiring and retaining employees was difficult. Most of those hired had worked for governmental agencies such as the State Press and Publishing Committee or the news agency TASS. They were excited about participating in this operation. The head of the editorial office explained, "In a government organization, yes, you are supplied with paper. You feel stable, but the salary is low, and there is no room for creative efforts. Here I have a lot of freedom to show my creativity." The opportunity to participate in a creative venture, to travel abroad, perhaps even to receive some hard-currency compensation did not, for some, outweigh the difficulties of working in the PTS environment. Two of the joint venture's employees resigned because they preferred jobs with more structure, less ambiguity. "They preferred the certainty of knowing exactly what they were supposed to do," explained Vasilit Senatorov. For one 40 year old employee, PTS offered his first chance to travel abroad. His outlook after joining the venture was "totally different" than before. He thought that he might change jobs to look for even a greater opportunity in another organization.

Gringaut and Rodale were still discussing who would do the printing and when the magazine would be published when, on the way to the Moscow airport, a bus struck the van they were in. All of the occupants were killed. After the accident, everyone working with PTS became dedicated to publishing the first issue. As a result, it was printed quickly, in January of 1991. Because the sausage plant was not yet finished and Advertising Manager Tishin had sold only a few ads, Rodale Press agreed, given small print runs, to finance the printing of the first several issues.

The partners decided on a press run of 50,000 copies of the first two issues, 75,000 for the next two issues, and 100,000 copies of issues five and six (see Exhibit 4). Advertising was still a tough sell, and the team in Emmaus had received a letter in August stating that PTS was considering terminating the contract with the magazine's distributor. The sausage plant was still not on line, and Rodale Press was providing all of the venture's hard-currency needs. Consequently, McCullagh reduced the press run of issue five to 75,000.

#### DISTRIBUTION PROBLEMS

After the printing of the first issue in January 1991, Wessel and McCullagh went to Moscow. McCullagh went in early March to attend a celebration of *Novii Fermer's* successful launch. In late May, Wessel visited Moscow but spent most of his time on legal matters and on the award to PTS of 30 acres outside the city for the creation of an R & D station similar to the Rodale Institute. The men returned to Moscow together in September 1991 to check on the venture's progress. They discovered that distribution problems were much more serious than Rodale employees in Emmaus had known. McCullagh and Wessel tried unsuccessfully to reduce the print run of issue five even below the 75,000 level, and they postponed issue six altogether.

Private Russian farmers numbered only about 12,000 at the time. Thus PTS had considered direct mail for distribution but found it to be a costly proposition (1.5 to 2 rubles per piece) with uncertain delivery. The state-owned magazine distributors services were also expensive. Senatorov, however, contracted with an independent book distributor, Blagovest, to distribute the magazine to large farm cooperatives, on kiosks, and eventually through subscription.

When Rodale managers asked PTS whether the copies had been sold, PTS responded that all the copies had been sold. While PTS had received some revenue, and could claim it had sold all of the copies of Novii Fermer to the distributor, Blagovest had not distributed the magazines. They were sitting in the Blagovest warehouse. "PTS's response was a reflection of our different views of the world," said Wessel. "Once Blagovest had bought the magazines, PTS figured it was their problem."

Wessel explained what went through his mind at that time:

When we heard this, we couldn't believe it. We were paying real money--U.S. dollars--to print the magazine. It was costing us at least \$0.60 a copy. And we have no hard currency revenues, so the entire production cost represents a subsidy from Rodale Press.

On the ruble side, the magazine sells on the newsstand for 4 rubles, but after the distributor takes a share, PTS gets only about 1.5 rubles, which is worth about \$0.06 if we could convert the rubles. Now, everyone knew, both the Russians and the Americans, that we were losing money on the deal. But we were willing to accept that as long as the magazine was getting out to the readers, as long as we were spreading our message, helping people, and building a business for the future.

What the Russians could not see was that magazines gathering dust in a warehouse were not achieving any of our goals. They were not being read; they were not doing any good for Russian farmers; they were not building up our brand name for the future. To add insult to injury, we were losing a lot of money. The Russians accepted this situation because they weren't paying the dollars and they were getting the benefit of the ruble revenue, small as it was. So I told them, if they really need the rubles, I'll just give them \$0.06 for every copy that we don't print and save myself \$0.54 a copy.

PTS talked to several distributors, but McCullagh and Wessel needed an ironclad plan before they would approve it. A representative from a particular distributor had numerous ideas. McCullagh asked him, "How are we going to get the copies from our printer to the people?" He just didn't respond. McCullagh even tried talking to him in Russian. "Which towns are you going to, and where are the newsstands?" he asked. The distributor could not answer, because he did not have a plan, just good intentions.

#### EDITORIAL PROBLEMS

The articles in the issues themselves were another problem. Some articles were acceptable; others were way off target for the intended Russian readers. Most American farming is so advanced, that it seems almost fantastical to Soviet readers. For articles, Rodale supplied PTS with back issues of *Organic Gardening* and *The New Farm* magazine, as well as copies of Rodale books and other U.S. agricultural magazines not published by Rodale. If PTS selected an article from one of these other magazines, Rodale would obtain

permission for *Novii Fermer* to print the article. Rodale suggested that *Novii Fermer* limit the editorial scope of the publication and restrict itself to material of practical use to Russian farmers.

Many of the articles selected by the Russian editor, Yuri Naumov, violated all notions of serving a target audience, however. At first the Rodale people thought maybe they weren't making themselves clear. They finally realized, however, that Naumov thought he had complete control over the contents of the magazine. He was simply ignoring input provided by DeVault, *Novii Fermer's* U.S. editor. As time went on, Wessel concluded,

Either he does not want to follow our direction or he just cannot understand what we are trying to tell him; that is, he's either insubordinate or incompetent. I don't think he understands the concept of the magazine. For instance, in one issue, he ran an article directly from our *Organic Gardening* magazine which reviews riding lawnmowers--an entire article, along with specifications, devoted to things Russians not only couldn't dream of buying, but never knew existed (see Exhibit 5). Another article he ran looks like something out of a coffee-table book--just pretty pictures showing how nice it is in America, nothing of practical value to Russian farmers.

Following publication of those issues, DeVault tried to assert more authority in the approval of articles to be included in the magazine. Naumov accepted DeVault's advice, but he still wanted to make the decisions. He did not recognize DeVault as having any authority. In March 1991, Rodale started advising Senatorov to fire Naumov. In the ensuing months, that advice grew stronger. In September, McCullagh finally told Senatorov to fire Naumov, but Senatorov had not yet done so.

#### THE SAUSAGE FACTORY

The sausage factory presented another problem. In April 1990, Nikolai Goliti, the Kudinova farm director, told Rodale that the sausage equipment could be installed in the plant by the end of the following month. U.S. suppliers of the equipment prepared it for shipment. By the end of May, however, the plant was nowhere near completion, so Rodale put the equipment into storage in the United States. Wessel traveled to Moscow four times in the summer of 1990. Each time he was assured that the plant would be completed in six weeks, so six weeks later he would return. After storing the equipment for almost a year, upon assurances of the plant's completion, Rodale finally sent the equipment to Russia. He had been at the farm at the beginning of September 1991, and the equipment was sitting idle in a storage shed on the Kudinova farm. Goliti had told him then that the plant would be finished in two months, in time for Wessel and McCullagh's November visit.



Wessel had attempted to identify why the factory had suffered such delays. One reason appeared to be materials procurement. Bricks, for instance, were available domestically but were often in short supply, especially for those businesses, such as PTS, that operated outside the centrally planned economy. Most bricks were produced by government-operated factories, and most of that production went to fill government orders. PTS could purchase bricks only if extra bricks had been produced. In addition, at the time, the government was trying to fill production with government orders, in order to stabilize the economy, which meant bricks were even harder to come by than usual.

Sometimes PTS would turn for bricks to the black market, where prices were often 10 times the government rate. Moreover, when the company was successful in locating bricks, it had to purchase them immediately and find a truck to transport them. Once the bricks arrived at the factory, PTS encountered another problem, a shortage of skilled labor for construction. Goliti was not particularly helpful, because he was involved in 11 other projects.

At first Wessel could not understand why PTS had not informed Rodale of the extent of the delays or, at least, been more realistic about timing. After a while, however, he learned an important lesson. As he explained,

The Russians do not like to share bad news with you, so they bend the truth a bit. They will find a way to put the best possible light on a situation, then and after the fact, come up with excuses. Nobody wants to take responsibility. We still do not have a factory, and I just got a letter saying it will be completed during the first quarter of 1992. It's beginning to look as if it will never get done.

By November 1991, Wessel was wondering if Rodale could get out of the sausage factory altogether. The company's expertise was not in the manufacture of sausage; even if the plant were up and running, Rodale would not know how to manage it. The original magazine concept required the hard-currency because it did not include advertising. If *Novii Fermer* could earn hard-currency advertising revenues, it might be a self-sustaining proposition. Rodale's challenge was to convince the farm director that he needed a partner who, unlike Rodale knew and cared about the manufacture of sausage. Rodale's investment in the sausage plant was the equipment, which was still in storage at Kudinova. Wessel believed that Rodale could recover its investment one of three ways: convince the farm to buy the equipment, find another partner for the farm, or repossess the equipment in order to sell it.

## The Meeting in November

Wessel leaned forward at this point and reflected on the overall progress of the venture:

The Russians feel that the Americans have no business telling them what to do. Our ownership of PTS is 50%. Vneshtorgisdat has 25%; and the State Farm has 25%. I have tried to explain to them the golden rule: We've got the gold, we'll make the rules. They don't like it. The PTS managers act as if they are our partners, rather than our employees.

Wessel also was frustrated by the perception of PTS workers' that they should be given shares in the company, but that the managers of the venture were responsible for profitability, with no participation required on their part. They seemed less concerned with whether the enterprise succeeded than with whether the individuals could come together, feel a sense of belonging, and commiserate about their sad lots in life. He sensed an almost mystical feeling of the family and union in a collective venture. Undoubtedly, these differing views of the business had clouded communications on many occasions.

Wessel also felt that the PTS employees did not seem to benefit from contact with the Rodale managers. He wondered if he and Chuck had not sufficiently impressed upon them the fact that "business is about doing things." For example, they still had no sausage and no marketing plan for selling the sausage. And yet several employees wanted to open a restaurant where they could serve the sausage. At the same time, he realized that part of the problem might be that Rodale had not done enough to understand the Russian people:

We have been told that the Europeans make a greater effort than we do to understand the problems of the Soviet Union. Europeans seem to devote more time to understanding the nature and root cause of their problems. Americans, they say, just want you to do the job--they do not care how you get it done.

With these problems on his mind, Wessel looked ahead to the next Moscow visit that he and Chuck had planned for mid-November, only a few days away. He knew that they would have to make several critical decisions. Should they refuse to participate in the venture unless the sausage factory were removed from the deal? Would it be fair or wise to fire the editor who had ignored their previous directives and did not seem to understand the purpose of *Novii Fermer*? How would they locate a new distributor for the magazine? If these issues could not be resolved, should he suggest that Rodale pull out of the deal altogether?

**RODALE PRESS IN RUSSIA**  
**Agricultural Statistics for Former Soviet Republics, 1991**

**Analysis of Agriculture in Soviet Republics**

	<b>Byelorussia</b>	<b>Ukraine</b>	<b>Russia</b>	<b>Lithuania</b>	<b>Latvia</b>	<b>Estonia</b>
<b>TOTAL POPULATION</b> (millions)	10.2	51.7	147.4	3.7	2.7	1.6
<b>TOTAL AREA</b> (mm hectares*)	20.7	60.4	1,707.5	6.5	6.5	4.5
<b>Cultivated</b>	9.5	41.8	217.5	3.6	2.5	1.4
Arable	6.1 (64.9%)	34.1 (83.7%)	133.5 (61.8%)	2.3 (67.7%)	1.7 (68.0%)	1.0 (71.4%)
Hay/Mowing	1.4 (14.9%)	2.0 (5.0%)	22.8 (10.6%)	.3 (8.8%)	.3 (12.0%)	.2 (14.3%)
Pasture	1.9 (20.2%)	4.6 (11.3%)	59.6 (27.6%)	.8 (23.5%)	.5 (20.0%)	.2 (14.3%)
<b>TOTAL FARMS</b>	2,733	10,609	26,305	2,222	4,509	1,167
Collective	1,614	7,885	12,200	749	327	173
State	893	2,557	12,832	311	251	136
Peasant	226	167	1,273	1,162	3,931	858
<b>LIVESTOCK</b> (millions)	60.5	392.6	N/A	22.5	15.5	8.9
Cattle	7.3 (12.1%)	25.6 (6.5%)	N/A	2.4 (10.7%)	1.5 (9.7%)	.8 (9.0%)
Pigs	5.1 (8.4%)	19.5 (5.0%)	N/A	2.7 (12.0%)	1.6 (10.3%)	1.1 (12.4%)
Sheep/Goats	.6 (1.0%)	93.0 (23.7%)	N/A	.2 (.9%)	.2 (1.3%)	.1 (1.1%)
Poultry	47.5 (78.5%)	254.5 (64.8%)	N/A	17.2 (76.4%)	12.2 (78.7%)	6.9 (77.5%)
<b>CROPS</b>	Grain Potatoes Vegetables Fruit Flax	Grain Potatoes Beans Sugar beets Sunflowers Vegetables	Grain Sugar beets Sunflowers Potatoes Flax	Flax Sugar beets Potatoes Vegetables	Grain Forage Potatoes Vegetables	Grain Forage Potatoes Vegetables

\*1 hectare = 2.47 acres

N/A = Not Available

RODALE PRESS IN RUSSIA  
Letter to Prospective Advertisers



**New Farmer**

A joint publication of  
Rodalé Press &  
Vneshtorgizdat, a major  
Soviet publisher

Rodalé Press, Inc.  
33 East Minor St.  
Emmaus PA 18098  
USA  
215-967-5171  
Fax: 215-965-5670

Dear Prospect:

I'm happy to introduce you to NEW FARMER.

Just a word of explanation about circulation and advertising rates. As indicated in the media kit's circulation information, we expect circulation of NEW FARMER to be 205,000. But note that we plan to reach that circulation gradually during the first two years of publication and that the advertising rates for each issue will be adjusted to reflect circulation. Advertising rates for the first two issues (January/February and March/April, 1991) can be found on the enclosed introductory rate card.

The circulation of the magazine (and therefore the advertising rates) will be determined by the rate of agricultural reform in the Soviet Union. Our marketing plan is to reach the economic decision-makers in the Soviet Union, the people who actually have the hard currency. These, of course, are the people you want to reach. As you might know, this audience is changing and growing almost daily. We want the circulation of the magazine to reflect this. Right now, hard currency and economic decisions in the agricultural area are still in the hands of relatively few government agencies (including state and collective farms). Accordingly, we have decided to set circulation for the first two issues at 50,000, a sufficient number to reach that audience. This will make NEW FARMER one of the largest farming magazines in the Soviet Union, even in its first few issues.

As agricultural and economic reform proceeds, as state and collective farms are broken up and economic decisions are increasingly decentralized (and actually made by "new farmers"), circulation will be increased accordingly. We now believe it is reasonable to expect circulation of NEW FARMER to reach 205,000 by the end of 1992. But since Soviet President Mikhail Gorbachev has made agricultural reform his top priority, economic decentralization may occur much more swiftly and we may reach the 205,000 circulation figure much sooner than we now anticipate.

I (as well as our sales representatives) will regularly update you as our circulation grows and our advertising rates change. We expect NEW FARMER to be a very prominent advocate for economic and agricultural progress in the Soviet Union. Our magazine will be your access to the future leaders of Soviet agriculture.

Sincerely,

Tania Tishin

RODALE PRESS IN RUSSIA  
Advertising Rates for *New Farmer*

**ADVERTISING RATES FOR NEW FARMER**

Ad Size/Color	ONE-TIME RATES			THREE-TIME RATES			SIX-TIME RATES		
	B&W	2-Color	4-Color	B&W	2-Color	4-Color	B&W	2-Color	4-Color
Full Page	\$2,505	\$2,830	\$3,250	\$2,305	\$2,575	\$2,960	\$2,255	\$2,515	\$2,895
2/3 Page	\$1,775	\$2,010	\$2,310	\$1,640	\$1,825	\$2,100	\$1,600	\$1,785	\$2,055
1/2 Page	\$1,375	\$1,555	\$1,790	\$1,270	\$1,415	\$1,625	\$1,240	\$1,385	\$1,590
1/3 Page	\$950	\$1,075	\$1,430	\$875	\$980	\$1,300	\$855	\$955	\$1,275
1/4 Page	\$800			\$740			\$720		
1/6 Page	\$525			\$485			\$475		
1/12 Page	\$300			\$275			\$270		
<b>COVERS</b> <b>(4-Color Only)</b>									
2nd & 3rd			\$3,510			\$3,195			\$3,125
4th			\$3,770			\$3,430			\$3,355

**RODALE PRESS IN RUSSIA**  
**Expected Circulation for *New Farmer***

The 6 republics chosen for the circulation of *New Farmer* —  
 Russia, Ukraine, Byelorussia, Lithuania, Latvia and Estonia —  
 present a majority of agricultural activity in the Soviet Union:

85.1% of all collective farms, 72.5% of all state farms and  
 more than 80% of all individual peasant farms are located in  
 these areas.

## REPUBLICS

Farms	Byelorussia	Ukraine	Russia	Lithuania	Latvia	Estonia	TOTALS
Collective	1,614	7,885	12,200	749	327	173	22,948
State	893	2,557	12,832	311	251	136	16,980
Peasant	226	167	1,273	1,162	3,931	858	7,617
<b>TOTALS</b>	<b>2,733</b>	<b>10,609</b>	<b>26,305</b>	<b>2,222</b>	<b>4,509</b>	<b>1,167</b>	<b>47,545</b>

of collective and peasant farms:  
 300 copies

Libraries in target republics (75% of 32,000 libraries):  
 24,000 copies

Farm social clubs (25% of the 85,000 clubs):  
 21,000 copies

Special agricultural schools with libraries in the target regions:  
 500 copies

Weekend farmers and other individual subscribers:  
 25,000 copies

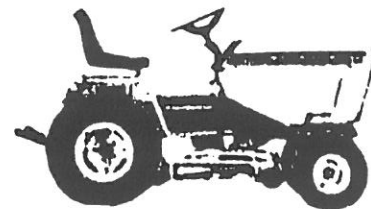
Distribution through kiosks:  
 74,500 copies

Samples and complimentary issues:  
 10,000 copies

**Estimated first-year total circulation:**  
 205,000 copies

**RODALE PRESS IN RUSSIA**  
Article on Riding Lawnmowers

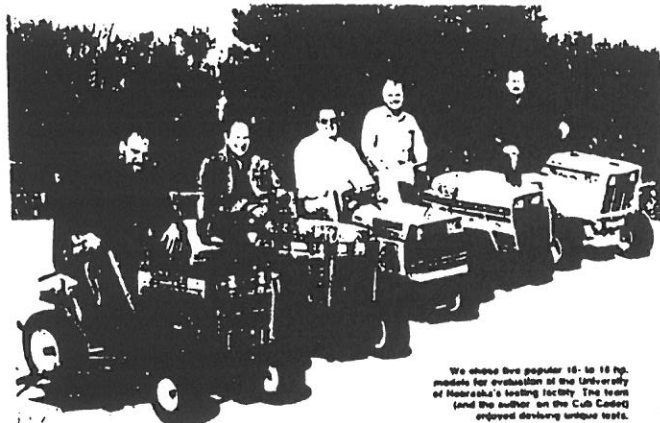
**МИНИ-ТРАКТОР  
ДЛЯ ОГОРОДА**



Выбрать модель трактора для семейной фермы — то же, что купить новый автомобиль. В обоих случаях в распоряжении американских фермеров неограниченный выбор моделей и вариантов. Конечно, мини-трактор гораздо дешевле машины, но и он стоит от 2 до 9 тыс. долл., а такая покупка заслуживает особого внимания и тщательного изучения предлагаемых вариантов.

Американский журнал Successful Farming нанял группу инженеров, которые провели серию испытаний пяти наиболее популярных моделей мини-тракторов, мощностью от 16 до 18 л.с. Местом проведения испытаний была выбрана техническая лаборатория университета штата Небраска. Инженеры применяли стандартные методы оценки производительности тракторов, оценивали уровень шума и комфортабельность. Мини-трактора проверяли в полевых условиях, пробовали с их помощью обрабатывать почву. В таблице приведены данные, полученные от производителей тракторов и при оценке их группой экспертов-инженеров в ходе испытаний.

Группа экспертов не стремилась выбрать лучший трактор. Их задача была — помочь сориентироваться потребителю на рынке сельскохозяйственной техники и приобрести модель, подходящую по цене и отвечающую потребностям фермы, сада или огорода.

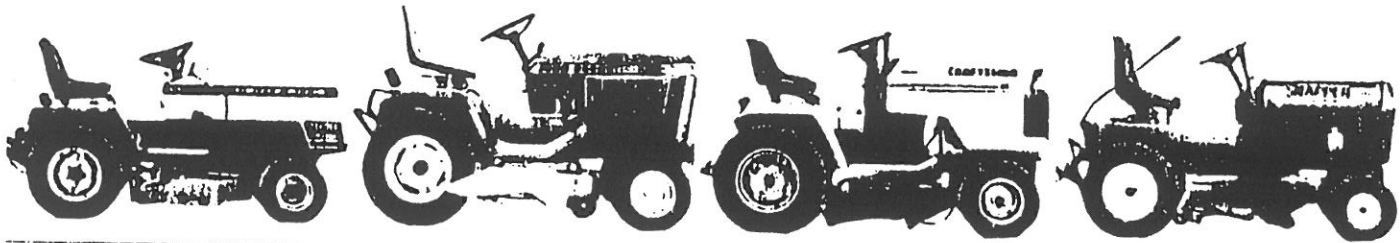


We chose the popular 16- to 18 hp. models for evaluation at the University of Nebraska's testing facility. The team (and the author on the Cub Cadet) enjoyed devising unique tests.

	Каб Кадет 1872
<b>Двигатель</b>	18 л.с. Козлер, 2-х цилиндровый
<b>Передача</b>	Гидростатическая
<b>Ра: мер косилки (дюймы)</b>	46,50 и 60
<b>Щиток приборов</b>	Амперметр и часы (световой индикатор масла)
<b>Чистая масса без косилки (фунтов)</b>	880
<b>Колесная база (дюймов)</b>	51,5
<b>Электрический стартер</b>	да
<b>Рулевое управление с усилителем</b>	Стандартное
<b>Механизм подъема рабочих органов</b>	Гидравлический
<b>Навесные орудия</b>	Почвообрабатывающее орудие, нож, роторный снегоочиститель, травосбиратель, дисковый нож, плуг, культиватор и ротационная косилка
<b>Предполагаемая розничная цена (долл.)</b>	6448

<b>Уровень шума при работе двигателя (дб)</b>	90
<b>Усилие на рулевом колесе (фунтов)</b>	20
<b>Диаметр поворота (дюймы)</b>	189
<b>Максимальная сила тяги (фунты)</b>	820
<b>Комфорт при работе на тракторе*</b>	2
<b>Удобство управления</b>	7
<b>Удобство обслуживания*</b>	11

\* Оценка комфорта и удобства управления и обслуживания основывалась на субъективных ощущениях инженеров, участвовавших в испытаниях. Чем ниже балл, тем лучше показатель.



Дейтц-Алик 1918	Джон Дир 318	Сярс Крафтсмен II	Снэппер ЛТ16
18 л.с. Коклер, 2-х цилиндровый	18 л.с. Онан 2-х цилиндровый	18 л.с. Бригс, 2-х цилиндровый	16 л.с. Бригс, 2-х цилиндровый
Гидростатическая	Гидростатическая	Механическая, 6 скоростей переднего хода	Механическая, 12 скоростей переднего хода
42,48 и 60	38,46 и 50	44	33,41 и 48
Амперметр часы и топливо (индикатор масла, передачи, вала отбора мощности)	Все индикаторные лампочки масла, батареи, вала отбора мощности	Амперметр	Амперметр
940	865	570	490
51	46	46,5	48
да	да	да	да
Дополнительное	да	нет	нет
Гидравлической	Гидравлический	Механической	Механический
Почвообрабатывающее орудие, нож, роторный снегоочиститель, погрузчик, прицепной опрыскиватель, плуг, разбрасыватель удобрений	Почвообрабатывающее орудие, нож, роторный снегоочиститель, травосборитель, погрузчик, прицеп опрыскиватель	Почвообрабатывающее орудие, нож, роторный снегоочиститель, травосборитель, диск, плуг, прицеп, разбрасыватель удобрений	Почвообрабатывающее орудие, нож, роторный снегоочиститель, травосборитель, прицеп
6799	6310	2297	3315

92	93,5	91,5	93,5
20	20	50	60
167	169	170	187
1000	950	720	500
1	2	4	3
7	9	13	12
		12	10

\* Удобство обслуживания оценивали по процедуре замены фильтров, свечей и масла.





## RODALE PRESS IN THE COMMONWEALTH OF INDEPENDENT STATES (B)

In early March 1992, Paul Wessel again sat down to assess the situation at *Novii Fermer*. He and Chuck McCullagh, vice presidents of Rodale Press, had canceled their planned trip to Moscow in November. At the last minute, they had learned that two of the three Russian members of the board of directors were not coming to the board meeting. The magazine had not been published for six months now, since issue five, which had come out in September. The next issue was due out this month, however. Some critical operating changes had been made in the last several months.

One of the conditions for resuming publication of the magazine had been made in September that Senatorov, general director of the joint venture, fire Vasili Naumov, the Russian editor. Four months later, in January, Senatorov fired him. U.S. Editor, George DeVault had hired a new editor for the publication, Victor Pinegin. Pinegin was fluent in English and communicated daily by telex with Rodale's offices in Emmaus. Wessel had just received from Pinegin a page-by-page outline for the next issue of *Novii Fermer*, and it looked consistent with the Rodale concept. PTS was planning to print fewer copies of this issue than previously, about 50,000. PTS was also renegotiating its contract with its Finnish printer in order to print *Novii Fermer* in its new Russian plant. Rodale would now pay for printing partly with hard currency and partly with rubles.

In Russia's deteriorating economic situation, interest among advertisers had declined to almost nil. "It was always an interest based on hope, never based on reality," remarked Wessel. "Now when we approach companies about advertising in *Novii Fermer*, they say we're crazy." For the upcoming March issue, Rodale was not even trying to sell advertising in the magazine. Rodale had also decided not to provide a product beyond their Russian readers' expectations. Accordingly, *Novii Fermer* would have a lesser quality execution, with less color and lower quality paper.

The rapid devaluation of the ruble had not greatly hindered operations. The Rodale team proposed raising the newsstand price of the magazine to 30 rubles, but Senatorov believed such a price hike might turn away the magazine's target readers. Wages in the city were generally rising at the overall rate of inflation but farmers were among the poorest segment of the population and experienced much smaller salary increases. Rodale had doubled the ruble salaries of the PTS staff in early January. The rent for the PTS office space had been 13,000 rubles in 1991. For 1992, the landlord asked for 1 million rubles, and PTS acceded.

PTS had also chosen a new distributor, the formerly state-owned Soyuz Pechat. This option was expensive, but at least Soyuz Pechat had a plan for distributing copies of the magazine.

Plans for the sausage plant had also changed. Wessel truly expected completion of the plant in mid-March. He had convinced Nikolai Geleti to let Rodale sell its interests in the operation if a suitable partner were found. The sausage plant made little sense as the hard-currency generator in the deal; while the original plans had called for selling half the sausage for hard currency, it had become clear that anyone with hard currency would purchase imported sausage. Wessel noted that the sausage plant should still make a handsome ruble profit.

Wessel and McCullagh had considered sending a seasoned Rodale employee, someone like DeVault, to PTS to help manage operations. In recent months, however, the risks of maintaining an employee with a family in Russia had multiplied. Such an undertaking would also be very expensive.

As of the spring of 1992, Rodale still had a strong commitment to its involvement in Russia. The project was not a huge cash drain; the company was paying hard currency only for the communication links and overnight mail. Wessel and McCullagh usually brought some petty cash for the PTS office when they visited Moscow. PTS was financing its own day-to-day ruble operating expenses. In fact, the joint venture had amassed a considerable ruble working-capital fund from the first five issues of *Novii Fermer*, the publication of several books, and the original contributions of the Russian partners. Summing up, Paul Wessel stated that Rodale's goal was to "stay in it and minimize our loss in the short run."

## **CONTROL DATA CORPORATION: ENTERING THE SOVIET COMPUTER MARKET**

On a cool Minneapolis morning in August 1968, J. G. Miles, vice president for Market Development at Control Data Corporation (CDC), contemplated the firm's marketing strategy for the Soviet Union. Miles had just spearheaded a project that led to CDC's first computer sale to the Soviets--indeed, one of the first computer sales ever transacted by a U.S. computer manufacturer with the Soviet Union. Although several U.S. companies had been selling computer equipment to other East Bloc countries for several years, being the first through the door to the Soviet Union was a big accomplishment, one which gained CDC significant recognition within the computer industry. With the benefit of his experience, Miles needed to decide whether the U.S.S.R. continued to present an attractive market for CDC's products, and if so, whether CDC should pursue another current opportunity for sales there.

### **Control Data**

CDC, headquartered in Minneapolis, Minnesota, was a leading U.S. manufacturer of electronic data-processing equipment during the 1960s. The company's several diversified divisions included a finance and insurance subsidiary, but CDC derived most of its revenues from equipment sales. The late 1960s were marked by rapid growth in the computer industry; in 1966 and 1967, respectively, CDC generated \$109 million and \$147 million in computer sales and \$62.1 million and \$97 million in rental and service income. The majority of CDC's sales were domestic, but international revenues were increasingly important.

### **The Soviet Market**

The Soviet Union first became interested in the Western computer markets during the mid-1960s, a time in which the United States dominated the world mainframe computer

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The draft of this case was originally prepared by Leonard Schwartz and John DePaulo of New York University's Management Decision Laboratory, Professor Myron Uretsky, Director. Rewritten by Professor Leslie E. Grayson and Research Assistant Grace S. Fogg, University of Virginia. Copyright (c) 1991 by the Darden Graduate Business School Foundation, Charlottesville, VA.

market. The Soviet computer industry, long isolated from the West, had not benefited from the intense transfer of technology taking place among Western nations, nor were Soviet computer products compatible with their Western counterparts. Soviet technology was an estimated 10 years behind the West. Despite these industry constraints, the need for computing power in the Soviet Union was growing rapidly. Scientific and commercial applications demanded increasingly sophisticated machines and software, but Soviet developers were unable to keep pace.

The U.S.S.R. Five Year Economic Plan introduced in 1966 called for a massive campaign to improve Soviet computing capabilities. In reality, years of training and investment were required just to meet current demand. Meanwhile, the growing need for computers and software and mounting pressures for improved computer capability, equipment, and software prompted the Soviet Central Planning Committee to look to the West for its advanced-technology needs.

At the same time as the need for computer capabilities in the Soviet Union was growing, a warming of relationships between the Soviet and U.S. governments was taking place. During this period, the United States began to shift from a policy of comprehensive trade denial with the Soviet Union to a policy recognizing the economic and diplomatic benefits of trade. President Lyndon B. Johnson's administration liberalized trade policies and encouraged cooperation with the Eastern Bloc. As a result, firms in all industries, including companies in sensitive, high-technology sectors, began to test the waters of East-West Trade.

Transferring technology to an East Bloc country was a long and complicated diplomatic process requiring several levels of approval. First, all trade between Western firms and Eastern government agencies was controlled by COCOM (the Coordinating Committee for Export to Communist Areas), a U.S.-led NATO committee supervising trade with Eastern Europe. Then, several agencies of the U.S. federal government, including the Department of Commerce, the Department of State, and the Department of Defense, exerted control over U.S. exports. Policies, in general, were designed to preserve national security, and any product with a potential military application was carefully scrutinized. Computer equipment fell clearly within this realm. Because U.S. regulations on the export of high-technology products were much more restrictive than COCOM's policies, U.S. firms were often at a disadvantage to West European companies when competing for business in the Soviet Union.

### **CDC's Entry into the Soviet Union**

As relations between the United States and the Soviet Union improved, trade between the two countries began to surge. When the U.S. Department of Commerce softened its stance on granting export licenses to the Soviet Union in the mid-1960s, Bill

Norris, chief executive officer of Control Data Corporation, was intrigued by the prospect of doing business with the Soviet Union. He decided that CDC should investigate the Soviet market potential for its products and test the recent changes in U.S. export-control policies.

In October 1966, Norris sent a memo to Miles outlining his reasoning and objectives for further study of the Soviet market. Miles responded immediately by contacting Jurgen Shalk, CDC's Eastern European sales manager in Frankfurt, Germany. Miles requested a report on prospects for sales in the East Bloc countries.

Shalk made a four-day visit to Moscow in December after his regular visit to his East European territory. While in Moscow, he met with officials from the Ministry for Electronics, the State Committee for Science and Technology, and Mashproborintorg--the Soviet foreign trade organization (FTO) responsible for import and export of precision instruments and communications equipment.

During a meeting at Mashproborintorg, the trade minister expressed interest in purchasing a CDC computer system for the Soviet Weather Service, which was familiar with the CDC 3800/3400 system that had been sold to the West German Weather Service and wanted similar technology. The Soviets were so confident in the CDC system, they told Shalk, that they would pass over comparable systems available from IBM, Siemens, and Remington Rand in favor of the CDC system if the price was right and they could agree on the appropriate technical configuration. All CDC would have to do was work out the terms of the contract and obtain the export licenses from the U.S. Commerce and State departments. The Soviet trade officials showed little concern for the existing embargo by the U.S. of technology exports to the Soviet Union; they merely stated that "the general situation seems very favorable here" for concluding the sale of a weather-monitoring system.

After returning to Frankfurt, Shalk sent Miles a memo detailing the events that had taken place in Moscow. He suggested that Miles join him on a trip to Moscow in the spring of 1967 to investigate the possibility of the sale further. Miles was excited about the prospect of a sale to the Soviets and asked Shalk to arrange for the appropriate contacts during a trip to Moscow in mid-March. He believed the weather system had a good chance of receiving export approval from the U.S. government because of its nonstrategic nature and function. He began to investigate the logistics of the sale from the U.S. side of the transaction.

In January 1967, Miles contacted Dr. Frederick Schuman, director of the U.S. National Meteorological Center in Washington, DC. Schuman urged Miles to consider selling the Soviets the CDC 6600, a computer that would tie into a worldwide system. With the endorsement of the United Nations, the World Meteorological Organization had established a telecommunications network linking major weather-watch facilities on every continent. CDC computers were already used in many of these installations, and Schuman believed the U.S. government would approve the sale of the 6600 system to the Soviet

Union. Far more advanced than the CDC 3800/3400 system, the CDC 6600 was one of the most powerful systems available. He suggested that Miles meet with Professor V. A. Bugaev, chief of the Moscow Meteorological Center, during his trip to Moscow in March.

Shortly after his visit with Schuman, Miles and two other CDC executives had an "off the record" meeting with a highly placed U.S. Defense Department official to explore the current U.S. stance on trade with the Soviet Union and to gauge CDC's chances of gaining approval for the sale of its 6600 computer. The official told the group that an East-West Trade Bill and Consular Agreement were experiencing trouble in Congress, but that the President, strongly in favor of opening up trade with the East, had asked the Secretary of Defense to investigate ways of supporting his interest. The Defense Department official emphasized that the Department did not wish to pressure CDC into undertaking any activities in Eastern Europe the company was not already considering, but he believed the company could be part of opening up trade, and he did want to be apprised of CDC's plans. The official also said that his office would stand ready to assist CDC if the company wanted to push for an export license for the 6600 system.

A week later, the CDC executives and the Defense Department official reconvened to outline CDC's strategy toward the East Bloc and the Soviet Union. In a diplomatic gesture, Miles stated that CDC's motives were not merely profit oriented, but that the company was interested in pursuing trade with the Soviet Union in support of the U.S. government's ongoing effort to improve East-West trade relations. CDC representatives also discussed the ineffectiveness of COCOM as a controlling factor in technology transfers to the East, and the problems U.S. companies were having in competing with Western European companies for Soviet business.

The tenor of this meeting was quite different from that of the first, however. The official told the CDC group that the end use of the technology was an important factor in gaining approval for technical exports. Therefore, the CDC 6600 system would be carefully scrutinized for any potential military applications. The official stressed that the export applications would have to specify the intended use and exact location of the equipment. The Defense Department was concerned about the difficulty of assuring that such a powerful system could be configured so that it could be used only for its intended, peaceful means.

The CDC group acknowledged the likelihood that the 6600 would be more powerful than any computing system the Soviets possessed at the time. To allay the Defense Department's concerns, CDC proposed an arrangement in which the company's in-house scientists would make periodic inspections of the system. The visits would be included in the sales contract as a service agreement to ensure that the systems were functioning properly and continuing to serve the customer's needs. Despite the inspection proposal, the Defense Department official remained concerned about transferring such advanced technology to the Soviets, and expressed the view that he could not support approval for

export of the 6600 system. If CDC were to propose a less powerful system, such as the 3800/3400, however, he would, provided the computer's use and location were certified, recommend approval of the export license.

### **Miles' Visit to the Soviet Union**

When Miles left for the Soviet Union on March 15, he was slightly disheartened that he could not offer Mashproborintorg the most up-to-date system for the Weather Service, but he was confident in the prospects for the sale of the 3800/3400 system. He joined Schalk and a sales engineer from the Frankfurt office in Moscow the next day. Together, they met with Bugaev and a Mashproborintorg official at the Soviet Weather Service.

After a warm greeting, Bugaev, indicating that the lower powered 3800/3400 would be insufficient for collecting and analyzing weather data throughout the Soviet Union, expressed a keen interest in the 6600 system. He also told the CDC group that the Weather Service's foreign-currency budget application had been withdrawn and that reapplying for funds could delay negotiations.

Miles aired his concern over obtaining an export license for the 6600 system, but the Soviets were not alarmed. The Mashproborintorg official indicated that the agency would pursue the issue directly with the U.S. Embassy in Moscow. Because CDC executives considered, however, that despite efforts of the Mashproborintorg, the chances of obtaining U.S. government approval for export of the 6600 were slim, they believed their best sales prospect in the Soviet Union had reached a blind alley.

Determined nevertheless to make the most of the trip, the CDC group went on to other appointments, which included a meeting with representatives of the Dubna Institute for Nuclear Research located approximately 40 miles outside Moscow. The Institute, an agency devoted to nuclear research for peaceful means, wanted to participate in cooperative world scientific exchanges but lacked the computing power and compatibility to do so. The Dubna scientist had attempted to purchase an IBM 7090 system two years earlier, but IBM was denied the export license. Given the improved political climate, they wished to try again.

During the meeting, the Dubna representatives expressed interest in purchasing a CDC 1604 system, which was similar to systems used at U.S. nuclear research centers such as the U.S. Atomic Energy Commission labs at Brookhaven and Berkeley, California. One of the scientists had used the CDC 1604 computer at an exchange in Zurich and was impressed by its capabilities. The Institute could afford to spend between \$300,000 and \$500,000 and was not looking at Soviet-made machines, which were incompatible with world computing standards.



On the return flight to Minneapolis, Miles reflected on the trip and weighed his options. He knew Norris was anxious to conclude a deal with the Soviet Union. The 1604 computer sale to the Dubna Institute would be small in comparison with the sale of the 6600 system, but Dubna had the hard currency to make the purchase immediately. Negotiations with the Weather Service could be delayed for months while it awaited budget approval and a hard-currency allotment. Both sales would require export approval from the U.S. government.

### **CDC's Strategy**

Soon after returning to the United States, Miles and Hugh Donaghue of CDC's Washington office met with officials of the Department of Commerce and the Department of State to determine whether export approval could be received for either the 6600 or the 1604 system. During each meeting, Miles described the sales prospects, detailing the technology, the intended use, and the expected location in which each computer would be placed. He concentrated on the 6600 weather-system proposal for two reasons. It was more technically advanced than the 1604 and, therefore, a better gauge of current policy toward export control. Furthermore, the 6600 sale had the potential to generate greater sales revenues for CDC.

The Commerce Department was reluctant to allow the 6600 technology to be transferred to the Soviet Union, while the State Department favored the sale in support of the East-West Trade Bill, still pending in Congress. Miles concluded that getting an export license for the 6600 would be a long shot with the support of only one government agency. On the other hand, neither department foresaw any problems in supporting the sale of the 1604 system. Miles decided to put aside the sale of the 6600 system and concentrate on the 1604 proposal.

Closing the sale of the 1604 to the Dubna Institute was easier than CDC had anticipated, but it was a long process for such a small sale by Western standards. By July 1968, a system configuration including a mainframe, printer, and card reader had been designed, and a price of \$563,000 was placed on the package. Pending approval of the export license, negotiations with Techsnabexport, the nuclear engineering equipment FTO, were scheduled to begin in September.

In mid-August, CDC asked the Commerce Department to review the transaction and offer guidance on formalizing the contract with Dubna. At the same time, CDC submitted formal application to the Commerce Department for the export license. The review was conducted promptly, and no serious problems were anticipated in approving the license. The Commerce Department agreed to give its assurance for the export license and allow CDC to begin negotiations as long as the company complied with three requirements.

1. The contract should provide service agreement to give CDC access to the site.
2. The license application should include a clause with a clear statement of the intended end use of the computer system.
3. The contract should contain a clause stating "subject to granting of U.S. export license."

Armed with the assurances of the Commerce Department, representatives from CDC's European marketing division went to Moscow in September to begin negotiations. By mid-October, a deal was struck pending approval of the export license. When the export license was granted at the end of October, Miles returned to Moscow to finalize the transaction.

The CDC 1604 computer system was delivered to Dubna on March 1, 1968. It was installed in July and was up and running by August. The entire process had gone like clockwork. Norris was pleased that CDC had been among the first American computer companies to complete a transaction with the Soviet Union, and Miles believed that his organization benefited a great deal from the experience.

### **How Should CDC Proceed?**

Soon after the sale of the 1604 computer to the Soviet Union, CDC took a public stance on U.S.-Soviet trade during testimony before the Senate Sub-Committee on International Finance. The company's deposition stated:

It is Control Data Corporations' principal premise that the computer trade is more constructive than trade in any other commodity in obtaining better mutual understanding among the most influential people in the world. Computers are among the most highly prized commodities for import by those countries that do not have them, because the people of these countries believe that through computers they can most effectively restructure the operations of their governments, their scientific enterprises, and their industries to better fulfill their national objectives to attain a higher standard of living for their people.

With the deal for the 1604 concluded, Miles wondered if he should try to resurrect the sales proposal for the 6600. Mashproborintorg had recently indicated that the Weather Service was still interested in purchasing the system, but they were also looking at an equivalent model from IBM.

The Soviet Union represented a market with burgeoning demand, and the trade environment had improved. Still, Miles was concerned about how the 1968 Presidential election, only three months away, might influence the future of U.S.-Soviet trade relations. He wondered if efforts to restart the negotiations would be wasted upon the advent of a new administration. He thought waiting until after the election to make his next move might be prudent, but he was reluctant to relinquish CDC's lead to IBM. Also, considering the lengthy process required to close the deal for the 1604, and the resistance he had previously encountered to the sale of the 6600, Miles wondered whether potential for expanding business in the Communist Bloc was worth all the headaches.

# **JOINT VENTURES**

## ABB AND BERGMANN-BORSIG

Fritz Linnebach returned to his office in March 1991 after a discussion highlighting Bergmann-Borsig GmbH, another potential acquisition for his company, Asea Brown Boveri, to continue its expansion into what used to be East Germany. To place this opportunity into the right context, he recounted in his mind the recent developments and tried to focus on the strategic implications for ABB.

### CONVERTING TO A FREE MARKET ECONOMY

On November 9, 1989, after more than 40 years of division between East and West Germany, the government of the German Democratic Republic (GDR) opened the border to the Federal Republic of Germany (West Germany). About one year later, on October 3, 1990, before the first postwar all-German election, the GDR acceded to West Germany. The five new *Bundesländer* (states) of the former GDR and Berlin joined the ten existing *Länder* and West Berlin and became constituent states of the Federal Republic of Germany. With this move, the former GDR states were brought into the European Community, although some transitional measures applied until the end of 1992. Even before reunification, on July 1, 1990, the German Monetary Union had made the deutsche mark the legal currency in all of the GDR, which had opened the GDR to free trade.

These developments started the process to transform the socialist central-planning system in the new *Bundesländer* to a free-market system within the legal framework of the Federal Republic, based on private ownership, free trade, free competition, social security, and no regulation of prices. To facilitate this transition and to stabilize the situation, the German government immediately took the following actions: All former state-owned enterprises were converted into either limited-liability companies (*GmbH*) or stock companies (*AG*). Ownership of all shares of these new companies was given to the *Treuhandanstalt*, a trust agency established to modernize and privatize these former GDR companies as soon as possible. At the same time, the companies were required to present an opening balance sheet in deutsche marks (a *DM Eröffnungsbilanz*) to provide at least some basis for evaluation.

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This case was written by Professor Samuel E. Bodily and Dirk Schneider, Class of 1992, with support from Citicorp Global Scholars Program, as a basis for class discussion. Copyright (c) 1992 by the Darden Graduate Business School Foundation, Charlottesville, VA.

General procedures for retransfer of land and enterprises, for value equalization, and for settlement of open questions of ownership were established, which substantially reduced political and legal risk for future investors in real estate and other assets. To improve the overall infrastructure, the government started large programs to improve transportation, communication, and the public-utility system. The government also introduced an appropriate economic administration for the former GDR in the form of chambers of industry and commerce and branch offices of the Federal Ministry of Economics and the Federal Office of Foreign Trade Information. In addition, several individual *Länder* initiated incentive programs to promote the location of new industries and economic development.

All these changes were backed up by the financial power and the extensive economic experience of the Federal Republic of Germany. In contrast to the other East European countries, the new *Bundesländer* could build their growth on a proven economic and legal system. With average productivity at about 30% of the West German level, however, an expected decrease in employment of up to 40% because of unneeded workers, and estimated public-investment requirements of DM1,500 to DM2,000 billion over the next 10 years, investing in the economic future of the *Bundesländer* was not exactly risk free.

#### **ASEA BROWN BOVERI AG ZÜRICH**

In August 1987, Percy Barnevik formed Asea Brown Boveri (ABB) through a merger between Sweden's Asea and Switzerland's Brown Boveri, a giant with US\$17 billion in revenues and powerful competitive positions in pollution-control equipment, railway vehicles, and electric-power-generation technology. It was Europe's largest cross-border merger. In October 1988, Barnevik snapped up the steam-turbine business of AEG and signed a nuclear-reactor joint venture with Siemens. January 1989 saw a joint venture with the Italian firm Finmeccanica, a US\$1.2 billion company, and the taking of a 40% stake in BREL, Britain's leading railcar manufacturer. In February, ABB began to move into the U.S. -- buying Westinghouse's power-distribution and transmission units for US\$700 million. Moves in the U.S. continued in 1990 as ABB completed a \$1.6 billion takeover of boiler and nuclear-plant builder Combustion Engineering, which boosted ABB's North American sales to \$7 billion. By the end of 1990, consolidated revenues had grown to almost \$30 billion and ABB had a more than 20% global market share in the \$50 billion electric-power-generation industry. (See Exhibit 1 for ABB's 1990 and 1990 income statements).

With the European Community accounting for 25% of the previous year's orders, North America 24%, and Western Europe outside the European Community 29%, the group was now satisfied with its geographical spread. For the future, Barnevik predicted a decreasing rate of acquisitions, although the expansion into Eastern Europe would continue. He saw the former East Bloc, with its antiquated infrastructure and fouled environment, as a "huge market for our type of business. But we know it will be a rocky road."

## ASEA BROWN BOVERI AG MANNHEIM

ABB Mannheim in 1990 was the largest European and the overall second largest company within the ABB group. With a work force of 35,000 at over 50 locations in Europe, ABB Mannheim generated revenues of almost DM7 billion and a net income of more than DM150 million (see financial statements in Exhibit 2). Electric-power generating equipment and railway rolling stock accounted for two-thirds of the total business activity. While ABB Zürich structured the group activities in the rest of Eastern Europe, ABB Mannheim was largely responsible for the expansion into the former GDR. Therefore, to build a strong strategic position in the new *Bundesländer*, ABB established early joint ventures with more than 20 companies in its industry that were then government owned. These companies had a combined work force of over 11,000. "We are, in principle, prepared to assume the entrepreneurial responsibility for these enterprises and to make the necessary investments in these companies, most of which would probably be unable to survive if left to themselves," Executive Vice-president Eberhard von Körber stated in July 1990. "But the size of the investment will depend on [the companies'] DM opening balance sheets, which have not yet been published, on the company shares offered for acquisition, and on the necessary revamping effort."

Translating this statement into action, in December 1990, ABB acquired *Energiebau Dresden GmbH*, a manufacturer of high-voltage overhead lines, switch gear, and catenaries. To improve operating efficiency and to elevate the company's products to ABB standard, ABB estimated that an additional investment of DM30 million would be required until 1994. Two months after this purchase, ABB bought *Automatisierungsanlagen Cottbus GmbH*, the leading East German producer of power-plant control technology and process-automation equipment. Modernization of this acquisition would run as much as DM40 million over the next few years. Now, in March 1991, ABB and the *Treuhandanstalt* were negotiating the privatization of *Bergmann-Borsig GmbH* Berlin.

## THE BERGMANN-BORSIG PROPOSAL

The state-owned enterprise Bergmann-Borsig was established in 1945 out of the Bergmann Electricity Company in the East, which was heavily damaged by Allied air raids in World War II, and the workers of Borsig Electricity Company of the West, which was totally flattened by bombs and whose workers moved over to the East. Until the beginning of 1990, Bergmann-Borsig had grown to about 4,500 employees and occupied a major manufacturing site in what had meanwhile become a predominantly residential area in former East Berlin.

During the previous 40 years, while the back wall of the company constituted about 1 kilometer of the Berlin Wall between East and West, Bergmann-Borsig had built a leadership position among the East bloc countries in the power-generating equipment business. The company manufactured steam turbines up to 110 megawatts (MW) and gas turbines up to 24 MW, generators, and heat exchangers for both utility and industrial use. Not only was Bergmann-Borsig the predominant supplier to all East German power plants, it also maintained extensive assembly and service contracts with major power plants in the USSR, Poland, and

other East Bloc countries. Consequently, Bergmann-Borsig could provide immediate access to the expected business of building and remodeling East German and East European power plants and systems.

A recent survey of plants in the former GDR had found that 50% of the steam generators were older than 20 years; another 30% were aged between 10 and 20 years. Steam and gas turbines presented a similar picture. Furthermore, estimates of the region's air pollution had concluded that the annual emissions of carbon dioxide and sulfur dioxide were roughly two and seven times higher, respectively, on a per-person basis than in the rest of the European Community. Based on these and similar studies, Frost & Sullivan, a New York-based market research firm, estimated the sales of electric-power equipment in the new *Bundesländer* to total more than US\$2 billion over the next three to four years. The firm's estimates for Poland predicted an increase from US\$1.7 billion in 1990 to US\$2.1 billion in 1995. The markets in Czechoslovakia, Bulgaria, and Romania were expected to increase during the same period from US\$0.2 billion to US\$2.5 billion. The total market in the former East Bloc in 1990 was estimated at about US\$4.4 trillion. (Exhibit 3 shows some estimated budgets for the power-generation industry for the German government and for several utilities). To secure a hefty share of this business, existing production facilities and contacts in former East Bloc countries would be helpful. On the other hand, these estimates were based primarily on need, not on the ability of the operators to pay for new equipment. Whether these countries or the companies would be able to pay on time and whether the political environment there would be stable enough to establish any reliable business relationship were other matters entirely.

From the earlier acquisitions, ABB knew that it could expect good basic knowledge in turbine, generator, and power-plant technology from Bergmann-Borsig. In addition to increase productivity, the work force (more than 50% were unionized) had already been reduced to 3,500, and labor relations were, considering the circumstances, good. Because no language barrier interfered between Bergmann-Borsig and the German or Swiss ABB operations, the integration would be easier than that of other candidates in Eastern Europe. Tooling and process knowhow would be easy to provide from Swiss and German operations, and early investments would be highly rewarded by significant government incentives (for details see Exhibit 4). So, Bergmann-Borsig clearly presented an attractive opportunity.

On the other hand, the required investments for new heavy machinery would still be significant, and an entire rearrangement of the factory layout would be needed. Moreover, the expected Eastern market could fail to materialize, and ABB had still not seen an opening balance sheet from Bergmann-Borsig. ABB would inherit productivity levels that might be only 30% of those of ABB Mannheim, even though wages would be expected over time to equal those in western Germany. A significant issue was whether productivity levels would rise as fast as wages. That the number of employees would need to be reduced, however, by at least one-third, was certain.

The *Treuhand* would negotiate much more than a purchase price with ABB. The investments made by ABB and their impact on the local industry structure could become a major



issue. The *Treuhand* also preferred a guaranty of a certain level of employment, at least over the initial several years.

Linnebach thought about how well this acquisition fit into ABB's overall international strategy. Would the acquisition strengthen ABB's global position or would ABB be better off expanding existing Western companies? Would ABB be able to turn Bergmann-Borsig around quickly enough? Linnebach did not want to get the company into a debacle. The thought crossed his mind that, if ABB decided to go ahead, he might be asked to run the Berlin facility. He would then be expected to compete with the business he had developed back in Mannheim-- and that would not be easy.

Exhibit 1

ABB and BERGMANN-BORSIG

ABB Asea Brown Boveri AG, Zürich Income Statements  
(in DM millions, except as noted)

	<u>1989</u>	<u>1990</u>
Orders	21,640	29,281
Total revenues	20,560	26,688
Work force	189,493	215,154
Research & Development	1,361	1,931
Investment in Plant, Property & Equipment	783	961
Investment in holdings	3,090	677
Total assets	24,156	30,247
Operating profit	1,257	1,790
Income before taxes	922	1,130
Income after taxes	589	590
Owners' equity	3,907	4,247
Return on equity	16.8%	14.5%
Return on investment	17.0%	19.7%
Return on sales	6.1%	6.7%

## Exhibit 2

## ABB and BERGMANN-BORSIG

Asea Brown Boveri AG Mannheim Consolidated Financial Statements  
(in DM millions, except as noted)**BALANCE SHEET**

	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
<b>Assets</b>					
PP&E	737	733	772	871	897
Inventory	2,205	2,171	2,071	2,324	2,248
Advances	-1,325	-1,327	-1,252	-1,417	-1,331
Receivables	1,110	938	993	1,079	1,239
Other assets	187	133	129	153	161
Cash and cash equivalent	1,705	1,584	1,429	1,423	1,588
Total assets	4,619	4,232	4,142	4,433	4,802
<b>Liabilities</b>					
Stockholders' equity	546	539	557	618	721
Debt obligations	792	689	321	255	380
Pensions	508	583	659	792	849
Unearned advances	442	442	417	475	446
Accrued liabilities	865	1,419	1,574	1,672	1,677
Other liabilities	729	560	614	621	729
Total Liabilities	4,619	4,232	4,142	4,433	4,802

**INCOME STATEMENT**

	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
Total revenues	5,443	5,439	5,720	6,566	6,896
Materials	2,180	2,149	2,353	2,763	2,720
Labor	2,090	2,169	2,256	2,372	2,483
Depreciation	204	206	234	269	281
Taxes	60	37	38	87	184
Other expenses	888	858	804	996	1,076
Income	21	20	35	79	152
Cash flow	288	274	309	441	505
Work force (numbers)	36,567	34,370	34,151	34,650	34,962

Exhibit 3

ABB and BERGMANN-BORSIG

Existing Budgets in Power Generation Industry  
(in DM millions)

<b>Government:</b> (1991-2000)	Power generation and supply	60,000
	Environmental protection	<u>70,000</u>
	<b>Total</b>	<b>130,000</b>
<b>Utilities:</b> (1991-1993)	RWE-Energie AG	750
	Preußag AG	1,820
	Westsächsische Energie AG	110
	Energie Spree-Schwarze Elster AG	240
	Energie Sachsen-Ost AG	550
	Bayernwerke AG	<u>2,400</u>
<b>Total</b>	<b>5,868</b>	

Exhibit 4

ABB and BERGMANN-BORSIG

Investment Incentives

**Financial incentives (main elements)**

Investment allowance (for depreciable and movable assets, tax free)

July 1, 1990 - December 31, 1991	to 12 %
January 1, 1992 - December 31, 1994	to 8 %

Investment grants for movable and immovable assets, taxable like a revenue)

Investments for:

- the establishment of a business to 23 %
- expansion to 20 %
- readjustment and rationalization to 15 %

Incentives may be increased to 10 %

**Tax incentives (main elements)**

Preferential depreciation (December 31, 1990 - December 31, 1994)

50% in the first year, plus regular linear depreciation

Income and corporation tax (marginal rate of 50%)

Exempted for two years if:

- the business founded before 1 January 1991
- the annual profit does not exceed 10,000 DM

Trade capital tax and property tax

Not levied in 1991



## GM HUNGARY

In February 1989, General Motors Corporation (GM) signed a protocol with the Hungarian government to initiate a feasibility study of a new engine-manufacturing facility and an automobile-assembly plant in Hungary. During the year, GM executive teams in Europe and the U.S. examined the opportunities available in Hungary for the manufacture and sale of automobiles. The project had a high profile within GM, because it was the company's first serious examination of an East European market. GM engaged several outside consultants, academics and East European authorities to assist in its analysis. By December 1989, Robert Jones, a senior executive at GM Europe (GME) had to make a recommendation to GM senior management in the U.S. about the Hungarian project.

## GM IN EUROPE

In 1989 GM sold 7.9 million automobiles, which made it the largest automotive company in the world. GME, with its Opel and Vauxhall lines, sold over 1.5 million automobiles in 1989, up from 1.3 million in 1987. GME sales were \$19.7 billion in 1989, up 11% over 1988. GME was the fastest growing of the "Big Six" European car makers; Opel or Vauxhall held first, second or third position in 12 of the 16 West European country markets. To meet increased demand, the company operated assembly and manufacturing operations in 15 countries and had made a public commitment to increase production capacity by 12.5% by 1994.<sup>1</sup>

One of the first priorities for GME under this expansion program was to increase capacity for its "Family I" engines, used in the Corsa and Astra models. Because no space was available for expansion at any existing European facilities, GM management in Zurich, Switzerland decided in 1988 to explore potential greenfield sites for an engine plant.

While the need for additional plant capacity was primarily caused by increased demand in West European markets, GM also included expansion into the former East Bloc countries in its planning. As Robert Jones put it:

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<sup>1</sup> GM 1989 annual report.

Our strategy for Eastern Europe is that we want to sell cars in every country; that's first and foremost. Each [East European] country, without question, has a capacity and a desire. The question is how quickly they can go through the restructuring necessary -- go through the unemployment, the rebuilding, and the time associated with the process.

The restructuring in Eastern Europe required a tremendous amount of hard currency, which was currently not being generated by the local countries. While the exchange controls that existed in the East European countries in 1989 were being liberalized, the need for hard currency could cause some countries to tighten up on convertibility in the future as they had done previously. GM's Jones recognized this potential problem.

One of our feelings is that, for Eastern Europe, you need to visualize an operation that is largely exchange balanced. No matter what the government may be currently saying in terms of free convertibility and exchange availability, we don't think it's prudent to rely upon that, just given the rebuilding these countries have to undertake.

Another goal of the expansion program was to establish GM's first major strategic operation in Eastern Europe. While the company had been selling vehicles on an export basis to East Bloc countries for over 25 years, it did not have any local production in the East. As Exhibit 1 shows, however, demand for Western automobiles in the Eastern countries was clear, but Jones's assessment was, "We think just about every [East European] country is going to be short of foreign exchange for an extended period of time." Therefore, if GM wanted to tap into the East European markets, it was going to have to use locally made automobiles.

#### **ANALYSIS OF EAST EUROPEAN COUNTRIES**

In the fall of 1988, GME's Strategy Board made the decision to enter the East European market. The decision was based on an analysis by GME's New Business Development team in Zurich and a task force consisting of personnel from GME's Technical Development Center, material management, market forecasting, legal, and finance staffs. The task force concentrated on the primary political and economic risks associated with doing business in Eastern Europe on a broad, general level.

This first-cut analysis was, in Jones's words, "crude" because of the lack of information on Eastern Europe at the time. A summary of the task force's findings is in Exhibit 2. Based on this information, the GME Strategy Board approved a go-ahead in Eastern Europe and narrowed the focus of the analysis of potential sites for its East European expansion to three countries, Hungary, Poland and Czechoslovakia.



The second-stage analysis of the three countries was more in-depth than the first-stage analysis. As Jones stated, the purpose of this study was to "satisfy ourselves that we think the economic prospects are good; that the fundamentals are in place in terms of good monetary and fiscal policies; that the government is stable; and the work force is skilled, productive and technically capable."

This analysis was completed in December 1988 and presented to the Strategy Board. Based on the criteria stated by Jones, the task force recommended that Hungary be chosen as the first developmental site for GM in Eastern Europe.

### THE SELECTION OF HUNGARY

Of all the East European countries, Hungary offered the most attractive environment for foreign investment. The country had an area of approximately 36,000 square miles, which made it slightly smaller than the state of Indiana. The population in 1989 was approximately 11 million people, 96% of which were Magyar, or Hungarians. The economy was fairly industrialized; 40% of the gross domestic product (GDP) was generated by the industrial sector. In addition, 40% of GDP was traded internationally, primarily to other East Bloc countries and the Soviet Union but with some trade to the Free World.

During the 1980s, Hungary earned a reputation as an innovator among the East Bloc countries. In 1982 it joined the World Bank. In 1984 it was the first Communist country to establish a secondary bond market. In 1987 foreign-investment laws were changed to allow foreigners to own 100% of Hungarian companies and to repatriate dividends in hard currency. In 1988 the government made another strong move toward capitalism when it cut subsidies to local industry and promised to force unprofitable companies into bankruptcy. Finally, in January 1989, the government opened a stock market and offered ownership positions in state-owned companies to the public.

Nevertheless, many obstacles confronted economic progress in Hungary. Similarly to the other East European countries, Hungary was neither capitalist nor socialist. It functioned somewhere between the two systems. The government had removed many of the barriers that had impeded economic growth and development, but the socialist mindset was still heavily ingrained in the population. Moreover, the government reforms to move the economy toward capitalism had increased inflation and lowered the standard of living for the Hungarian people. While many Hungarians welcomed the changes of capitalism, few looked forward to the struggle and pain associated with that change.<sup>2</sup>

GME also had some specific strategic reasons for preferring Hungary as the location for the engine-manufacturing and automobile-assembly plants. The first was Hungary's strategic location. Bordered by Austria, Yugoslavia, Romania, the Ukraine and

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<sup>2</sup> See "Hungary in 1990," UVA-G-424, for a detailed review of Hungary at this time.

Czechoslovakia, Hungary lay in the heart of Eastern Europe. One option for GME was to run a new plant as a satellite of an existing GME facility in Western Europe. A plant in Hungary would fit well in that scenario, as GM maintained a large Family I engine facility in Austria, approximately 100 kilometers (km) from the Hungarian border.

The fact that Opel had maintained a market presence in Hungary for over 25 years was also a big positive factor. The task force projected significant market potential for Western passenger cars in the domestic Hungarian market. (These projections are in Exhibit 3.) The established Opel presence, coupled with the lack of other automobile production in the country, made Hungary the Strategy Board's first choice for the proposed plant site.

Hungary's leading role among the East Bloc countries in opening to the West was also an important factor in swaying the GME Strategy Board, as was the country's relatively stable macroeconomics in comparison with other East European countries. Other factors included the availability of a skilled work force that required low wages and salaries (see Exhibit 4) and Hungary's favorable joint-venture regulations.

In addition to the favorable joint-venture environment, negotiations with the Hungarian government appeared possible on other incentives needed to make an investment in Hungary attractive. Tax incentives were the most easily quantifiable. GME was able to negotiate a tax holiday for 10 years and set a maximum income tax of 20% after that period. The ability to convert and transfer funds freely was also key, although continued availability of these rights was uncertain. The Hungarian government also promised to make certain infrastructure improvements (e.g., providing natural gas to the site) to facilitate the operation of the proposed plant.

The U.S. government also played a role in the decision; its granting Hungary preferential status as a developing country provided GM with certain tax benefits based on the amount of its Hungarian investment. The European Economic Community had also designated Hungary a preferential-status country.

#### **THE SZENTGOTTHARD PROJECT**

In February 1989, GM signed a protocol with the Hungarian government to initiate a feasibility study on development of an engine-manufacturing facility and automobile-assembly plant in Hungary. A project team was formed within GME in April 1989 to do the third-level, or project-specific analysis.

The first tasks for the team were to decide if a joint-venture partner was necessary, and if so, to select a partner. Because, theoretically no legal limitations existed on foreign ownership of business, a wholly owned subsidiary in Hungary was a possibility. As Jones stated, "We obviously prefer to do things on a wholly owned basis, but on the other hand, GM has a great deal of experience with joint ventures."

The project team concluded that, because of the high risk levels of operating in an emerging market such as Hungary, a local joint-venture partner would be valuable. GM had a prior relationship with RABA, a state-owned enterprise that had manufactured axles for GM's Truck & Bus Group. Thus with Hungarian government support, GME approached RABA, then engaged in the manufacture of farm tractors, as a potential partner.

One advantage that RABA contributed was a new plant in Szentgotthard, just 2 km from the Austrian border. The Hungarian government had built the plant to meet the need for farm tractors, but the 5-year plan was subsequently changed and the plant was deemed unnecessary before it was outfitted with any manufacturing equipment. Because the plant was never completed, it had no employees and RABA offered GM complete freedom to staff the plant, should GM decide to join forces on the new facility.

The presence of the already completed facility and the cooperation exhibited by RABA management during the negotiations made the decision as to a joint-venture partner relatively easy. In August 1989, RABA was officially selected as the joint-venture partner, should GM management decide to go forward in Hungary. The next step for the project team was to propose production scenarios for the facility and validate their feasibility.

The project team recommended that the Hungarian plant become a satellite operation of the GM plant in Austria. This plant, located outside Vienna less than 220 km from the Szentgotthard site, was GME's most highly regarded facility. The key support function provided by GM Austria would be in engineering. The Austrians would provide technical support on the purchase and installation of equipment for the Hungarian plants and also train new personnel on GM operational procedures and specifications.

The goal set for the engine plant was to be on-line and meeting all GME requirements by 1992. The plant was to be under GME management and receive support functions from GM Austria. Production would be limited to Family I, 1.6-liter, overhead-cam engines. Initial capacity would be set at 200,000 units per year, 98% of which would be exported. The exports would generate US\$32 million per year for import of complete knockdown (CKD) kits for GME's new Astra passenger car, which would then be assembled and sold to the local market.

The CKD operation was also to go on-line in 1992. It would be strictly an assembly operation receiving CKD kits and components from other GME facilities. The same facilities and building that housed the engine plant would be used for the assembly operation, with only minor expansion required. The local-market forecast called for an average requirement of 11,700 cars for 1992-1998. The US\$32 million to be produced by the export of engines would initially provide less than half, however, of the US\$74 million needed for importation of the Opel CKD kits. Thus to ensure that the project was run on an exchange-balanced position, the export of 3,000 cars per year, primarily to Yugoslavia, was forecasted. Robert Jones commented on the process used in projecting the potential volume for the Hungarian project:

To get at the volume you think that you are going to do in the assembly plant, you basically start with an industry assessment and what you think your reasonable share of that industry is. By definition, you get into economic factors, political factors and social factors. To get at the industry estimate, you have to make some competitive judgments to get at your share calculation. From that point forward, it becomes more of an execution: can you deliver the assembly plant with an investment that you predicted? We have done other small-scale assembly plants, so we have some good benchmark data, which becomes a basis to determine what we think it should be for Hungary. Because we have done it a number of times, we have fairly high confidence in our ability to predict.

Based on the findings of the project team, the feasibility of the Hungary project was approved in September 1989. In November a delegation of Hungarian government officials met with GM Chairman Roger B. Smith in Detroit, Michigan to discuss GM's plans in Hungary. The Hungarian delegation confirmed potential incentives that could be provided should GM decide to go forward. Final negotiations were then held between GME staff, RABA and some additional Hungarian government officials.

One of the key issues discussed with the government was its ability to provide, through duty protection or other means, some form of competitive advantage for the fledgling Hungarian operation. If developed, the GM plant would be the only domestic car manufacturer in Hungary. Because of the small size of the potential market and the limited resources of the Hungarian people, the initial GM plant would be relatively small. This smaller plant would be at a cost disadvantage to many of the high-volume plants maintained by GM competitors outside Hungary. As Robert Jones recalled:

We thought we needed to lock down a certain rate of advantage associated with a local vehicle assembly on a small scale for it to stand up over time versus imported vehicles. We explained that to the Hungarian government: "Yes it's not Adam Smith, but you're not ready for Adam Smith yet. I think you are ready to restructure. You are trying to generate employment. You are trying to modernize. While this might not be very economic, it's a positive step for you to take initially and it will contribute to growth in local suppliers."

Hungary's duty rate on automobiles in 1989 was 10-40%, depending on the engine size of the automobile. In addition, Hungary also charged a 25% value-added tax. Even though Hungary was a member of the General Agreement on Tariffs and Trade, its tariffs on cars were not bound, which meant the Hungarian government could raise them without fear of penalty from trade partners.

## THE DECISION

By December 1989, GME was ready to prepare a final report for GM senior management on the Hungary project. Detailed financial projections with extensive sensitivity analysis had been prepared, but even with the sensitivity analysis, this project could not be clearly justified on its financial aspects; too much uncertainty that could never be quantified accurately still surrounded entering an East Bloc country.

To overcome this lack of quantitative information, GME emphasized the strategic implications of the Hungarian project in its report to GM management in Detroit. GME believed that the strategic rationale for the investment needed to be compelling, as other, more traditional options existed for GME to obtain the engines. Finally, if GME were to recommend to Detroit that GM go forward in Hungary, it would also have to determine a schedule for implementation. With that thought in mind, a final task-force meeting was called for the afternoon.

Exhibit 1

GM HUNGARY

East European Automobile Demand  
(in 000s)

<u>Country</u>	<u>1992</u>	<u>1995</u>	<u>2000</u>	<u>Trend Growth</u>
Bulgaria	60	67	81	3.8
Czechoslovakia	180	202	244	3.9
East Germany	225	305	460	9.4
Hungary	135	150	180	3.7
Poland	250	277	329	3.5
Romania	110	123	148	3.8
Yugoslavia	<u>270</u>	<u>300</u>	<u>350</u>	<u>3.3</u>
Total	1,230	1,424	1,792	4.8

Source: GM projections.

## Exhibit 2

## GM HUNGARY

Eastern Europe:  
Country Data Summary

<u>Country</u>	<u>Population</u> <u>(millions)</u>	<u>Income</u> <u>per Capita</u> <u>(US = 100)</u>	<u>Trade</u> <u>Balance</u> <u>(\$billions)</u>	<u>Current</u> <u>Account</u> <u>(\$billions)</u>	<u>Country</u> <u>Debt</u> <u>(\$billions)</u>	<u>Interest</u> <u>Payments</u> <u>(\$billions)</u>	<u>Interest</u> <u>as a %</u> <u>of Exports</u>	<u>GDP %</u> <u>Annual</u> <u>Growth</u>
Bulgaria	9.0	29	(1.3)	(1.5)	10.0	0.4	14.0	3.0
Czechoslovakia	16.0	46	(0.1)	(0.3)	7.0	0.3	5.0	3.5
East Germany	16.0	49	0.1	0.6	21.0	0.8	8.0	8.0
Hungary	11.0	36	0.7	(0.6)	21.0	1.2	20.0	3.5
Poland	38.0	26	1.0	(0.6)	41.0	3.4	49.0	2.8
Romania	23.0	23	3.8	3.5	1.0	0.0	0.0	3.0
Yugoslavia	<u>24.0</u>	29	<u>0.2</u>	<u>1.2</u>	<u>20.0</u>	<u>1.4</u>	<u>14.0</u>	<u>2.8</u>
Total	137.0		4.4	2.3	120.0	7.6	15.0	

Source: GM internal documents.

Exhibit 3

GM HUNGARY

1995-2000 Hungarian Automobile Market  
GME Average Share of Segment Forecasted

<u>Automobile Size</u>	<u>GME Share %</u>	<u>Number of Competitors</u>
Mini	0	4
Small	4	8
Compact	33	6
Mid-size	20	5
Large	18	5
Exclusive	0	0

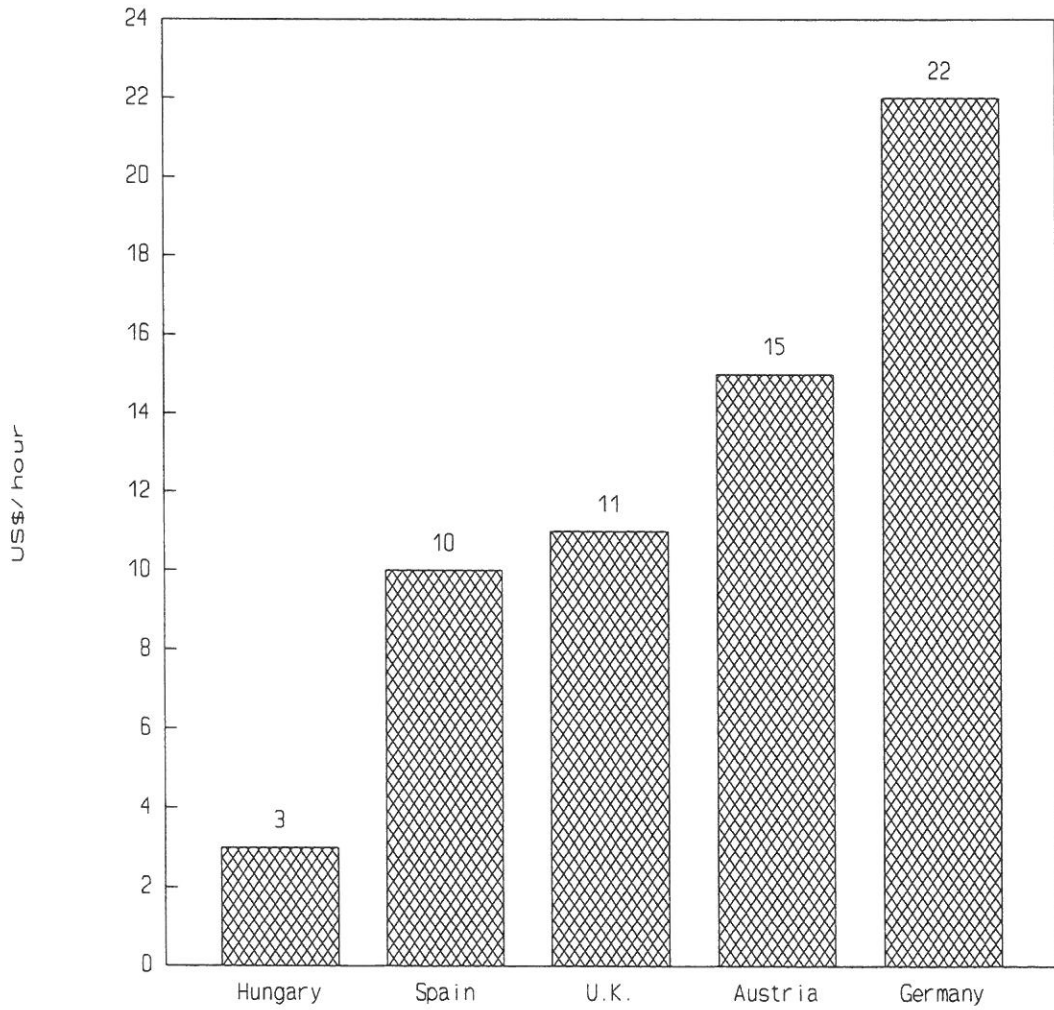
Source: GM projections.



Exhibit 4

GM HUNGARY

Average Labor Costs





## PRAHA HOTEL

In November 1989, the Communist government of Czechoslovakia was removed from power and the new Czechoslovakian Republic was formed. Shortly after the Republic government gained control, it transferred jurisdiction of the Praha (Czech for Prague) Hotel from the Communist Party to the Municipality of Prague 6, a borough of the City of Prague. Prague 6 immediately began operating the hotel as a commercial enterprise. What had once been a privileged playground for party officials and foreign dignitaries was opened to all guests and visitors for the first time. (See photograph in Exhibit 1.)

Almost immediately, many unsolicited expressions of interest in purchasing the hotel began pouring into the Ministry of Privatization and the Municipality of Prague 6. Because these inquiries exhibited little consistency in scope or nature, the municipality engaged an Advisory Group to evaluate the opportunities that existed for the hotel.

The Advisory Group consisted of EuroInvest, Inc., Bankers Trust Company and the law firm of White & Case. EuroInvest, a New York-based consulting company, specialized in investments in Czechoslovakia. Bankers Trust was an international merchant bank specializing in global banking services and trading activities that had been involved in several advisory assignments in Eastern Europe. White & Case, an international law firm, had advised the Czech government on several privatizations.

The Advisory Group was engaged for several purposes: to establish internationally accepted criteria for the selection of a manager and an investor for the development of the property; to introduce and implement a controlled auction process; to help the Municipality choose among the submitted proposals; and to assist in negotiating the final agreement.

In the first phase of the auction process, the Advisory Group prepared an Offering Memorandum and contacted 200 potential investors. The Offering Memorandum contained information derived from a study conducted by an independent accounting firm about the hotel market in Czechoslovakia and the hotel itself. It also contained specific guidelines set by the Czech government concerning capacity expansion, the selection of a hotel management company, and the development of an office and retail complex on the site. The Advisory Group set a mid-December 1990 deadline for receipt of initial indications of interest from potential acquirers. Following the deadline, the Advisory Group reviewed the proposals and invited several groups to participate in the second phase of the auction.

During the second phase of the auction, the invited interested parties were given access to the hotel's managers, who provided additional information. Based on this information, the interested parties submitted final bids to the Advisory Group. The Advisory Group analyzed these offers and recommended the most favorable bids for consideration and final selection by the Municipality's Divestiture Committee.

In March 1991, the Municipality signed a preliminary agreement with a consortium of investors to enter into a joint-venture ownership of the Praha Hotel. The consortium included Swiss Bank Corp., Central European Property Development, Ltd. (a U.K. developer), and Development Management, Ltd., a U.K. project manager.

### **THE PRAHA HOTEL**

The Praha Hotel was built by the Communist Party of Czechoslovakia in 1981 at an estimated cost of \$42.8 million. Located 20 minutes from downtown off Europa (formerly Leninkova) Avenue in one of Prague's finest neighborhoods (see Exhibit 2), the hotel was an elegant six-story brown-and-white brick palace. It contained 124 rooms, including 32 "small" suites and 8 "presidential" suites. Each room contained a private balcony overlooking Hradcany Castle.

In addition to being one of only three hotels in Prague with phones that allowed direct international dialing, the Praha contained such amenities as an indoor swimming pool, a sauna, pool tables, a bowling alley, tennis and volleyball courts, a beauty shop, a cinema, and a massage parlor. The interior of the hotel was extravagant, with wood-paneled public areas the size of caverns filled with leather armchairs, and marble staircases illuminated by crystal chandeliers. Off the center atrium, which contained a tropical garden, were small rooms used solely for playing chess.

The local citizens had always viewed the hotel with a mixture of awe and resentment. Until the 1989 revolution, the hotel had never been open to the public. It was used only as a hotel and conference center for Communist Party members and selected foreign dignitaries. Built on the site of a former public park with a commanding view of the city, the hotel was long a symbol of the excesses of the Communist Party. Despite all its elegance, the Praha was severely underutilized while under Party control; it averaged less than 50% occupancy.

### **THE PROPOSED JOINT VENTURE**

Under the terms of the preliminary agreement signed in March 1991, the Municipality of Prague 6 would retain 49% ownership of the Praha Hotel, while the consortium would own 51%. The consortium also had the right to sell equity participations in its ownership share to outside investors. According to a report in *American Banker*, the group estimated that it would eventually sell a 45-46% stake to select investors in a private offering.

The consortium included an ambitious \$110 million restoration and expansion plan in its bid. This plan called for modernizing the existing facilities to five-star quality and immediately adding 200 rooms and 60,000 square feet of office space. An additional 120,000 square feet of retail and office space would be added over time. Of the entire \$110 million to be funded by the consortium, \$33 million would be in the form of equity capital. The remaining \$77 million would be raised through secured financing arranged by Swiss Bank; it would be the first mortgage financing undertaken in post-Communist Czechoslovakia. Daniel Arbess, an attorney with White & Case and the primary advisor to the Municipality, commented on the uniqueness and the difficulty of the financing structure:

We are creating the legal instruments as we go. There isn't a lot of legal infrastructure here for the kind of financing that we are doing in this project. Most privatization projects have tended to focus on the sale of equity as a way of raising money. This one is largely debt financed. It's a \$110 million deal and something like \$77 million is going to be raised in the form of debt. So it's going to be the first really secured project financing done in Czechoslovakia with project risk and no state bank or other state guarantees.

A key aspect of the winning consortium's bid was the involvement of the Hyatt International Corporation as hotel managers for the Praha. Hyatt provided the consortium with international marketing clout and a long history of effective management of up-scale business hotels. Hyatt also brought experience in operating hotels in Eastern Europe. The company had managed a hotel in Budapest, Hungary since 1982 and was a majority shareholder in the Hyatt Regency Belgrade (Yugoslavia), which opened in August 1990. At the time of bid, Hyatt was also in the process of negotiating a joint venture for the operation of a 300-room hotel in Warsaw, Poland and had begun negotiations on a two-hotel deal in the Soviet Union.

The Czech government also played a role in the consortium's successful bid. Two weeks before the preliminary agreement was reached, the Czechoslovak Parliament passed a far-reaching piece of legislation governing the divestiture of the more than 4,000 state-owned properties. This legislation provided for great flexibility in the sale process by requiring each enterprise to prepare its own project, allowing solutions to be individually tailored to each situation and eliminating close state supervision. This de-standardization, together with the removal of government bottlenecks, allowed the Advisory Group to negotiate the preliminary agreement of this unique arrangement with the consortium in a short time. Nevertheless, many issues remained before a final agreement could be signed.

#### **OPEN ISSUES**

One of the most important issues facing the consortium was the need to develop collateral instruments that would assure the lenders to the project of receiving a *hard-currency* security interest in real property equal to their hard-currency loan exposure. Daniel Arbess explained this issue:

The complicating risk here is related to currency in two respects. In ordinary circumstances, a domestic company which earns foreign currency would be required to offer all of it to the state bank for domestic Czech crowns [koruna, the domestic currency]. If, on the other hand, it requires foreign currency, the company goes to the state bank and buys the foreign currency with crowns. That's all well and good except that, in this situation, the foreign lenders do not want to take any currency-exchange risk. Because of this, we have to create a kind of mortgage with a very unique foreclosure feature on it, which allows banks to foreclose and receive directly proceeds in foreign currency. This allows the banks to avoid taking the liquidity risk of going through a foreclosure and winding up with a bunch of crowns.

Another issue for the consortium was the liquidity of the Czechoslovak banking system. While the Republic government was allowing free convertibility of the crown, its ability to convert large amounts of crowns into hard currency was questionable. In this transaction, with \$110 million involved, the consortium was unlikely to be able to repatriate large amounts of capital in the foreseeable future.

The ability of the hotel management to establish a level of service commensurate with the five-star status that the consortium sought was also a concern. The biggest challenge, according to Ivan Chadima, the president of EuroInvest, was "the work force's egalitarian attitude, which is not conducive to pampering guests." Chadima did believe that a third-party manager, such as Hyatt, would be more effective in creating a high-service environment than was the current management, but high wages would be the key incentive in improving service.

Another concern of the consortium's was that it would have to pioneer the laws under which privatization would operate in Czechoslovakia. The legislation passed by the Czechoslovak Parliament provided a reasonable framework within which to operate, but there were no certainties that the privatization would close smoothly. Even after closing, the consortium would have the Municipality of Prague 6 as a 49% partner. While the consortium members believed that political risk in Czechoslovakia was low, the lack of a successful precedent in the privatization process was worrisome.

A great deal of uncertainty also surrounded the renovation and expansion project. While Central European Property Development, Ltd. and Development Management, Ltd. had relevant experience in construction projects in Eastern Europe, the companies had not been involved in such a large project in Czechoslovakia. Assurances were given about the availability of quality construction materials and skilled labor before the preliminary bid was made. The project managers were now charged with making firm estimates of the project budget and a time schedule for completion. With 70% of the financing coming from banks on a project-finance basis, the lenders needed a high level of "comfort" that the consortium would be able to complete the project on time and within budget. With its own \$33 million investment, the consortium was interested in the same assurances.

## STRATEGIC OPTIONS

Despite the many open issues, the consortium believed that the underlying premise for the Praha Hotel project was sound. Eastern Europe, especially Prague, definitely lacked quality business hotels, and hotel development was likely to be a key factor in the privatization process. As one New York banker quipped, "You've got to have a place for all those bankers to stay." In addition, the Praha was already an existing structure, and a relatively new and elegant one. Getting approval to expand an existing property would definitely be easier than embarking on a new construction project.

The consortium's partners in the project were also strategic assets. A well-known and high-quality manager such as Hyatt provided the project a great deal of credibility. The enthusiasm and cooperative spirit of the Municipality of Prague 6 was also a positive factor. Jiri Herman, the mayor of Prague 6, had said, "We are excited to be at the forefront of the privatization of Central Europe. Prague will soon boast a world-class hotel. It is an important step in launching our city into a new era."

The consortium now had to make a decision on how to proceed with the Praha Hotel project. On the one hand, the group could be a pioneer and lead the way in privatization in Czechoslovakia. This strategy could produce large returns before others were able to get up to speed and compete, or it could become a long and expensive process that would lead the way for others to profit. On the other hand, the consortium could pursue more of a "settler" strategy and take its time negotiating with the Municipality. The consortium could wait until the privatization process was established and the business climate clearly ready for such a venture. This strategy would be less risky than the alternatives but could result in the loss of a great deal of the potential upside. Marriott had taken this approach in its negotiations with the Advisory Group and had not been selected as the joint-venture party.

With the preliminary agreement signed, the consortium now had to consult with its advisors and plan a strategy for its investment in the Praha Hotel.

Exhibit 1

PRAHA HOTEL

Photograph of the Praha Hotel, July 1991





Exhibit II  
Map of Prague, Czechoslovakia





## MANUFACTURING BICYCLES IN HUNGARY

## COMPANY BACKGROUND

Bicycle manufacture in Hungary began in 1929 at the Weiss Manfred factory in Csepel. This factory was the sole producer of bicycles in Hungary. In 1931, the factory extended its product line to include motorcycles. Annual output had reached 90,000 units by World War II, and after the war, manufacture of two-wheeled vehicles quickly recovered. In 1948, production returned to pre-war levels; it grew consistently, to reach 254,000 units by 1975. Of this total, over 110,000 bicycles were exported. Hungary also imported over 250,000 units, however, to help satisfy domestic demand. Imports were from the Soviet Union rather than Western countries to save on Hungary's scarce hard-currency reserves.

The strong growth in demand prompted the government to expand capacity at Csepel beginning in 1975. The development program called for the factory to discontinue the motorcycle line, which had experienced losses from the start, and to use the freed capacity to increase bicycle production.

At the time, Hungarian bicycles had artificially high prices because the forint, Hungary's currency, was overvalued. The state plan assumed an exchange rate of 60 forints per dollar (Ft./\$). Between 1975 and 1980, the forint appreciated steadily against the dollar, so that by 1980, it stood at 37 Ft./\$, which made the prices of Hungarian exports fully one-third more expensive than expected. The plan also anticipated continued large state subsidies and an annual export revenue of \$10 million (600 million forints).

Plant conversion was completed in 1977 at a cost of 600 million forints, and it increased capacity to 500,000 bicycles per year, but production never reached planned levels. In 1980, almost 400,000 units were produced, but the line lost money because of high costs and low prices that exports had to maintain in the competitive export markets of the Free World. To limit losses, the company had to cut down on hard-currency exports, so that by 1985, production dropped to 244,000 units and capacity utilization fell to 49 percent. Table 1 presents statistics on domestic bicycle production and sales for 1975-1985.

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This case was written by Dr. Istvan Vecsy under the direction of Dr. Ferenc Nemes, Hungarian Management Development Center; revised by Sean M. Kelly, research assistant, under the supervision of Professor Leslie E. Grayson, University of Virginia. Copyright (c) 1989 by the Darden Graduate Business School Foundation, Charlottesville, VA. WP6008L

Table 1--Bicycle Production and Demand  
(thousands of units)

	<u>1975</u>	<u>1980</u>	<u>1983</u>	<u>1985</u>
Bicycle production	254	374	260	244
Exports	112	151	1	0
Imports	252	207	212	200
<u>Domestic sales*</u>	<u>338</u>	<u>286</u>	<u>423</u>	<u>420</u>

\*Data not corrected for changes in domestic inventory.

An organizational change was also made at Csepel in 1975. After discontinuing motorcycle production, the Csepel plant was consolidated with Hungary's only factory making machines for the garment industry, to create the Bicycle and Garment Industrial Machine Factory (KKG). In 1983, the government turned the factory over to independent company management as a commercial, for-profit organization. Expansion had been planned while KKG was under state control and state assistance was available to support the factory. After becoming independent, however, KKG lost many of the advantages that state enterprises enjoyed, such as extra subsidies to support unprofitable companies. To compensate for lost subsidies and loans, management was forced to charge higher prices, which hurt export sales.

#### KKG in the Mid-1980s

KKG's production in 1985 was valued at about 1.6 billion forints and came from two main product groups. Bicycles made up about 43 percent of total revenues, and garment industrial machine provided the balance. Bicycles, consumer goods, could be produced profitably only in long production runs on assembly lines. The garment machines, in contrast, were industrial in nature, such as cloth-cutting, button-sewing and ironing machines, manufactured in small lots in job-shop operations. KKG was the sole Hungarian producer of the garment machines, and imports of these machines were insignificant. About 75 percent of the machines were exported. The Soviet Union was the major export market, receiving about 95 percent of the machine exports. The strong demand for machines kept that factory's capacity utilization at about 80 percent. The company had long-term sales agreements for this segment and future demand was expected to grow beyond capacity. Bicycle sales produced no profit, but sales of the garment manufacturing machines yielded an average profit of 20 percent to produce an overall profit of 12 percent for KKG. Return on assets and wages for KKG in 1985 was 12 percent, or 152 million forints. KKG's medium-term goals called for 5 to 7 percent profitability for bicycle manufacturing, including state subsidies.

The stability of revenues from the two product lines was quite different. Because of long-term contracts and strong demand, sales and profits from garment industrial machines were fairly stable. In contrast, bicycle sales were seasonal, with most sales coming in the first half of the year.

In 1982, the company began a 10-year repayment schedule on the state loans it had received in 1975 to expand bicycle capacity. The annual cost was 37 million forints. The company was due to receive 20 million forints in subsidies in 1986.

## Bicycle Markets

The average useful life of a bicycle was about 10 years; Hungarian bicycles lasted somewhat longer. World production in 1985 was about 41 million units, 60 percent of which was produced in the United States, Japan, West Germany, France, Italy, and the United Kingdom. China produced an additional 10 million units annually, but only for domestic consumption. Only about 12 percent of world bicycle production entered international trade. The largest potential export market was in the less developed countries, because penetration was low there.

The bulk of bicycle production and sales in Western countries was of expensive racing and semi-racing bikes, used primarily for sports and leisure. Hungarian production, dominated by the nature of domestic demand, was concentrated on camping and hiking bikes, used more for transportation. These products were lower priced. Table 2 shows the distribution of bicycle production by type in West Germany and Hungary.

<u>Table 2--Types of Bicycles</u>	<u>West Germany</u>	<u>Hungary</u>
Sporting, multi-gear bicycles	55.4%	5.0%
Children's bicycles	19.6	15.0
Folding/camping bicycles	10.9	32.0
Hiking bicycles	2.6	43.0
Other	11.5	5.0
Total	100.0%	100.0%

Since 1975, in Europe the bicycle had become less a means of transport but also a hobby item. The trend was caused by several innovations in design, including the multi-gear rear hub and new materials for body construction that gave the vehicle a more "sporty" appearance and significantly lower weight. These innovations made racing bicycles easier to turn and brake and safer in traffic.

## Production Characteristics

Bicycle manufacture could be divided into five stages: (1) machining the front and rear hubs, steering rod headset, and drive; (2) cold forming and sheet pressing; (3) soldering and welding the frame; (4) surface finishing (electroplating and painting); and (5) preassembly and final assembly. Western companies manufactured only the components that had high transportation costs, such as frames, forks, and steering rods, and purchased parts with low transportation costs from specialized producers, which reduced overhead. They were able to concentrate on the assembly process, increase labor productivity significantly, and cut unit costs.

The quality of Hungarian bicycles was acceptable, but not equal to that of Western products. They weighed about 10 percent more than comparable Western products and were made from lower quality components. Many domestic models lacked reflectors, a hub gear shift system, rim brakes, and other equipment that were standard on most Western bicycles. The styling of Hungarian bicycles, however, which included color stripes, choice of colors, and the quality of finish, was up to international standards, and the durability of the machines exceeded that of Western products.

Bicycle demand in Europe and North America, including Hungary, is seasonal. Wholesalers concluded contracts in February and March. The main retail sales period lasted from Easter to the beginning of school vacation in the summer. Dominant players in the bicycle market kept large inventories which allowed them to deliver on short notice and maintain level production through the year. KKG was not allowed to do this because of Hungarian inventory-accounting practices. As a result, Csepel's capacity utilization varied substantially through the year: the company was unable to accept all orders to be filled in the first half of the year but had problems filling capacity in the second half. Extending credit terms sometimes induced purchasers to accept predelivery and relieved the seasonality problems.

#### Profitability Problems

Bicycle operations had been losing money since the plant expansion was completed in 1977. Losses amounted to 361 million forints in 1980, but had decreased to 90 million forints by 1983 after exports were discontinued. Because of low export prices and high production costs, the company stopped losing money only when it discontinued exports in 1985. Reasons for high costs on the bicycle line at KKG could be divided into regulatory problems and productivity problems.

In many ways, the firm's profitability was hurt most by the excessive economic regulation of the Hungarian economy. The turnover tax, levied on sales and the labor bill, inflated domestic prices. In addition, the steady appreciation of the forint in the late 1970s and early 1980s, raised the export prices of Hungarian bicycles abroad.

Under the economic reforms of 1980, domestic prices were subject to limits based on export prices and the cost of imported raw materials. (For a description of these reforms, see the "Country Note on Hungary," UVA-G-365). Because of the reforms, the company was unable to pass along its higher raw-materials prices to domestic consumers. The result was that domestic prices were steady from 1980 to 1985, while material costs rose, squeezing margins. After exports ceased, bicycles were transferred to the "free price" category, but prices still could be changed only with the permission of the State Price and Material Bureau.

The company was unable to import cheaper parts and assemblies from Western companies--at first, because of Hungary's earlier import-substitution policy, and later, because of hard currency shortages. The company might have benefited from production sharing with foreign firms, but the government had levied a protective tariff of 37 percent on imported bicycle parts, which made the cost higher than the company's production cost. Table 3 illustrates the original import cost relative to Csepel production cost.

Table 3--Comparison of Production Costs

World Part or Assembly	Production Cost at Csepel (Ft./unit)	Price on Market (Ft./unit)
Front hub	25.2	18.0
Rear hub	182.0	158.0
Saddle	130.0	100.0
Pedal	73.1	46.9

Fixed costs were driven up by poor capacity utilization, long transport routes and unnecessary transport costs caused by decentralized workshops in the factory, and high heating and energy costs. In addition, domestic prices for raw materials and semi-finished products used in production such as steel bands and tubes were higher than the world price, which raised material costs for Csepel.

Finally, low productivity and excess personnel mandated by government policies against layoffs resulted in staffing levels about 40 percent higher than a comparable Western plant. Excess workers and resulting low productivity meant that bicycles carried extra indirect costs of about 1,000 forints per unit.

The productivity of the technology used at Csepel was lower than that used in competing plants. Some technology was obsolete, and production processes were less well organized than Western competitors, which hurt labor productivity. For example, at Stesr-Puch, a West German company, preassembly and assembly required 26 and 55 minutes, respectively. At Csepel, 44 and 92 minutes were required for the same operations, over 67 percent more.

#### Csepel's Potential Market Position

Domestic demand for Csepel bicycles was expected to remain stable until 1990, although a shift to multi-gear bicycles was expected to continue. KKG was altering its production mix to satisfy that expected change in demand, but company managers wondered what else could be done to make Csepel's bicycle business a success. They realized that their main difficulty in making a business plan was that financial data like that found in Western companies was unavailable because of the socialist accounting system.

The theoretical capacity at Csepel was 400-500,000 units; 1985 production was 244,000. Imports in 1985 amounted to 200,000, and managers at Csepel wondered if they could recapture some or all of the domestic market, and if so, how.

Another possibility was to re-enter the export market. In the past, KKG had exported bicycles to the United States, Canada, the United Kingdom, the Netherlands, Sweden, Finland, and Iran. The company had had little

distribution support, however, in foreign markets. In contrast, major English, French, and Japanese companies had established national or regional sales and service networks in their major export markets. The networks helped to gather market information and to push new products. KKG's poor market information and inflexible production system limited its ability to exploit market trends. For instance, KKG missed the boom in camping bicycles because welding facilities were not available until demand began to decline.

Although children's bicycles were normally produced with cheaper materials and technology and sold for lower prices than adult bicycles, Csepel produced adult and children's bicycles with the same materials and technology, and the quality of both model types was the same. Consequently, the quality of Csepel children's models was about equal to the international standard, but the old designs and greater weight of the adult models rendered them inferior to world standards and unable to command world market prices.

Because of its outdated technology, Hungarian bicycles were relegated to the low price/low quality category in developed-country markets. Export prices asked by Csepel, however, were 30 to 80 percent higher than those of comparable products from other Eastern European countries and from Asia. The product mix was heavily weighted toward products with declining demand, like hiking and camping bicycles. Market demand was significantly higher for multi-gear sporting bicycles, which could be sold only at a loss by Csepel.



# MARKETING

## MARKETING SOVIET VODKA IN GERMANY:

### V/O SOYUZPLODOIMPORT

"Vodka martini--shaken, not stirred."  
James Bond, From Russia With Love

Ivan Chekov, director of V/O Soyuzplodoimport, the Soviet foreign trade organization responsible for liquor exports, sat back in his chair and considered what might be a turnaround in the phenomenal success his organization had achieved selling vodka in the West German market. In the last decade, sales of Soviet vodka to West Germany had taken off, but recently, growth in demand had begun to slow. The slowdown was particularly worrisome because the Ministry of Trade viewed vodka, more than any other Soviet-produced alcoholic beverage, as its best opportunity for export expansion. Furthermore, the continued growth of vodka exports was a significant means of earning much needed convertible currency.

Chekov was scheduled to meet with Foreign Trade Ministry officials in two weeks to present a plan for reviving vodka exports to West Germany. As he poured himself a jigger of Moskovskaya, one of the brands exported to West Germany, he reviewed the facts and considered his options.

#### **Vodka as an Export Product**

Vodka had several export advantages over other spirits produced by the Soviet Union. The Soviets had excess vodka production capacity and up-to-date equipment. Unlike sparkling wine or cognac, two other alcoholic products produced by the Soviets, vodka production was unaffected by weather or agricultural disease. It also did not face the trademark-infringement problems associated with marketing "champagne" or "cognac," the names for which were patented by the specific regions in France where they were produced, and could not be applied to Soviet sparkling wine or cognac-like products.

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The draft of this case was originally prepared by Robert Grant of New York University's Management Decision Laboratory, Professor Myron Uretsky, Director. Rewritten by Professor Leslie E. Grayson and Research Assistant Grace S. Fogg, University of Virginia. Copyright (c) 1991 by the Darden Graduate Business School Foundation, Charlottesville, VA.

Vodka had a long production history in the Soviet Union and was used in many national traditions. Just as French champagne and Scotch whiskey were associated with their countries of origin, most consumers associated vodka with Russia. Although Soviet vodka was regarded as a luxury commodity in many countries because of its relatively high retail price, it was much more affordable than such other types of imported premium liquors as French cognac or Jamaican rum. Finally, vodka traveled well; while wine and champagne required refrigeration for transport and storage to ensure against spoilage, the quality of vodka did not deteriorate without refrigeration.

### **The Market for Soviet Vodka in West Germany**

Until the late 1950s, vodka was virtually unknown among West German consumers, but consumer preference trends for lighter, "tasteless" alcohols and mixed drinks created a vodka boom in the 1960s. As vodka became more popular, German domestic vodka production proved insufficient to satisfy demand, which forced West Germany to import significant quantities of vodka from other countries. The Soviet Union began exporting vodka to West Germany in 1961, and the clear liquor quickly gained popularity among consumers. Annual exports increased from 200,000 bottles in 1961 to 1.9 million bottles in 1971.

While over 80 different brands of vodka were marketed in West Germany, 7 brands, with a combined 75 percent market share of all vodka consumed, dominated the market. These 7--Moskovskaya, Pushkin, Smirnoff, Gorbachev, Nikita, Vyborova, and Eristov--were produced locally or imported from the Soviet Union, Poland, or Finland. Gorbachev, one of the successful local brands, had gained its popularity through an advertising campaign that associated it with the Trans-Siberian Railroad, giving it a distinct Russian image.

Liquors in West Germany were commonly available in grocery stores. The official drinking age was 18, but no identification card was required to purchase alcohol. Vodka consumers in West Germany tended to be in the 18-35 age group. Exhibits 1 through 5 give background on Russian vodka supply and demand in West Germany.

In the late 1970s, a combination of factors contributed to a general decline in alcohol consumption. The West German economy was faced with an economic slowdown in 1977. At the same time, an 18 percent increase in taxes on alcoholic beverages significantly increased prices. Growing public concern for alcohol abuse and its health consequences also resulted in several anti-alcohol campaigns. Hard-liquor advertising, in fact, was banned from television, and regulations on drunk driving were tightened.

### **Distribution Within West Germany**

V/O Soyuzplodoimport (SPI) was established in 1968 to handle all large whole liquor-export operations in the Soviet Union. The vodka was transported from the Soviet Union to the West German border by Sovtransavto, a Soviet transport firm. Once inside West Germany, the vodka was delivered to distributors by Vestora, a joint Soviet-West German shipping company.

The distribution of vodka in West Germany required several channels. Plodimex, a Soviet-West German joint venture, contracted to buy vodka from SPI for resale to distributors throughout Europe. The two main distributors of Soviet vodka in West Germany were Cherry Import, which supplied the West German domestic market, and Vodka-Russ, which delivered vodka to the West German "free zone" and supplied several other European countries. The West German distributors, in turn, sold the vodka through a network of independent sales representatives to wholesale dealers and retail stores.

### **Cherry Import**

This family-owned limited partnership was established in 1961 to import Soviet alcoholic beverages into West Germany. In 1978, Cherry Import, handling approximately 92 percent of total imports, was by far the largest supplier of Soviet vodka to the West German market. It was also one of the founders and principal shareholders of Plodimex.

Cherry Import's network of independent sales representatives worked on a commission basis. They coordinated the logistics of obtaining orders from customers and processing orders to suppliers. Cherry Import and other suppliers had only to deliver the goods and bill the customers. In 1976, Cherry Import worked with 50 commercial agents and 110 sales representatives serving more than 8,000 customers in West Germany. The company operated 25 warehouses and two central distribution facilities--one in Dusseldorf and one in Cologne--from which Cherry Import could guarantee delivery anywhere in West Germany within 48 hours.

National advertising had played an important role in increasing Cherry Import's share of the Soviet vodka market. In 1975, the company spent a total of 2 million DM, approximately 6 percent of revenues, on various types of consumer and trade advertising. Wholesalers and retailers also spent substantial sums on local advertising and the sponsorship of promotional events.

### **The 1978 Contract**

Sales contracts between Plodimex and SPI were based on annual Soviet production quotas of goods designated for export. The 1978 contract covered the sale of 220,000 deciliters (dl) of vodka priced at 70 DM and included free storage in West European cities. SPI allowed a discount of 1 DM per dl for advertising and a 5 percent discount for breakage and loss during transportation.

Plodimex contracted with Cherry Import to provide 150,000 dl of Moskovskaya vodka for 74 DM per dl in 1978. Under the terms of the contract, Cherry Import supplied SPI with labels, bottle collars, and other supplies bearing the Cherry Import logo, and Cherry Import was required to spend at least 2.0 million DM on advertising.

During negotiations, Cherry Import had argued for an uneven delivery schedule that would correspond with seasonal fluctuations in demand for vodka. The importer proposed delivery of 30,000 dl during the first half of the year and delivery of the remaining 120,000 dl during the second half. Plodimex knew that all delivery schedules depended on Soviet production schedules, however, and that distributor contracts had to reflect the predetermined production schedules. Because Plodimex worked on thin margins, any increase in its inventory holding costs would drastically reduce its profits. After lengthy discussions, Cherry Import agreed to accept delivery of 70,000 dl during the first half of 1978 and 80,000 dl during the second half.

During 1978, SPI began to experience delays in the delivery of labeling supplies from Cherry Import, which SPI suspected was a ploy by Cherry Import to retard the supply of Soviet vodka to West Germany. Because West German vodka sales were slowing, significant quantities of vodka remained in Cherry Import's warehouses, which raised its inventory holding costs. The oversupply of vodka in the West German market was even forcing some of Cherry Import's customers to export vodka to other countries.

### **Chekov's Dilemma**

Chekov reviewed the questions that needed to be resolved before meeting with his superiors at the Foreign Trade Ministry. Could SPI get Plodimex to convince Cherry Import to increase its vodka purchases if SPI offered a less erratic delivery schedule? Should he consider using other West German distributors? Should SPI refocus its efforts on expanding export agreements with other West European countries?

Finally, Chekov still considered vodka to have the best export potential among Soviet alcoholic beverages for generating hard currency for the Soviet Union, but was it? Perhaps other liquor-export possibilities existed that Chekov had not yet considered.

Exhibit 1

MARKETING SOVIET VODKA IN GERMANY:

V/O SOYUZPLODOIMPORT

Leading Vodka Brands in West Germany

<u>Brand</u>	<u>Country of Origin</u>
Moskovskaya	Soviet Union
Gorbachev*	West Germany
Pushkin	Czechoslovakia
Smirnoff	United States
Nikita	West Germany
Vyborova	Poland
Eristov	West Germany

\* Interestingly, the great success of Gorbachev was attributed to the "Trans-Siberian Railroad Game" advertising campaign, which associated this vodka with the Soviet image of Siberia and its well-known railroad.

Exhibit 2

MARKETING SOVIET VODKA IN GERMANY:

V/O SOYUZPLODOIMPORT

Soviet Vodka Exports to West Germany

<u>Year</u>	<u>Amount (in dl)</u>	<u>Increase over Previous Year</u>
1973	128,700	
1974	139,800	8.6%
1975	147,100	5.2
1976	155,700	5.8
1977	163,200	4.8
1978*	169,200	3.7

\* 1978 figures taken from contracts dated January 9, 1978.

## Exhibit 3

## MARKETING SOVIET VODKA IN GERMANY:

## V/O SOYUZPLODOIMPORT

## 1978 Soviet Vodka Exports to West Germany

	<u>Size</u> <u>(in liters)</u>	<u>Amount</u> <u>(in dl)</u>	<u>Market</u> <u>Share</u>
Cherry-Import		155,100	91.4%
• Moskovskaya 40%	0.5	150,000	88.3
• Moskovskaya 40%	0.75	2,075	1.2
• Zubrovka 40%	0.5	1,500	0.9
• Stolichnaya 40%	0.75	601	0.4
• Moskovskaya 40%	0.5	600	0.4
• Stolovaya 50%	0.5	300	0.2
All Others		14,800	8.6
		<hr/>	<hr/>
Total		169,900	100%

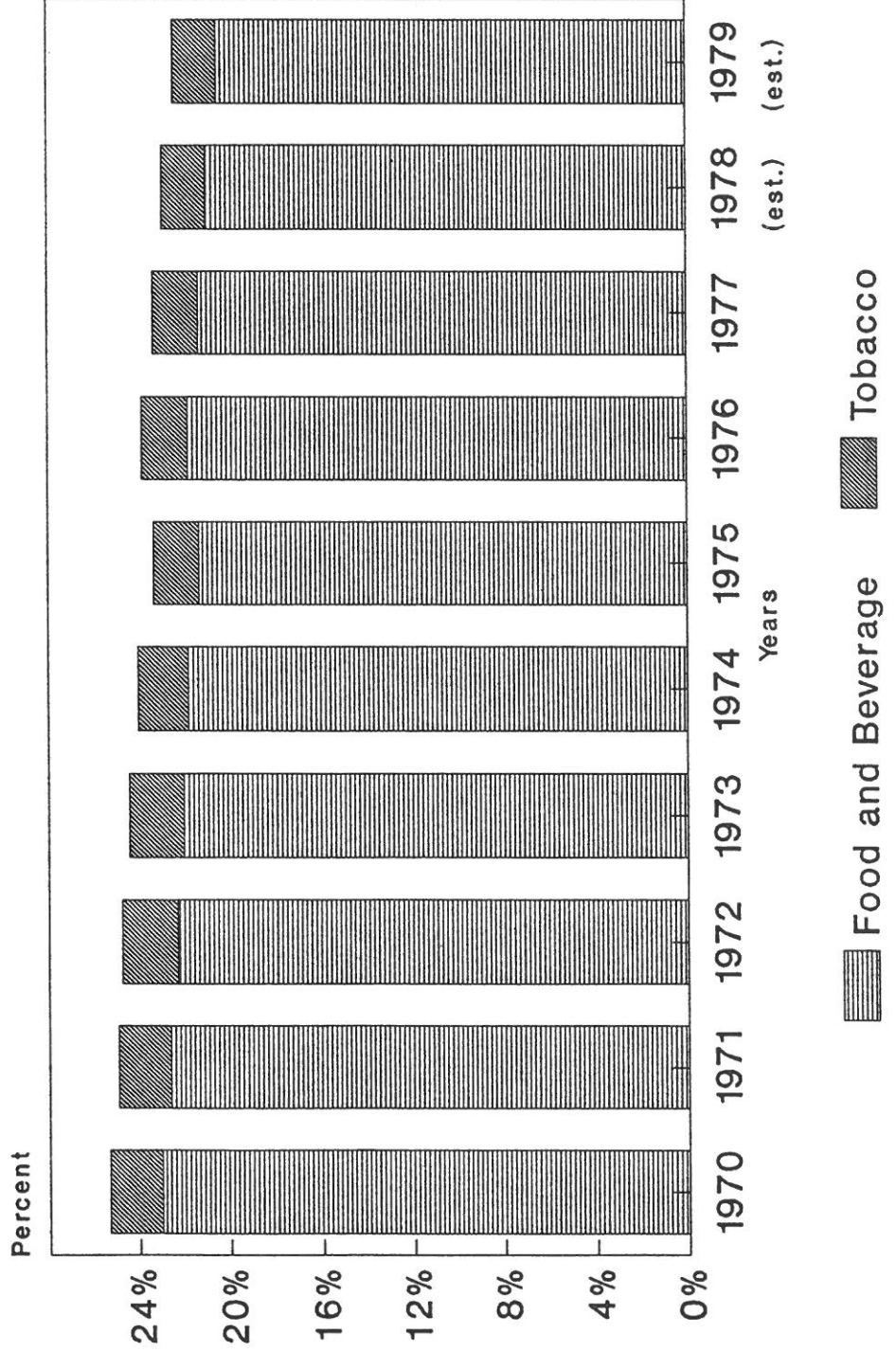


Exhibit 4

MARKETING SOVIET VODKA IN GERMANY:

V/O SOYUZPLODOIMPORT

West Germany: Food, Beverages, and Tobacco as a Percentage of Disposable Income



Source: U.S. and World Food, Beverages and Tobacco Expenditures 1970-1983

## Exhibit 5

## MARKETING SOVIET VODKA IN GERMANY:

## V/O SOYUZPLODOIMPORT

## Food, Beverages, and Tobacco Expenditures in West Germany

Item	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Total Expenditures										
Gross Domestic Product	675,300	750,560	723,740	917,270	984,580	1,026,510	1,119,690	1,196,110	1,285,140	1,392,460
Disposable Personal Income	427,970	473,360	528,190	575,190	624,750	689,420	730,340	775,370	824,790	890,000
Personal Consumption Expenditures	363,130	402,920	445,230	487,630	525,630	577,180	625,000	671,780	715,760	769,060
Food, Beverages and Tobacco	107,970	116,390	126,780	137,090	144,140	154,310	165,260	173,520	181,670	190,270
Food and Beverages	98,140	106,000	115,410	124,680	131,510	141,350	151,740	159,210	166,630	174,500
Tobacco	9,830	10,390	11,370	12,410	12,630	12,960	13,520	14,310	15,040	15,770
Net Savings	59,120	63,920	76,090	79,830	91,010	103,880	96,840	94,430	99,450	112,750

Source: U.S. and World Food, Beverages and Tobacco Expenditures 1970-1983.



## HERMAN CORPORATION

On June 14, 1974, as Robert G. Kaveny, Jr., president of the Herman Corporation, watched the sunrise from his office window, he reflected on the deal his firm had recently closed with the Soviet Union. He couldn't help wondering whether this deal marked the dawn of a new era for Herman. The contract to supply molding equipment to the Soviet Cheboksary Tractor Complex was the first transaction Herman had completed with the USSR in almost 40 years and the first ever for Kaveny. Despite his inexperience, however, he was certain that his firm had done many things well in the negotiation, and he had learned a great deal. By piecing together the aspects of the negotiation that had been most crucial to closing the transaction, he was considering ways to improve his position in future negotiations and ways to pass his experience along to others within the Herman organization.

### Herman Corporation

Charles Herman founded the Herman Corporation in 1890 in Zelenpole, Pennsylvania, to produce an innovative molding machine he had developed. Previously, molding machines had used a tamping process in which repeated jolts to a molded flask packed sand tightly around the pattern. Herman's unique process substituted compressed air for the tamper. Charles Herman's ingenuity helped the Herman Corporation become a leading maker of foundry equipment in the United States, and his compressed-air technology was used for nearly 70 years. Then in 1958, the Herman Corporation revolutionized the entire molding process with the introduction of the hydraulic-powered "Moldmaster."

Rising labor costs in the late 1960s and early 1970s induced Herman's customers to look increasingly to automation as a way of remaining competitive in the United States and world foundry markets. This industrywide shift to capital-intensive production significantly increased demand for Herman's products, and in 1973, sales reached a record \$5.3 million.

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The draft of this case was originally prepared by Robert Grant of New York University's Management Decision Laboratory, Professor Myron Uretsky, Director. Rewritten by Professor Leslie E. Grayson and Research Assistant Grace S. Fogg, University of Virginia. Copyright (c) 1991 by the Darden Graduate Business School Foundation, Charlottesville, VA.

The positive outlook for the growth and future of the foundry industry in the mid-1970s prompted the Herman Corporation to expand capacity. A new 3,500-square-foot factory constructed 300 feet away from headquarters doubled Herman's production facilities. The increased floor space gave Herman an opportunity to buy state-of-the-art equipment for the critical fabricating department while consolidating assembly and testing in the old building.

### **The Foundry Industry**

The automated casting process used by automated foundry equipment involved the use of sand molds to shape molten iron. The following five steps were required:

1. Sand molds and cores were manufactured.
2. Molten iron (nearly 3,000 degrees Fahrenheit) was poured into the mold.
3. The casting was cooled and separated from the sand.
4. Any remaining sand was blasted off with steel shot.
5. The casting underwent final finishing.

Worldwide increases in demand for laborsaving foundry equipment accompanied the expansion of US foundry-equipment industry in the early 1970s. Among that demand, the Soviet Union had looked to the West, particularly the United States and West Germany, for advanced equipment to improve the efficiency and reliability of its foundry operations. Industries that used the forging processes included the automotive, construction equipment, air conditioning and refrigeration, hydraulic equipment, agricultural equipment, and the internal combustion engine.

### **Herman's Soviet Trade History**

The Herman Corporation began trading with the Soviet Union in 1926, seven years before the United States officially recognized the Bolshevik government as the legitimate administrator of the Russian states. During World War II, lend-lease sales to the USSR accounted for nearly all of Herman's production. By 1947, Herman had sold the Soviets over 300 jolt-molding machines, and during this 21-year period, Herman established a solid reputation with the Soviets as a producer of high-quality founding equipment.

The advent of the cold war in 1947, however, placed severe constraints on Herman's ability to continue doing business with the USSR. Reluctantly, the company decided to terminate its lucrative Soviet trade. Herman believed, in retrospect, that it gained a great deal of respect from its industry peers for forgoing activities in the Soviet market.

Herman re-entered the East-West trade picture in 1972 with a bid to supply foundry equipment to the Soviet Kama River Truck Plant. It lost the bid to C.E. Cast Co., however, a division of Combustion Engineering and one of Herman's primary competitors. Kaveny described the reasons for this failure as follows:

C.E. was very strong in the automotive industry in the US. We were not. We are stronger in other types of castings. Because of that, the Soviets leaned very heavily to C.E. on the Kama Plant. So we were not in [contention for] it at all, and in the long run, that's the best thing that every happened to us. We were really babes in the woods as far as preparation of the quotations, how to price the equipment, and so forth.

### **The Cheboksary Tractor Complex**

During August 1973, Metallurgimport, a Soviet foreign trade organization (FTO), wrote to Kaveny requesting information on Herman's molding equipment and related sand systems. The Soviets were interested in hiring a contractor who could provide both types of equipment for their Cheboksary Tractor Complex.

Kaveny's response to Metallurgimport expressed interest in preparing a bid only on the molding-equipment contract. Bidding on the sand systems was not practical because Herman was not in that line of business and the systems would have to be subcontracted to another manufacturer. Within a month, Herman received word from George Shukin in the New York office of the Cheboksary Purchasing Commission that Metallurgimport would entertain a bid on the molding contract.

In November 1973, Metallurgimport notified Kaveny it would be sending specialists to the United States to meet with Herman personnel. An entourage of six engineering specialists arrived in January to begin the technical negotiations.

### **Negotiations**

Technical negotiations between Herman and Metallurgimport continued over the next six months. Herman engineers designed equipment specifications and provided layouts of the three foundry lines to the Soviet specialists, who reviewed each quotation and requested changes. The quotations were then reworked by Herman and resubmitted to the Soviets. Ten or twelve iterations of this process were needed before the Soviets were satisfied with the design and layout of the molding systems. Kaveny found the Soviet engineers to be "super sharp" on foundry applications: "I think they were sending us the cream of the crop. They asked all the right questions. We were very impressed with their ability."

With US State Department clearance, Herman took the Soviets to see several American tractor installations, including Caterpillar Tractor Company. The group also visited half a dozen foundries that were manufacturing parts similar to those that would be made at the Cheboksary complex.

In the spring of 1974, technical negotiations were nearing completion. The Metallurgimport engineers were convinced that they wanted to do business with Herman, and the discussions turned to commercial matters. Kaveny soon realized that Herman would be unable to manage these negotiations alone. The company simply had no experience in commercial contract negotiations with the USSR.

On the recommendation of business associates, Kaveny approached Julian Hoffman, President of International Machinery, for assistance. Hoffman had represented many American companies in negotiations with Soviet customers since 1955. Furthermore, Hoffman knew George Shukin and many other Soviet trade officials personally. Hoffman's expert advice proved invaluable to the Herman Corporation. He advised the Herman negotiators on the extensive documentation required by Soviet contracts, the best way to manage extended visits of Soviet specialists, and the many possible pitfalls and hidden penalties. Hoffman focused his efforts on pricing techniques that would help protect Herman from problems later in the negotiations. His guidance enabled Herman to enter the commercial negotiations with a well-defined pricing strategy.

A group from Metallurgimport arrived in May to negotiate the commercial contract. These vice-presidents were specialists in negotiating advantageous commercial contracts for the Soviet FTO.

Kaveny, aware that the location in which negotiations are held can have a decided impact on the outcome, was relieved that commercial negotiations would take place in the United States. Despite this home field advantage and Hoffman's preparation, however, Kaveny still found negotiations difficult: "It was a brand-new experience for me, going on for days, with them pounding on the table saying our price was too high, and that sort of thing."

The negotiations were complicated by the Soviet negotiators' lack of decision-making authority. Most of the decisions were made by Soviet technocrats in Moscow. Communication delays between the Soviet negotiators and their superiors frustrated Kaveny and unnecessarily extended the negotiating process.

Finally, after much deliberation, a 10 percent price reduction in Herman's original price proposal was agreed, and the two sides shook hands and went out to celebrate. On returning, they began to work out the specific details of the commercial contract.

## **The Financing Question**

A week later, George Shukin called Kaveny to relay a new wrinkle in the contract negotiations. Shukin informed Kaveny that Metallurgimport was reconsidering a proposal from a West German competitor who offered long-term, low-interest financing in addition to substantially the same technical expertise as Herman. Kaveny contacted the US Commerce Department in Pittsburgh and got immediate action. Within a couple of hours, a representative from the Bureau of Trade in Washington had contracted Shukin to open the discussion of credit terms. According to Kaveny,

I was told that if, when I went to the Kama Purchasing Commissions to sign the contract, the subject of credit was brought up, I should leave the room immediately and call the man at East-West Trade, who would get somebody higher up involved. Fortunately, the credit issue never came up.

The U.S. Export-Import Bank was specified by the commercial contract to provide direct financing. The Soviets would make a 10 percent down payment of \$3.5 million toward working capital for Herman. The payment was due 45 days after the contract was signed. To qualify for the down payment, Herman was required to provide a bank guarantee to the Export-Import Bank in the name of Metallurgimport. The guarantee would function like a letter of credit or performance bond on the contract. When Herman requested the guarantee from its bank, however, the company found that obtaining it would be more complicated than had been anticipated: "We went to the bank with which we had been doing business for many years. They looked at the size of the contract, the size of Herman, and the Soviet Union, and (after many days discussion and delay) refused."

As a result, Herman had to scramble to obtain the credit backing required by the contract. Finally, another Pittsburgh bank agreed to give Herman the letter of credit. Two more weeks of negotiations ensued, and the contract was signed on June 13, 1974. The official closing date was changed to June 12 because the Soviets believed 13 to be an unlucky number.

## **Project Execution**

Once production was underway, several problems arose. According to the contract, Herman was required to produce on-board bills of lading in order to receive payment for equipment shipped to the Soviet Union. The proof-of-delivery requirement did not in itself present a problem, but the contract also stipulated the use of Soviet shipping to transport the equipment from the United States. Herman soon found that Soviet shipping schedules were unreliable, and long delays were frequent. On several occasions, equipment sat in New York or Baltimore for as many as 30 days awaiting a vessel. While the equipment sat, the Soviets were able to delay payment, thereby extending Herman's cash-flow cycle.



The warranty obligation also created problems. Herman had agreed to provide a 12-month warranty on all equipment that would begin on the equipment's commissioning date. Because the Soviets controlled the commissioning dates, they also controlled the starting date of the equipment warranties. As a result, Herman was left with an open-ended warranty obligation.

### **Conclusion**

Despite the expert services of Julian Hoffman, the Soviet contract had been full of surprises. Herman experienced difficulty from performance requirements to paperwork details. Over all, though, Kaveny was pleased with the contract, but he still wondered how he could avoid such problems in future contracts with the Soviet Union.

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

### Situation

A team of four MBAs arrived at Huta im. Tadeusza Sendzimira (HTS) in Krakow, Poland, on September 3, 1991. Greg King, Herb Taft, Ann Ball, and Bonnie Conroy were part of a new program called the MBA Enterprise Corps. The Corps was a consortium of the top 16 American business schools that sent recent MBA graduates to Eastern Europe to help companies transfer from a planned economy to a market economy. In order for the Corps members to gain a better understanding of the people and cultures in Eastern Europe, they were required to *live on the economy*. In other words, the MBAs were paid the same salary as the people at HTS.

In early December 1991, after they had been at HTS only three months, the acting general director, Ryszard Kaczor, requested a report from the team describing the problems they saw at HTS and their proposed solutions. The report needed to be completed in one week.

### The Company

Huta im. Tadeusza Sendzimira, formerly the Lenin Steelworks, was the largest manufacturer of steel and rolled-metal products in Poland with a capacity of 2.1 million tons per year. Its production covered a wide range of metallurgical products: coke, coal chemicals, refractories (corrosion-resistant substances), hot- and cold-rolled products, pipes, bars, angles, coils, forgings, and castings. The mill complex could have been a city in itself. The multiplant structure combined a refractories plant, a coke chemistry plant, the blast furnaces, a steelmaking plant, rolling mills for hot slabs, plates, hot billets, sections, and strips, and plants for cold-rolled sheets, welded tubes, metallurgical processing, engineering and casting, repair, and power. The plant was a big maze.

The mill complex was located 10 kilometers east of Krakow's old city in a region called "Nowa Huta" (translated as "new foundry"). The mill employed about 24,000 people and, including direct suppliers and customers, supported a population of 250,000.

HTS was owned and controlled by the state. It had been built and commissioned by the Russians in 1955. The steel technology used was 1900 American technology sold to the Russians in the 1920s. The Russians sold it to the Poles after World War II. The Russians built the mill near Krakow to show the *intellectisa* who was now in control. The people of Krakow held a grudge against the mill, because the mill was built on prime farm land and was a major polluter of the area.

In 1991 the mill was 36 years old, and its structures and grounds were deteriorating. The two main administration buildings were for the "management" and for "social" activities. "Management" included the production, finance, sales, marketing, and accounting functions. The "social" activities were the trade unions, catering services, transportation services, and medical facilities. The two buildings stood on either side of the main gate. The effect was similar to an entrance to an amusement park, because the two buildings were symmetrical and, with their crown-like facades, looked like castles.

The years of production had built up a film of coal dust over every object and building in the complex. Old equipment had been left in the open air, and its rusted remains were scattered everywhere. Workers wore no special protective equipment or respiratory equipment anywhere in the mill. No money was spent where it wasn't absolutely necessary.

Because the mill was a state-owned enterprise, a governmental agency, the Ministry of Industry, appointed its general director and had a hand in making other major appointments and decisions. The workers' council, composed of elected worker representatives, and the five trade unions, including Solidarity, participated in the process by nominating candidates and voting on major issues. Every proposal was a political battle. To the four MBAs, the decisions that came out of these groups were not based on business issues and, in some ways, appeared to have been decided before the discussions.

When the MBAs arrived, HTS had no general director. An acting general director was appointed after about a month, but he could not provide the mill with leadership to change any conditions or carry out any long-term planning. In the meantime, a wrangle over who should be the next general director of HTS dragged on. Despite the fact that Jerzy Knapik won the workers' council election for the post, no decision had been made by the Ministry of Industry. (The well-informed in Krakow were not surprised at Knapik's victory; he had a powerful backer in the form of Krakow's Archbishop Macharski, who had been a fellow student of Knapik's.)

The Ministry was hesitating to appoint a general director because the Sejm (Poland's parliament) had just been elected into office, and it was having difficulty forming a governing coalition among its 26 parties. The Ministry did not want to make any decisions that might have an adverse effect on Ministry personnel's jobs. HTS, and most other state-owned enterprises, had been put on hold.

HTS was a microcosm of Poland; it had no leadership, decisions were made through political battles rather than sound economic evaluation, and people waited for the government to act. The MBAs quickly learned that understanding state enterprises would be crucial in helping Poland and its businesses. The old systems and ways of thinking that supported the old regime still existed. If changes were to occur in businesses, new ways suited to the new market economy had to be adapted.

### **The Economic Environment in Late 1991**

Poland was a homogeneous country with a population of 38.4 million in 1991. More than 94 percent of the population was Catholic, some 60 percent lived in urban areas, and 49 percent of the land was considered arable. The per-capita gross national product was approximately \$2,000. The middle class was dwindling and a small wealthy class was developing, but the majority of the population was in the lower classes.

Almost all businesses had problems with bad receivables and bad payables. In some respects, it was all the same money: one state agency owed money to another one. This circle of debt created cash-flow problems for the whole business community. Companies had to resort to accepting only cash or certified bank payments in order to assure payment for their goods.

Poland held its first free elections since World War II for the Sejm in the fall of 1991. In early 1992, the Sejm was composed of 26 parties, with no governing coalition. This situation had produced insecurity in the people, businesses, and foreign investors. A further effect of the government's instability was a volatile economy, which made future planning difficult.

Up-to-date market information was a key factor in planning for the future, because what was "normal" in the past would never return. Unfortunately, accurate information on markets was difficult to find, although some resources did exist.

The planned economy had eliminated many decisional aspects of operating a business that are extremely important in a market economy. For example, the market can force businesses to stagnate or fail that do not adapt to customers' needs. Such had not been the case in Poland's planned economy. Thus, for businesses to survive and thrive in a new market economy, a different way of thinking was needed.

The Polish people's wants and expectations were changing because of the entry of foreign goods into the country and the influence of foreign business practices. Companies had to change to meet those needs.

Land ownership, banking systems, and legal systems were not established. Without these support systems in place, foreign investors were hesitant.

### **The Marketing Department**

HTS's Marketing Department was formed the month before the Corps members arrived. It was called a "marketing" department because that was the new buzz word in Eastern Europe. People thought that companies were supposed to have marketing departments, but that did not know what marketing was or if the company needed it. The department had been staffed with people handpicked because of their technical skills, age, exposure to western thinking, and language abilities. The department had a manager, an assistant manager, seven marketing personnel, and two secretaries; of these, nine were women and four men. Expectations of the department were high because of its newness and the arrival of "The Americans."

The mission of the department was not solely marketing. The company as a whole expected direction, goals, and strategy from this department, because of the department's youth and the support it was to receive from the team of MBAs. Requests for guidance from all areas of the company came to the Marketing Department. The MBAs believed that it should have been titled the Change Department, because change seemed to be more of its mission than marketing.

The physical layout of the department's office space was a hint to what work meant to the staff. The eleven people sat in three small rooms at three to four desks per room. The desks usually butted up against each other, face-to-face. This arrangement was not so much to aid in working together as it was to facilitate talk and enjoying coffee. There was one telephone, one computer, and a broken copy machine. Each person purchased his or her own supply of paper, folders, note pads, staplers, paper clips, etc.

### **The First Month**

The four MBAs wanted to start their work right away but realized that they had to let their department members get comfortable with them first. The first few weeks in the Marketing Department was a time of mutual sizing up between the Corps members and the staff. At first, communicating was difficult. Most of the department members spoke some English, and the four MBAs were learning Polish, but neither group knew enough of the other's language to make talking easy.

In time, the Corps members realized that the people at HTS did not know what to do with the department or the four MBAs. During the first week, the manager and assistant manager of the department asked the team to look at a few of the problems they had been asked to work on by directors of other departments:

- Develop a motivation system for the Trade and Sales Departments
- Fix the bad-receivables and bad-debt problem
- Create a western accounting and costing system
- Investigate what should be done about the changing transportation costs
- Design an information system for management
- Recommend how to change the organizational structure to make the company work better
- Teach English

In some ways, to have the ability to influence the heart of an establishment like HTS was an MBA's dream, but King, Taft, Ball, and Conroy held back their initial rush to solve the problems in conventional western ways, because that would not teach this company how to solve problems in the future and adapt solutions to its new environment. HTS wanted quick and easy answers; however, the MBAs had to explain how they would go about tackling each of the proposed problems. They first needed information—about the company, the industry, and the country. Without spending time researching and analyzing the problems, the root problems would not be identified and solved.

The four MBAs noticed that the managers appeared to be instantly defeated by the amount and complexity of the proposed work that needed to be performed to reach answers. The words that the MBAs spoke sounded right, however, so with what may have been primarily blind acceptance, the department decided to try and identify the root problems.

### **The Teams**

Because of the amount of research work and questioning to be done, the MBAs decided they should split up the work. By working directly with small groups on projects of limited scope, the MBAs believed they could teach the Poles all the skills needed to gather information, organize and analyze it, and share the results. The managers of the Marketing Department and the MBAs agreed that each MBA would lead a project team containing one or two members of the Marketing Department. The teams had autonomy, but advice was frequently needed from the two managers as to the best way to approach delicate issues.

The four projects were market segmentation, industry and competitor analysis, distribution, and internal company capabilities. The projects overlapped, so the teams would get together often to talk formally and informally. Weekly status meetings were held in which each team reported what it had found out and what it planned to do next. The meetings were a formal way to share information, but informally the team members talked every day about what they were doing. The formal meetings were at first held in both English and Polish, but that approach took too much time; thus they decided to use only Polish. The MBAs had the responsibility of making sure their Polish counterparts could explain what important information had been found.

Taft's team worked on industry and competitor analysis. Information and statistics on individual countries' and the world steel markets were plentiful in western countries, but in Eastern Europe, the information was hard to find. There was no one place to go, such as a science library, to gather this type of information. At times, the team felt as if it was in an information vacuum.

The team wrote letters to western steel companies and bureaus for some important information. For information on the Polish market, other mills' brochures and the Polish statistics office were great sources.

This team discovered that there was an overcapacity of steel in the world. This fact alone was crucial to designing a strategy for HTS.

HTS's internal capabilities was Ball's project. What skills the people had, what technology was being used, and what technology was needed were the major questions that this group tried to answer. Ball and her team spent a lot of time talking to the plant managers and touring the individual plants. The team developed a flow diagram showing how raw materials came into the plant and the processes they followed to final product.

This task identified the causes of many problem areas. For example, HTS's product quality was poor, and at first the reasons appeared to be poor procedures, old equipment, and careless material handling. These conditions did exist as partial causes, but the main reasons for poor quality were found to be the poor quality of raw materials and the inconsistent quality of the natural gas used in the heating process.

King and his team worked on a distribution system. Transportation and packaging were problem areas for HTS and for Poland; the country's infrastructure was deteriorating. Rail had been used in the past, but now customers wanted trucks used for delivery. The team discovered that wholesalers were one of HTS's largest customer groups and the group to which this issue was most important. This switch required HTS to distribute differently from the past, but the company had not taken any action to meet the new demands.

Conroy and her team had the market-segmentation project. It involved finding out who the customers were, what industries the customers were in, what products and services the customers needed and wanted in the future, and where the customers were. Conroy knew that HTS should be gearing its production toward the needs of the customers, but the people at HTS had always operated by producing what the central planners told them; they had never thought much about why one product was being produced rather than another or about making a product of higher quality.

In order to prepare for customer visits, this team initially talked with departmental managers to find out what information HTS already had on its customers. They found most of the information existed within the company; it was simply not in an organized manner or all in one place. Next they developed detailed questionnaires for the customer visits. If the

customer owed HTS money, a debt-payment plan was also developed to propose to the customer.

Customers were amazed and pleasantly surprised that HTS, the largest state-owned steel mill, was visiting and asking how they could be better served. In the past, because HTS was the only supplier of certain products in Poland, it would use that "power" to play games with customers.

While these projects were going on, all the members of the Marketing Department and the four MBAs went on numerous internal plant tours to learn as much as possible about the whole HTS operation. These visits were the first time any of the Marketing Department people had seen the inside of the plants, and the visits helped them understand the problems and processes in the complex. The MBAs wanted to meet with the acting general director, but for unexplainable reasons, a meeting could never be scheduled.

The process of gathering information by the four teams took longer than King, Taft, Ball, or Conroy had originally estimated. Teaching the reasons behind each step and how to carry it out added time to the process. The general lack of office equipment delayed scheduling meetings and analyzing results. Visiting customers entailed a whole set of protocols (or formalities) that had to be followed—documentation, approval stamps, and room reservations.

No one felt any kind of urgency to get the work done, however. The Poles relied on the Americans to lead them in the right direction and give them the tools to find the information, and the Americans relied on the Poles to communicate properly with the people and be open with information. Everyone was working hard, maybe the hardest they had ever worked. Close relationships were developing, some friendships were being built, and the Marketing Department members were gaining a confidence that they did not previously have.

The differences in culture and work ethic between the Poles and Americans caused additional delays. Poles are proud people and do not like to admit that they do not know something. It took Conroy, Ball, Taft, and King time to realize that they could not assume their counterparts knew something even if they said they did. The MBAs learned to ask many questions to assure themselves that the information was, in fact, understood.

People often got sick. Indeed, there were seasons, of sorts, when people were sick in shifts—two weeks here, two weeks there. Work continuity was impossible. Work was not a priority, and the people had little incentive to work. A doctor was needed to stamp a verification slip, and doctors decided how long one would be out of work. In short, doctors had the power to give people paid time off from work.

Strikes were a deterrent to working on the projects. In the United States, a strike in a major industry is big news and uncommon; in Poland, strikes of one sort or another seemed to occur all the time. Any sort of strike involved a great deal of time, during which



those involved got no work done and others spent a good deal of time watching and waiting instead of working. First the people prepared to strike; this was like a three-week warning period. A strike did not necessarily involve picketing or stopping production; HTS had a hunger strike, for example, during which five men did not eat for 12 days until the Ministry of Industry agreed to put in new technology in the mill. Just after the four MBAs arrived at HTS, the Solidarity trade union called its members out on strike in an attempt to force the Ministry of Industry to confirm the appointment of Knapik as general director.

### **The Request**

When the Marketing Department received the request from the acting general director in the first week of December for a report on what problems the department had identified and what solutions it proposed, it was clear that he wanted to see the opinions of "the MBAs." Everyone in the department knew that he had said the report was urgent and needed to be done in one week so that he could use it to help win the general director position over Knapik. Both men would be presenting their plans for restructuring HTS to the Ministry of Industry before the appointment would be made.

A week did not leave the MBAs much time to combine all the information that had been gathered by the teams and make a clear, concise proposal for the restructuring of HTS. The opportunity to have a huge impact on HTS, and possibly Poland, was hard to resist, but the task would be impossible to complete if people in the Marketing Department were involved in the process. Teaching them each step, translating, and writing everything in Polish would take much longer than one week.

The four had to decide how to get the job done. If they worked night and day for a week, they could produce a report, in English, that was respectable. The report could help HTS get leadership and help HTS produce better products and services in order to survive, but how would the Marketing Department members feel if they were left out of the process? Hadn't their efforts brought everyone to this point?

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

Greg King, Herb Taft, Ann Ball, and Bonnie Conroy knew they risked losing the trust they had built with the members of the Marketing Department if they wrote the report independently. They decided that writing the report on time would potentially help the mill survive, however, and that goal was the more important one. They isolated themselves from the department for a week and wrote the report.

The Marketing Department people watched from afar. The Poles did not completely understand what was going on, but they expressed hopes that the final report would put all the pieces of the teams' research together.

The four MBA Enterprise Corps members spent extra time on the wording of the report. They had learned that certain words when translated into Polish had different meanings from the English definitions. They wanted to be sure to use words that would convey the intended message. Each conclusion and proposed solution was described in detail so that no assumptions were made.

The final product was a 40-page report titled "Focusing Huta im. Tadeusza Sendzimira on the Customer: Evaluation of Market Conditions and Customer Demands." People could not wait to read it. An English version went straight to the Ministry of Industry. Translating the document took three more weeks.

After the Poles read it, the atmosphere changed. No one in the Marketing Department or in the company understood the report, and they could not see the connection between the work they had performed and the report. By writing the report without the Polish partners, the MBAs had excluded them from the most important link. The MBAs lost a lot of the trust and momentum they had built.

King, Taft, Ball, and Conroy never found out what the Ministry of Industry thought of the proposal, but it no longer mattered because Jerzy Knapik was appointed general director and the report got lost in the political shuffle.



## WORKING IN POLAND: CONTINENTAL OPAKOMET WHITE CAP (A)

As she eased into her seat, Irene Carlson felt herself somewhere between familiarity and unfamiliarity. She had not been out of Eastern Europe for 14 months, and she needed time to assimilate her experience. After graduating from business school, she volunteered to work in Krakow, Poland, for a year as part of a program called the MBA Enterprise Corps. The Corps's mission was to help companies in Eastern Europe transfer from a planned economy to a market economy. If the experience of the west could simply be transferred to Eastern Europe, then, in some ways, the answers to Eastern Europe's questions about how to operate were available before the questions were formulated. Poland and the other East European countries would not be recreating western systems, however; instead, companies in these countries needed to create something unique to their needs and traditions.

Carlson was not sure if she was pleased with her year's work or not, whether she was happy or sad to be leaving. Had she made a difference? Had she helped Continental Opakomet White Cap develop usable systems to meet the market demands? Would she ever know if they worked?

### The Company and Its Joint Venture

Przedsiębiorstwo Opakowan Blaszanych (Opakomet) manufactured metal closures for glass containers in four sizes and in various coatings and printings. (The appendix contains a copy of the brochure for the company's products and services.) Under Poland's planned economy, Opakomet was one of nine closure and packaging plants in the country. When the free market was established, the nine plants broke apart and most became separate companies. Opakomet remained one company with its sister plant Opakomet-Grzegorzki, which was also in Krakow and produced cans and crown bottle caps. Opakomet was still state owned at the time of Carlson's internship and, therefore, its fate would eventually be decided by the Polish government.

Opakomet became Continental Opakomet White Cap (COWC), a joint venture between the Polish government and Schmalbach-Lubeca/White Cap of Hannover, Germany, in October 1990. White Cap owned 51 percent of the venture, and the Polish government

Opakomet, and Opakomet had become White Cap's only Polish licensee. In early 1990, when Opakomet wanted to buy more equipment, White Cap negotiated the joint-venture agreement. At that time, Polish joint-venture law allowed such ventures an exemption from corporate taxes for five years and expatriation of profits (defined as a surplus of export revenues over import costs).

Under the final agreement, the Polish partner was to operate the company. The managing bodies were a supervisory board and a management board. The supervisory board was a group of individuals appointed by the partners to monitor activities and give advice with respect to operations and financial matters. An 80 percent consensus of the supervisory board was needed for any decision. The management board comprised the general director, the assistant general director, and the directors of finance, technology and production, and sales. The management board was responsible for day-to-day operations and for implementing decisions made by the supervisory board. Both boards were monitored by the partners in monthly Assembly of Partners meetings.

The partners had entered into the joint venture for different reasons. For White Cap the joint venture was a small investment with large potential, and because Opakomet was already a licensee of the White Cap process, the basis for a relationship had already begun. The joint venture would create a new source of supply and help White Cap capture a share of the East European market, which was potentially larger than Western Europe's.

As a strategic move, investment in Opakomet was also a way to prevent competition in White Cap's established western markets. Opakomet had the ability to produce caps more cheaply than White Cap, although the product was of lower quality. If Opakomet were to export to the west, it could undercut White Cap's prices.

In White Cap's analysis, the risks and negative sides to the venture were nothing out of the ordinary when entering Eastern Europe. Politically, Poland was still forming a democratic government and new policies, but the possibility of the venture's being nationalized, expropriated, or otherwise seriously damaged by some Polish law or decree could be covered by insurance.

The speed of Poland's change from a planned economy to a market economy and the economic hardships to be weathered during the transition were big unknowns. Given the huge national debt, backward industries, inadequate infrastructure, and lingering economic barriers, to expect the markets to emerge at astonishing speed was unrealistic. Donald Kendall, former chief executive officer of PepsiCo, made an important point when he said, "Anybody who's going to Eastern Europe or the Soviet Union on the basis of cheap labor is making a big mistake." The combination of low wages, low productivity, and a union-controlled government trying to steer the Polish economy to free-market status created an uncertain environment.

White Cap believed that the risk of Opakomet's taking advantage of the partnership, breaching the agreement, operating counter to White Cap's interest, or strengthening itself as a future competitor existed for any business venture. In White Cap's view, the joint venture's success hinged on creating a management team that wanted it to succeed. Opakomet seemed to want and need a "true" partner with the experience and ability to help it expand its business, and White Cap was ready to be that partner.

The joint venture, with \$3.06 million in cash and equipment to be invested by White Cap, would give Opakomet capital, technology, and exposure to western systems and business methods. Opakomet also gained security by getting a western partner.

From the beginning, however, the partners had different expectations in certain areas. White Cap evidently believed that Opakomet recognized the costs of reducing the venture's risk: work methods and policies had to change. For the strategy to work, the work force would have to change to meet new quality and consistency requirements. The nature of "work" would gain a new meaning. Unknowingly, White Cap maintained control over Opakomet by not sharing all available information and, in effect, hindered the operation of Opakomet.

Carlson believed these different expectations would not necessarily have been a problem if each side had recognized the situation. Unfortunately for COWC, all the later tensions Carlson found sprang, she believed, out of the contradictory expectations. The western partner wanted COWC to become "western" and to be a source of caps while remaining competitive in Poland. The Polish partner wanted all the benefits of being "western" without sacrificing too much of the old work ethic and without interference in the Old regime's "system."

### **The Business Environment in 1992**

COWC operated in two external environments: Poland's economy and the packaging industry. Poland was a homogeneous country with a population of 38.4 million in 1991. More than 94 percent of the population was Catholic, some 60 percent lived in urban areas, and 49 percent of the land was considered arable. The per-capita gross national product was approximately \$2,000. The middle class was dwindling and a small wealthy class was developing, but the majority of the population was in the lower classes.

Almost all businesses had problems with bad receivables and bad payables. In some respects, it was all the same money: one state agency owed money to another one. This circle of debt created cash-flow problems for the whole business community. Companies had to resort to accepting only cash or certified bank payments in order to assure payment for their goods.

Poland held its first free elections since World War II for its parliament (the Sejm) in the fall of 1991. In early 1992, the Sejm was composed of 26 parties, with no governing coalition. This situation had produced insecurity in the people, businesses, and foreign investors. A further effect of the government's instability was a volatile economy, which made future planning difficult.

Up-to-date market information was a key factor in planning for the future, because what was "normal" in the past would never return. Unfortunately, accurate information on markets was difficult to find, although some resources did exist.

The planned economy had eliminated many decisional aspects of operating a business that are extremely important in a market economy. For example, the market can force businesses to stagnate or fail that do not adapt to customers' needs. Such had not been the case in Poland's planned economy. Thus, for businesses to survive and thrive in a new market economy, a different mindset (way of thinking) was needed.

The Polish people's wants and expectations were changing because of the entry of foreign goods into the country and the influence of foreign business practices. Companies had to change to meet those needs.

Land ownership, banking systems, and legal systems were not established. Without these support systems in place, foreign investors were hesitant.

COWC was also part of the packaging industry. As noted previously, the packaging industry in Poland had been one large state-owned company. In 1991, COWC had only one domestic competitor in metal lids and had 47.9 percent of Poland's cap market, but producers of substitute products—plastics, tetra-paks, and cans—were quickly making inroads in Poland.

COWC's primary customer operated in the food-processing industry, which was highly seasonal because it was tied to crop harvests. More importantly, however, the food-processing industry was one that Poland had chosen to promote to foreign investors.

### **COWC's Sales Department, February 1992**

Six people worked in the Sales Department when Irene Carlson arrived—an acting director, the sales manager, and four salespeople. The only connection to sales that this department had was that the personnel received the calls from customers and generated invoices. They were order-takers.

To identify the department's needs, Carlson first took time to learn the language, learn about the people, observe people's actions, understand how the company operated, question the old system, and build a working trust. She quickly realized that her thinking

process and that of the people with whom she worked were different. Their values were different. Their assumptions, priorities, and wants were all different from hers. This was the single most important factor she discovered: no change could be implemented without adapting the change to the people's value system.

COWC was in a unique position. Even though competition was increasing, it still had time to learn and make the changes to compete. Carlson's initial observations identified the major needs of the Sales and Marketing Department, some of which involved the whole organization and some of which involved management decisions and support. For a western company, these needs were somewhat obvious, but for a company developed under a planned economy, they were not. The basic needs were as follows:

Only a "Sales" Department existed, with a few responsibilities that could be termed marketing. The company had to indicate visibly to its employees and to its customers that the way of selling its product was changing. The department needed to be reorganized on the basis of the capabilities of its personnel and the characteristics of its market environment.

COWC and its Sales and Marketing Department did not have any goals. COWC operated for today, not tomorrow. Setting goals and working toward them had not been needed in the past. Under a planned economy, state-owned and -operated companies were told what to produce, when to produce it, and whom to sell it to. In order to set goals, COWC needed to know where it had advantages and where it could equal or surpass competitors' advantages: overall quality, delivery, lithographics, price, costs, sizes, colors, coatings, quantity, availability, warehouse, production time, or additional services.

Until the company and each department defined its goals, no plan or strategy could be developed. With the goals defined, however, systems (an information system, an ordering system, a payment system, a delivery system, and a motivation system) could then be designed to support the plans and strategy. Of particular importance to the Sales and Marketing Department was a system of incentives. Carlson believed the motivation system did not need to involve solely monetary rewards, but it did need a set of support and reward mechanisms—for example, displaying in a visible area achievement graphs showing increased sales of products and services and increased market share, gifts such as theater tickets for achievements, bonus holiday time, recognition in some way for such efforts as gaining the most new customers in a month, or a share of increased profits. The motivation system was needed to encourage both team and individual achievement. Before any systems could be put in place, however, someone had to consider the present capabilities of the whole company, including products, technology, and the skills of the employees, as well as what future capabilities COWC would like to have.

Because of the changing market environment, COWC's Sales Department had to learn to sell its products and services **actively** rather than simply process orders. Such selling would involve contacting customers and showing them how COWC's products and services met their needs. The planned economy had not developed proactive sellers; they were not



needed, because everything was decided for them. Thus a major question was how to make order-takers into salespeople in an emerging market economy.

COWC needed to understand customers' needs and wants, their industries, the Polish economy in which they operated, and its own capabilities. Then it could approach the customer with products and services that were needed, which would make selling COWC's products easier. Analyzing the market and the customer would also help in forecasting future sales, which would help COWC's management make better investment decisions. The Sales and Marketing Department had to build this knowledge base.

Carlson discovered that the people in the Sales Department already had much of the knowledge needed to create a strong market position for COWC, but the information was not organized in a usable form. The information needed to be put together and shared among all members. In addition, the staff needed to learn how to use that knowledge, how to obtain more information and the new skills that applied in a market economy, and how these steps would help COWC grow. In addition to the "hows," the "whys" also had to be answered; the people needed to understand why certain information was needed to make good business decisions.

Carlson also realized that the Sales and Marketing personnel wanted to be responsible for their own budget. She was not sure that they truly understood the accountability that went along with such control, but believed that it made good business sense for the management of COWC to want managers to be responsible for the actions of their departments. Such delegation of responsibility would best use the company's expertise; the Sales and Marketing Department should be the people with the most knowledge of selling and marketing. It would also create trust between top management and the departments, and make people accountable for their work. Thus Carlson supported the department's desire for budget control as a key step in creating a competitive company.

However, the people in the department did not yet know how to sell their ideas to top management. They had the experience and some knowledge, but they were easily discouraged by the first rejection of an idea or were scared of the system. They needed to learn to show how their ideas and plans benefited the company and why. (Management, of course, needed to define what information was needed in order to evaluate these possible opportunities. Management was also responsible for encouraging new ideas, but to do so involved the sort of individual confidence that was not possessed by many Polish business people.)

## **The Action Plan**

### **Initial planning**

The department could have been organized in many ways. Carlson decided to introduce a planning process in the department in order to establish goals and a plan to reach them. Several processes were possible, but she was not sure which would work or be the best to try. She did not believe that simply explaining to the people in the Sales and Marketing Department about their environment and how it would change would get them to change. They already knew the current environment, and they were skeptical about changes because they had been waiting for change a long time and could not see "western" advantages occurring. Simply telling them to make plans a certain way, she believed, would lead to changes that would last only a short time. The next alternative was to walk them slowly through the process piece by piece and let them make mistakes, which would help in the learning process and at the same time allow them to see the "why" while learning the "how." Carlson adopted this approach, but it involved an unbelievable amount of patience and time.

A working team of the Sales and Marketing director, the Sales and Marketing manager, one of the salespeople, and Carlson was established and met weekly. The process they followed went from establishing a goal, to defining tasks, to assigning responsibilities, to creating time schedules and deadlines. Carlson's intention was that everyone in the department learn to think about the future. First, however, they needed the basic tools and information for this analysis.

### **Information gathering**

Carlson found that the information the Sales and Marketing Department needed was available—within their own minds, company, or country—but they did not know how to organize the information or what to do with it. The buzzword "database" was used extensively; it seemed to promise instant organization and results. Carlson believed that a database containing information about sales and customers could indeed be valuable, but it was only one step: using the information to make decisions would have to follow.

Designing the database and outlining its uses helped COWC decide what information management needed to forecast sales, production, and investment. The people at COWC did not really understand how to get the information. The easy approach for Carlson would have been simply to create a database—design it, get the information, and build it. She believed, however, that such an approach would do little for the company and that getting people to use an unexplained database would probably be difficult. The details of any database—what it will look like, the software, the hardware, the maintenance, etc.—are complicated. She decided, therefore, that each step should be taught, so that the how and why were understood.

Decisions about the database design could be made only after asking extensive questions and trying to draw links between the questions to make sure that the database would meet COWC's needs. This process took time and required many adjustments. Different methods were used to gather data from different sources. Some methods worked well, and others had to be modified in the process.

Talking about how the whole process—collecting data, building a database with accurate, consistent information, and then using the information to help the company make better decisions about the business—did not break down the barriers people had against seeing opportunities in the future. Although forcing them to answer a series of logical questions helped open their minds, they could not repeat the same line of reasoning a day later. To Carlson, these were the first clues to a deeper set of problems: the learning process would have to be reversed. First she would get the information and use it, which would let the department see how it helped them in their jobs and helped the company. Then she could show them how the information was gathered and used.

Questionnaires were used for gathering information from within the other departments of COWC and for requesting information from customers. The questionnaires were carefully worded and laid out, but consistency in the information was nevertheless a problem. The main reason was the respondents' lack of understanding about why the information was needed. Hence the learning process created a circular problem. Some inconsistencies could also be attributed to people resisting "giving up" information; information was considered power, and relinquishing it, even for the betterment of the company, was not always acceptable.

The most important source of information on past sales came from the book of invoices. By organizing sales volume by month, by customer, and by industry, Carlson hoped to show the department how market forces affected the company. Then future sales forecasts could be made.

All the members of the department had their own *szafa* (cabinet) where they kept documents. The *szafas* were kept locked behind solid doors so that no one could see what was in them. The department could not improve operations, however, without freeing all this information for everyone to use. Therefore, each *szafa* was opened, and each document reviewed. Many were old and not useful, but much information was very useful and relevant to the information gathering. The people did not even know what information they had. After this process, however, each person had a better idea of what was available and where it was kept.

One last source of information was White Cap. The communication link between COWC and its western partner, however, was not good. Language was one barrier, and another was the lack of middle managers' caring about and understanding each other's organizations. They were part of the same company but so autonomous that a need for conversation was rare.

After a visit to the German partner's plant, however, an informal relationship was started between the sales and marketing managers. An agreement was reached in which the western partner would start sending press and market information to COWC, and COWC would send White Cap an outline of its marketing strategy and sales results. Writing the first letter from Opakomet's Sales and Marketing Department to White Cap's clarified for Carlson that Opakomet did not know how to communicate with its partner. Helping them formulate their ideas and messages, sentence by sentence, onto paper, proved to be an important bond between Carlson and the Sales and Marketing people. It forced them to understand each other's thought processes while also starting a working relationship between the joint-venture partners.

Industry and competitive information came mainly from the government statistics office. The information base had to be built for COWC from scratch, because it did not yet exist. Newspapers, trade magazines, and leading industry companies were other sources. The people began to feel inundated with information and did not know how to organize it and put it all together. The problem was not getting information (although it was not the best) but knowing how to use it to think about the market as a whole and the future potential of the market. Those links were not instinctive in the company.

A decision diagram was created with checklists and standardized forms for each step. Each item on the list had to be completed before continuing to the next; each source had to be checked. Checking included talking to people in the company, calling customers, and reading press information. The standardized forms forced people to think about their assumptions as well as the links between information.

In theory, Carlson thought, this approach should have worked, but in practice it failed. No clear results could be shown, and the amount of information caused confusion. Carlson became extremely frustrated and began to lose her patience. The department members could not independently analyze information and disregarded any information they did not understand.

## **Training**

The most important training involved teaching the Sales and Marketing people about their own company. A training program was established in which each person was trained for a total of two weeks and spent time in every department, from security to technology. The process was a learning experience for both trainees and trainers. The trainers had to organize their thoughts about what they did and how it fit into the rest of the company. The knowledge the trainees obtained was designed to help make stronger links between their work in the Sales and Marketing Department and production. Further training programs for Sales and Marketing people placed priority on business and marketing tools and a second language, either English or German.

For her part, Carlson tried to make sure that all the steps in the process of identifying the company's needs and developing solutions were also taught, but she found that much of what she said was blindly accepted. No one criticized, asked questions, or offered opinions unless forced, partly because people seemed to believe a westerner had all the right answers. What people retained and how they adapted it to other situations were unknowns.

Communicating always in Polish was difficult for Carlson and took time. A few of the people spoke some English, but she discovered that she sometimes assumed they understood a task when it was discussed in English when they did not. (They would never say they did not understand.) Hence it became important to use mainly Polish to communicate. Her language skills improved over time, but it was still very stressful always to be using Polish.

### **The brainstorming session**

Carlson noted that, throughout COWC, day-to-day operations were performed without any recognition of the future (mostly because no one talked about what the company wanted to do and could do). People did not think past a day or a week: nothing would be different because no actions were being taken to make things different. She hoped that if the Sales and Marketing Department created goals and a strategy to meet those goals, maybe this approach would spread throughout the company. It was difficult for the Sales and Marketing Department to work on this creation, however, especially without knowing the company goals. She decided to have a brainstorming session with all the managers of the different departments to see what they thought about the company's future.

Carlson believed that creating the right atmosphere, one in which ideas could be expressed, was important. Having the session during work hours was not possible, so the session was held after hours with the motivation to attend in the form of a snack. This decision was a big deal; the 7 am-to-3 pm work schedule was rarely extended.

A description and the rules of "brainstorming" were distributed a few days in advance. The most important rule was that no one was allowed to evaluate the ideas during the session. An outside interpreter translated for Carlson, and a scribe wrote the ideas down as they were voiced. The process, at this time, was more important than the actual results.

In the session, Carlson first presented a brief description of where COWC was at that point, its sales and market position; then the floor was opened to ideas of where COWC could be in the future. What were the possibilities?

Carlson was afraid of raising people's expectations that all the ideas would be implemented. So she explained that the ideas were to help the Sales and Marketing Department formulate its goals and strategy. The reason each department's participation was

important was because each department would be affected by any strategy chosen and must be willing to help reach the goal.

People seemed willing to voice their opinions. At the end of the three and a half hours, the room had 200 ideas on large sheets of paper around its perimeter. Many of the ideas were fringe benefits and not strategic; nonetheless, the Sales and Marketing Department was different after the session. Its members had more energy to finish their assigned tasks. The brainstorming session helped to make more links with the "why." Carlson thought that maybe the expectations of the Sales and Marketing Department were higher now.

Other departments also now thought differently about the Sales and Marketing Department. The whole company seemed to be more active for a period after this session. Did knowing that a future for the company existed change them somehow?

The next step was to tie the results of the brainstorming session with the needs of the Sales and Marketing Department. Carlson tied in personal and career goals at the same time. This concept was new, but one that the manager of the department needed to see because it was his job to delegate work. Carlson believed that work is generally best performed by people who can and want to do it. People put limitations on themselves. In Poland, some of these limitations were instilled by the 40 years of communism in which individual initiative was discouraged, and some by Poland's long history of little movement between the classes. These limitations had to be broken in order for people to see their roles in taking advantage of opportunities and in planning for the future.

Five months after Carlson had arrived, the team of four met again to develop goals and strategy. Each person wrote down his or her personal goals on a piece of paper, but no one else read them. As the department's goals and strategy were being developed, each person was responsible for assuring that his or her personal goals were being met. The manager was also responsible for the members of the department not present. People usually made the connections subconsciously, but Carlson believed that their recognizing individual goals would help individuals understand the process of setting and reaching goals in general.

Each person had been asked to be responsible for bringing to the meeting any information that would be needed. The intention was to ensure that people would be prepared, that relevant information would be considered, and that decisions would be connected to all the relevant information. In preparation, the team members were to re-read the "needs" analysis, review training notes and outline information on further training, categorize the brainstorming-session ideas, and summarize industry and market analyses. Each task that the department had been working on during the last five months provided the team with the information needed.

The manager was to write the detailed goals that he had for his department. For this meeting, the manager finally spent time thinking about his department and defining long- and

short-term goals. He did not know how to reach them, but he identified where he wanted to go.

After a few sessions, the team had identified the short-term tasks that were necessary to reach the long-term ones. People in the department were given responsibility for certain tasks, and the new marketing strategy began.

### **Then What?**

Then the old system stepped in and broke the continuity.

The general director resigned. The general director had run the plant, but his attention was less on COWC's business than on making deals in which he somehow personally benefited. Use of a company car, unlimited vacations, and personal favors/deals with selected customers were his way of doing business. He acted the part of director perfectly, as if years of experience had piled up in him somewhere along the line. His plots and behavior were not only a distraction, but they also affected the actions of most of the employees. No one knew all the pieces of his plots and no one would ever say a word for fear of losing their jobs. Everyone knew, but no one knew.

Then, many cartons of lids disappeared over a weekend, and the clues indicated that the general director was responsible. He went along with the investigation until it became apparent that he was not going to be able to clear his name, and then he resigned.

To Carlson, the incident was legally, ethically, and morally wrong. She found allowing him to resign similar to prosecuting Al Capone for tax evasion when his other actions were so much more damaging. To her surprise, not everyone in the company believed he had done anything wrong. Their definition of right and wrong was different from hers.

Work was disrupted throughout the company while the investigation occurred and after awhile, the new director "cleaned house." In the midst of this management change, summer arrived and vacations began. Summer was the busiest season; late May through August, many clients were in and out of the office, but people nonetheless took long vacations. If only one person at COWC knew how to do something or held certain information, everything had to be put on hold when that person left for weeks of vacation. Everyone in the Sales and Marketing Department took 1-3 weeks off during this time, and the discontinuity hurt the company's sales.

Carlson concluded that work was not people's priority. Most got no enjoyment from their work and saw no significance in it. Spending time with the family and away from work was important.

At the same time, no one had time or wanted to make time to do the kind of planning Carlson was trying to introduce. Maybe the project was too big for introduction all at once and should have been divided into smaller pieces. Maybe the lack of rewards tied to goals made all the work performed so far seem pointless. Whatever the reason, the momentum had stopped, and Carlson's time in Poland had run out.



COWC's Product Brochure



We manufacture Twist-Off metal caps according to the White Cap "Total System" as the only licensee in Poland.

# CONTINENTAL OPAKOMET WHITE CAP



COWC is a joint-venture company established on 1 October, 1990 by Opakomet-"Artigraph" and "Continental Can Europe".

Opakomet-"Artigraph", Krakow's famous metal packaging company that has been in business for over 60 years, has experience, a high reputation, equipment leasing and a convenient central European location. Continental Can Europe is the international leader in the packaging industry, and supports COWC with capital from the United States.

Our company specializes in producing the Twist-off metal closures under a licence with White Cap for their famous "Total System".

Our White Cap "Total System" closures give you:

- Quality
- Certainty
- Reliability

Our caps are used for sealing glass containers for food products and provide the following advantages:

- hermetic sealing.
- easy opening and reclosing.
- suitability for pasteurization and sterilization.
- attractive appearance of the total package.

In our production, we use sealing compounds, lacquers and printing inks from the best Western firms well-known throughout the world to provide our high quality products.

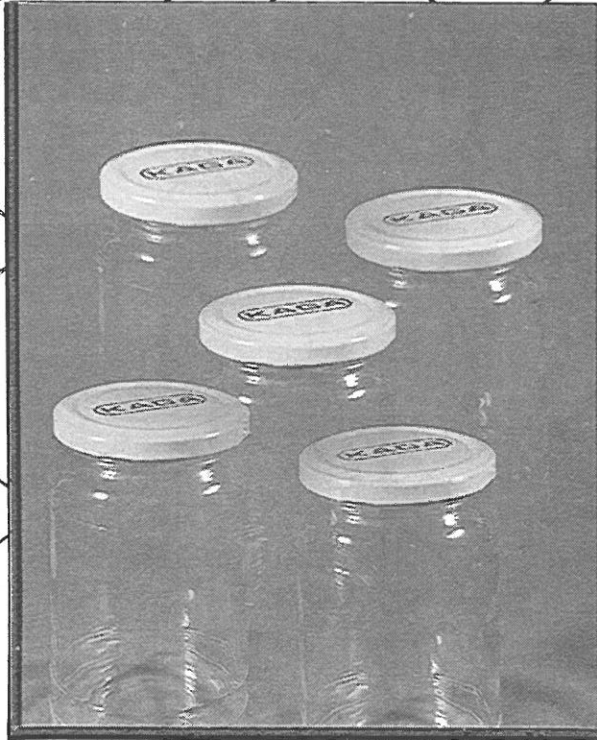
All our products are certified to come into contact with food by the Health Authorities.

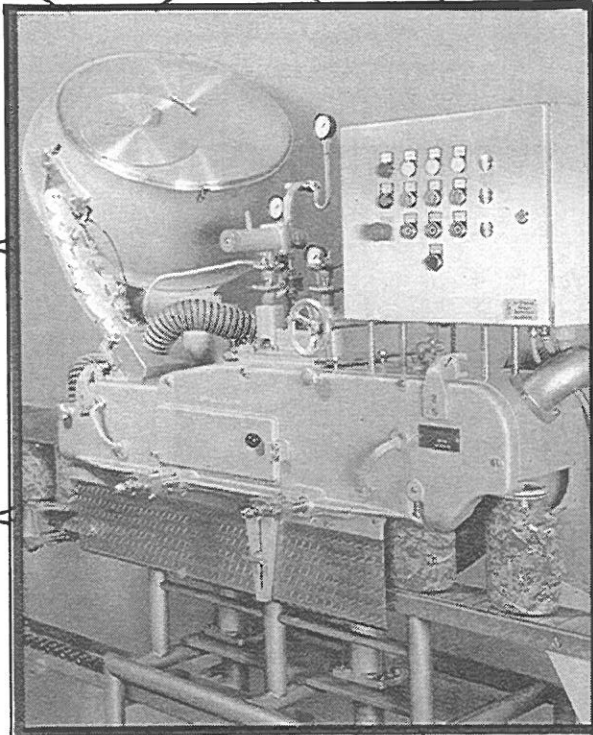
Every step of our production process is subjected to strict quality control. This ensures our guarantee that none of our customers will receive the caps in poor condition, only caps of the highest quality.

All our production machines and equipment come from well-known Western companies: MB, LTG and Mallaender.

We offer:

- RTS 66 and RTS 82 (4 and 6-lug) caps to seal glass containers for food products requiring pasteurization and sterilization.
- RTO 43 and RTS 110 caps to seal glass containers for food products requiring pasteurization.





Additionally, through our affiliate company, Schmalbach-Lubeca in Germany, COWC is the only distributor in Poland of 27-110 mm White Cap closures.

All our Twist-Off caps are available in three versions:

- coated with lacquer (gold)
- coated with enamel (white)
- printed

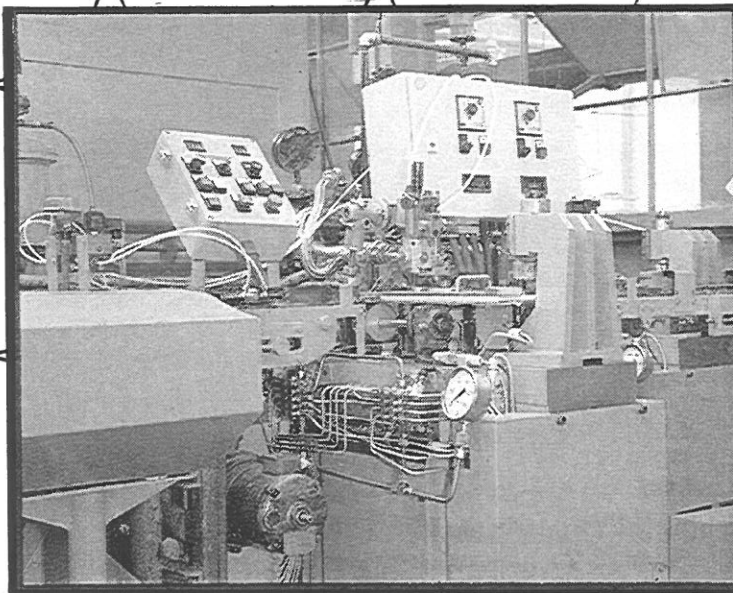
On request of our customers, we produce printed caps with artwork prepared by the customers. We also can arrange designs prepared by our artists, according to the suggestions of the customers.

We offer assistance in choosing the proper glass containers and labels. We are in contact with glass manufacturers, and have many different examples of glass containers.

Our caps are packed into 375x375x350 mm cartons. At the customer's request, these cartons may be packed on europallets of size 1200x800 mm and wrapped in plastic foil. The total weight of the carton and caps is 14.5 kg.

The caps are packed, as follows:

RTO 43	3000 pcs. per carton
RTS 66	1050 pcs. per carton
RTS 82 (4-lug)	700 pcs. per carton
RTS 82 (6-lug)	650 pcs. per carton
RTS 110	230 pcs. per carton



We offer a wide range of coating services, such as lacquering, enameling, and printing of metal sheets, for all kinds of metal containers.

We lease capping machines, supplied by the German company Schmalbach-Lubeca, on very favourable terms. Additionally, we provide complete maintenance service for the leased capping machines, and technical training of the customer's personnel in operating the machines.

We invite you to cooperate with us. We are always open to suggestions from our customers.

Our products are appreciated by our domestic customers, as well as gaining wider acceptance in foreign markets.



## Continental-Opakomet White Cap

spółka z o.o. joint-venture  
31-201 Kraków ul. Pielegniarek 7

Tel. switchboard (48-12) 33-28-33  
secretary (48-12) 33-28-85  
sales (48-12) 34-10-73  
purchasing (48-12) 33-46-12

Fax (48-12) 33-48-04  
Telex 03253 58 kobl pl  
03255 10 cowc pl

Poligraficzna S.c. „KMK” — Koźmice Wlk./Wieliczki

## WORKING IN POLAND: CONTINENTAL OPAKOMET WHITE CAP (B)

On October 8, 1992, a month after Irene Carlson, the MBA Enterprise Corps member, left her position at Continental Opakomet White Cap, she received a fax in the United States from the Sales and Marketing Department:

Hello,

How are you? We are carrying on somehow missing you a bit, though we are able to prepare graphs. Hereby I pass you the graphs showing our sales volume in accordance with your schemes, prepared for us by the end of each month. Pan Wnuk [acting Sales and Marketing director] suggested me to pass you these sheets as proof of our ability to make them by ourselves. I do hope you can accept them.

Let me tell you the kind regards in the name of the whole Dzial Sprzedazy i Marketingu.

Change had occurred. The systems put in place were being used to help COWC make decisions—better business decisions.



# NEGOTIATIONS





## **THE AMERICAN TECHNOLOGY CORPORATION:**

### **THE PITTSBURGH GROUP**

(Negotiating Technical Licenses)

"Stodgy" Hanson, general manager of the Pittsburgh Group, a manufacturer of pollution-control devices and part of American Technology Corporation, sat in his office reviewing the technical discussions for licensing the group's latest catalytic-converter technology to the Soviet foreign trade organization, V/O Transimport. Hanson was confident that he was offering the best technology to the Soviets, but the talks had bogged down on the issue of technical disclosure prior to signing the agreement. While he knew the Soviets needed some information in order to evaluate the proposal properly, giving too much information could negate the need for the Soviets to buy the technology. Hanson wondered how much further he could go without risking loss of the entire deal.

### **Background**

American Technology Corporation (ATC) was a conglomerate, with headquarters in New York City, engaged in such diverse areas as transportation technology, chemical engineering, and even entertainment technology. The Pittsburgh Group was one of ATC's transportation technology divisions. ATC acquired Pittsburgh in the mid-1960s when its pollution-control work received industrywide recognition. The group's particular expertise was in the area of automotive-emissions control.

The Pittsburgh Group acquired its name because it drew much of its younger staff from nearby Carnegie-Mellon University. These alumni were augmented by graduates from other top-notch U.S. engineering programs. In addition, many of Pittsburgh's senior staffers

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This case was prepared by Jack Austin and Leonard Schwartz of New York University's Management Decision Laboratory, Professor Myron Uretsky, Director. Revised by Professor Leslie E. Grayson and Sean M. Kelly, research assistant, University of Virginia. Copyright © 1990 by the Darden Graduate Business School Foundation, Charlottesville, Virginia.

were gathered from the body of engineers displaced when the U.S. space program decelerated in the late 1960s. One of Pittsburgh's company philosophies was to use space-age technology to resolve everyday problems. Pittsburgh's first major contract had come from a Midwestern city seeking to apply turbine-engine technology to a solid-waste disposal system.

ATC's first contact with the USSR was made five years earlier than the time of the case, when the Soviet State Committee for Cinematography requested a bid on some special optical equipment from ATC's Filmcor Division. Although Filmcor prepared a presentation for some Soviet officials visiting New York City, a contract was never concluded, because after further investigation, Filmcor determined it would not prove profitable to pursue the deal. Filmcor nevertheless conducted the seminar because it believed that such a good-will gesture was entirely in keeping with the spirit of a "free trade" bill recently passed by the U.S. Congress.

Although Pittsburgh never had a licensing agreement with the Soviet Union, it had concluded numerous similar arrangements throughout the world. For instance, during its ten-year history, Pittsburgh had licensed automotive- emissions technology to Mitsubishi (in Japan), to AM General Corporation (an American Motors affiliate in Canada), and to a South American firm desiring to enter the North American market. Pittsburgh's management had also considered selling a license to a Polish car manufacturer interested in West European distribution.

On April 15, ATC's President Johnson Miller received a letter of inquiry from V/O Transimport asking ATC to enter the bidding for a Transimport contract for catalytic convertor technology. Miller presented the inquiry to ATC's board of directors at the May Corporate Planning Committee meeting. After considerable discussion, Miller told Pittsburgh Group General Manager Hanson to prepare some product literature with which to respond to Transimport. While leaving the meeting room, Donald Bhuel, an ATC director, commented to Miller, "This could be a good entry point for all of ATC. Pittsburgh could use the cash anyway, couldn't it, Miller?" Miller assured Bhuel that he would apprise the Planning Committee as the deal developed. He contemplated Bhuel's comment. Pittsburgh had been in a cash bind for awhile.

On May 6, Miller telephoned Hanson and told him ATC was interested in exploring the license's potential sale to Transimport: "Stodgy, this looks like it could be a good deal all around. Lots of benefits and prestige. The Planning Committee felt it would be a good feather in our cap and that it might provide some of the operating cash that Pittsburgh needs to fund further development activities. But I want to assure you that the decision is yours and yours only. We haven't decided it for you. Let's talk soon." Miller and Hanson set up a meeting for the next week.

After hanging up the telephone, Hanson called in his chief engineer and project director, a young man named Jimmy Greenberg. The two discussed the potential license

for over three hours. Pittsburgh had four fully patented convertor technologies, including a recently developed Pittsburgh X-17i convertor (PX-17i). Greenberg told Hanson, "I'm still reluctant to license our work. After all, that's our home secret that keeps us in business."

### **The Technology**

The PX-17i, which Pittsburgh had developed two years earlier in response to strengthened U.S. auto-emissions regulations, was considered a top-of-the-line technology. It functioned through a different converter system from prior Pittsburgh convertors. The PX-17i was housed within a special metal casing attached to a vehicle's exhaust system. Inside the metal casing, a fiber honeycomb contained J2-treated neutral particles. The "special catalytic agent" J2 was just one of several chemical agents Pittsburgh's emission research department had developed. The J2 agent was added to the honeycomb particles through a process called "particulation." In order to achieve particulation, certain closely guarded secret temperatures and pressures (as well as specific equipment) were required. The J2 production process also required a second catalyst to which Pittsburgh referred as C-Special. Without C-Special, the chemical additives in J2 could not function efficiently.

Pittsburgh's PX-14, PX-15, and PX-16 technologies all functioned in a more common convertor process. The 17i's unconventional nature, as well as its power, led Greenberg to suggest that the PX-16 converter might be more appropriate for the Soviet deal.

Greenberg prepared a technology report for the May 15 meeting with Miller. Meanwhile, Miller arranged for Vinnie Morton, one of ATC's top international lawyers, and Roger Frick, a license-pricing man from corporate headquarters, to sit in on the meeting.

### **The May 15 Meeting**

Hanson welcomed Miller to Pittsburgh, and the four men sat down to begin a review of the potential transaction. During his presentation, Greenberg pointed out the specifics that led to the 17i's development. He suggested, "It might be an unnecessarily powerful technology for the export cars, although it might be well suited to industrial-worksite vehicles if the casings were adapted to the different engine type." Hanson noted that Pittsburgh was investigating licensing PX-16 technology to a Polish car manufacturer, but although Pittsburgh was ready to have an American automobile manufacturer introduce the PX-17i technology, Hanson believed "the technology might be a bit new to be licensed."

Miller followed with a discussion of Pittsburgh's cash-flow problems. He gave several reasons why Pittsburgh ought to "beef-up" the amount of available development funds. Hanson agreed with Miller and suggested Frick confer with Pittsburgh's finance director to assess the financial implications of selling a PX-16 or PX-17i license. After considerable

technical discussion, Hanson and Greenberg concurred that further data (such as the actual emissions standards the convertor would have to meet) were required from Transimport.

The men deliberated upon one final problem over lunch. Miller asked ATC's lawyer, Morton, if he anticipated any problems with the U.S. Office of Export Controls. The only potential problem Morton perceived was the PX-17i's chemical process. "Of course," Morton continued, "because the 16 has a more familiar chemical process, there would be less of a problem, but I cannot anticipate anything major on this." Hanson asked if this point implied ATC should pursue the 16 instead of the 17i. "Clearly not," Morton replied. "It only makes sense to go ahead with what you feel is appropriate."

Just to be on the safe side, Morton suggested that Miller have Hanson discuss the matter with Bill Conrad, a friend of his in the Bureau of East-West Trade. Conrad was an engineer with whom Morton had worked in the past, and Morton was confident Conrad could detect potential obstacles. Hanson agreed to talk with Miller in five days regarding Conrad's recommendation on the inquiry. In the meantime, Hanson assigned his marketing staff to begin preliminary proposal preparations.

#### **Hanson and Conrad Confer**

The morning after Morton, Miller, and Frick departed Pittsburgh, Hanson and Greenberg conducted a conference call with Bill Conrad. The three spent nearly an hour discussing possible export-control problems. Conrad explained to Hanson how to apply for the appropriate export-control license.

When Greenberg raised the issue of which convertor Pittsburgh should attempt to offer, Conrad asked, "Has Pittsburgh offered any other technology, particularly a similar one, in this area of the world?"

"Well, we have been reviewing the potential for a sale to Poland of the 16," Greenberg reported.

Conrad pondered this information a bit before replying warily, "Then I highly doubt the Soviets would be interested in taking a second-line technology. Aside from the Polish deal, if your company has sold a license--or the product itself--abroad, they probably know it. Look, it's a fairly common thing. They will want the most up-to-date technology. I wouldn't worry about the license problems. There is only a low probability of its not being approved." In order to expedite ATC's proposal preparation, Conrad offered to put Hanson and his marketing director in touch with an applications expert at East-West Trade.

Hanson commented to Greenberg on Conrad's last comment: "Jimmy, I think he's right. They want the top of the line and not the next best. I don't think they'll buy the next

best. But we're going to need the added 'specs' anyway for the modifications to the convertor."

"Do you think they really want the 17?" Greenberg asked.

"It's the best of its kind," Hanson responded.

### **Early Contacts**

Thus, ATC decided to formulate a proposal for Transimport, and Hanson informed President Miller of the project's progress. Miller forwarded a telex to Transimport requesting further convertor specifications. Five months later, Transimport notified Miller that it wanted ATC to present a technical seminar in Moscow.

Miller forwarded his telex copy to Hanson, who then telephoned Miller. The two discussed whether the costs and logistics involved made such a seminar feasible. Once they ascertained that it was, indeed, a sensible venture upon which to embark, Miller told Hanson that the "legal beagles" in Morton's office would handle all the arrangements.

Eight weeks later, Hanson, Greenberg, and two other engineers flew to Moscow to make the presentation. In order to embellish their seminar, the ATC staffers brought along Pittsburgh's usual convertor product literature (which Hanson's marketing director had thoughtfully translated into Russian), a film about the 17i's development, a slide show illustrating some of the 17i's technical points, and some general materials about the Pittsburgh Group. Hanson had also assembled a small business report in case questions concerning the potential deal's commercial aspects were raised.

The Moscow seminar was held in a Ministry of Transportation conference room. Officials from various related research institutes joined Ministry and Transimport representatives in attendance.

Perhaps two months after the Moscow seminar, Hanson received a telex from Transimport. It expressed Soviet interest in sending a delegation of six technical experts to the United States. The trip's purpose was (1) to gain further insights into the Pittsburgh product and (2) to initiate technical discussions designed to define the potential license.

When the six-member team actually arrived, it was composed of a Ministry of Transportation official, a Transimport vice-chairman, and a New York-based Soviet trade official, but only three genuine technical experts.

## **The Technical Discussions**

During the first two weeks of its visit, the Soviet team journeyed around the country to observe various facets of the convertor's manufacture and assembly. Pittsburgh obtained the consent of the American automobile manufacturer to whom it had sold the convertor, to show the Soviets a portion of the convertor assembly incorporated into an auto's exhaust system. Soviet team engineers Grigory Alexandrov and Nina Golikov commented to Greenberg that "the process appears to work exceptionally well, from the demonstrations we've seen. Assembly occurs very efficiently."

While imbibing what appeared to be an industrial-strength Harvey Wallbanger at one of the cocktail parties given for the Soviets, the third technical representative told Hanson, "I believe it should not be a hard task to modify the structural assembly for our cars." Hanson concurred with the engineer, Lena Kryukov.

While the engineering experts congregated around one table, Hanson and Transimport official Nikolai Asseyev repaired to another table to arrange further technical discussions. "The task that remains immediately ahead," Hanson told Greenberg after the party, "is not to give away the license in the process of selling it to them."

## **Hanson's Strategy**

Hanson and Greenberg conferred briefly before the formal Monday morning, March 7, technical discussions commenced. Hanson complimented Greenberg on the job that had been done to date. "The marketing boys have done just a fantastic job. The technical staff--you, Jane Janner, and the others--have given them a real feel for the product," he said.

Greenberg interrupted, "Nina told me the other day, after you had left the reception, that Asseyev had also spoken with a West German firm which was interested in selling them a convertor technology. Is that going to give us some trouble?"

Concerned, Hanson immediately called up Morton and asked for some guidance in light of this new development. Morton had been working on pricing with Frick and a Pittsburgh finance-staff member. Morton suggested that they get in touch with Conrad again.

Conrad advised them not to alter their basic strategy, but he mentioned that Pittsburgh should be aware other firms might be interested in the sale. "This provides your fellow negotiators with another source of information," he told them. "But, I think, and it's always an intuition, I think the time is right for this project. Call me if there are any substantial problems you cannot work out. We might be able to offer you some additional advice."

Since the PX-17i was fully patented, Pittsburgh felt assured that it had an advantage over the German competitor. The German technology was still awaiting its patent, which created some legal and cost complications for that firm.

The purpose of the impending discussions was to gain a mutual and rigorous understanding of what the license agreement might include and to discern what the technology being licensed was. The technology that both groups now believed should be the subject of the PX-17i license fell into two categories: (1) the information protected by the patent; and (2) proprietary production specifications classified as "know-how." That is, these were to be the substantive technical discussions. Hanson and Greenberg believed that all patent information could be freely discussed. They agreed not to discuss the C-Special details, however, because they were hesitant to talk about J2 production. There was a legal reason underlying this reluctance: the patent protected the ingredient details and chemical content of these items but not the manufacturing process. Greenberg suggested they attempt to delay discussion of know-how (including the various temperatures and mixing pressures and production-management techniques) for at least a short while. "Any of the details regarding C-Special will not be discussed," Hanson stated firmly. He sank into his hotel room chair.

"You look anxious," Greenberg commented.

"No, just expectant. This is a bit of a new experience. It's so much more detailed than our American deals--for products or licenses."

### **Outline of the Discussions**

Josef Vakulinchuk, the Ministry of Transportation representative, opened the Monday morning discussions by summarizing the two weeks of demonstrations and presentations: "I would like to thank our colleagues for the warmth and cooperation they have extended us. I am certain that this cooperation will be an important part of improving trade relations."

Following this greeting, each team (for a list of each team's members, see Exhibit 1) settled into its seats as a secretary brought in the morning coffee. Once the coffee was distributed, Asseyev began the actual discussions. He presented Transimport's desire to obtain a very detailed description of the process used to create J2 (the chemical compound used in the particulation process): "Well, I think the next order of discussion is the requirements of the J2 process; the last two weeks have given us a clear picture of the assembly process and the manufacture of the convertor casing."

"To begin with then," Greenberg responded, "we need to have some idea of the production scale for the convertor. The production requirements would vary from a small operation to a large-scale one."

Asseyev replied, "Yes, we appreciate the differences between lab production and commercial manufacture. Both must be possible for us to continue the project."

Greenberg leaned over to his right, briefly speaking to Janner, one of his engineers. Janner stood up, walked over to a paper chart in the room's far corner and began to sketch a diagram. "Let's begin," she said, "with the manufacturing requirements, since the lab equipment required is more elementary." She outlined the equipment types required to complete the particulation process. The Transimport team questions focused on the machine used to inject the J2-treated particles into the catalyst casing. Monday's session also covered the layout of equipment needed for preparation of the particulation process.

By the time the team decided to break Monday morning, they already had delved into two significant areas: the overall manufacturing equipment required and the proposed layout. Hanson did not wish to comment yet on the details of the layout. "That's part of the expertise you get by obtaining our license," he told Asseyev.

Asseyev allowed the point, but raised another, "We have not discussed the process of fitting the honeycomb into the casing and what the manufacturing requirements of that are. Without knowing these requirements, we cannot know the economic efficiency of your process. That is an essential point in these discussions. A more efficient process, one which utilizes less resources, would be more attractive. For example, there is the Swedish process which uses fewer stages than other convertor-agent production processes."

Hanson and Greenberg dined together that night so that they could review the day's discussions. Greenberg, fatigued by the protracted discussions, admitted, "Stodgy, I feel overwhelmed by all of these questions. Haven't we demonstrated the 17i's efficiency and production already?"

Vinnie Morton dined with Vakulinchuk on Monday evening. He was accompanied by a friend from the U.S. Department of Transportation. After dinner, Vakulinchuk told Morton that the Ministry wanted to procure the convertor in order to bolster export trade.

### **Tuesday, Wednesday, and Thursday**

Morton joined the Pittsburgh team on Tuesday morning to observe the discussions, and he passed along Vakulinchuk's Monday night comment to Hanson just prior to the opening of the talks. Hanson had arrived equipped with a presentation graphically depicting how J2 eliminated simulated emissions. The presentation was quite effective. Afterwards, Hanson told Morton both teams began to "seem more relaxed with each other."

These next three days of discussion focused exclusively on J2. The Transimport team inquired what J2's physical makeup was. Hanson had engineer Ray Grubrick explain the chemical composition, but not the control of the process which created J2.



"How do we know that our machinery will be technically able to reproduce the right circumstance for the creation of J2?" asked Asseyev.

"We have demonstrated it, you have seen the machinery. We cannot reveal the temperatures and pressures required to form the catalytic agent J2. Suffice to say, Nikolai, that would render the license useless," Hanson responded.

Morton interjected with a suggestion: "Why don't we break down the process into stages, and you can purchase different stages of information regarding the know-how associated with the processing of J2?"

"Do you not have faith," asked Asseyev, "in the total process that you must break it into little pieces to sell it? After all, we must know that the production requirements inherent in the license do not overtax the available resources within the Ministry's plan for this period."

"Furthermore," suggested Alexandrov, "we have to be certain of available sourcing of the proper chemicals. Take C-Special, as you call it. If we cannot get the inputs to create C-Special, of what use is this license?"

Asseyev elaborated upon Alexandrov's point. "Don't forget our purpose in this acquisition. We have to be able to assure a steady flow of production."

Tuesday's session ended in a deadlock. Morton and Hanson met early Wednesday morning. "Stodgy, we must break this stalemate. I am convinced we can work around the issues. I believe they want the license. Let's separate out the key pieces of information which cannot be revealed." Morton and Hanson jointly prepared a mental list of those items they absolutely could not "give away." In the meantime, Miller phoned Hanson to ask how the talks were proceeding.

Wednesday's session began with a reassurance from Asseyev: "We are very impressed with your product so far."

Hanson thanked Asseyev and added, "I hope we can move along in these talks."

The talks regarding J2's content and process continued. By Thursday's meetings, the Transimport team had yielded on the need to know the J2 production temperatures and pressures. To reciprocate, Pittsburgh outlined the total manufacturing-plant requirements for a large-scale convertor production-and-assembly operation. Aside from these points, the production- management techniques needed to produce the chemical agents efficiently and to manufacture the convertor device had not yet been discussed.

By such adroit maneuvering, Miller and Hanson obviated the need to reveal the two key pieces of know-how: (1) temperatures and pressures required for J2 creation and (2)

facts about the special catalyst used to create J2 (as well as the production-process particulars).

Greenberg, Hanson, Janner, and Grubrick joined each other for breakfast Friday morning.

"It's been a very long week," commented Janner.

"Very long," echoed Grubrick.

"It looks good, though," assured Hanson.

Greenberg commented, "I think they have everything they need to know to decide on the contract. Don't you?"

"They ought to," said Hanson. "As I understand it, they're leaving for Moscow this weekend."

"Will we be meeting over the weekend then?" inquired Janner.

"I don't know," answered Hanson.

### **Friday's Meeting: The C-Special Issue**

Asseyev opened up the Friday session. "Well, we start again. I think we can manage on the information you've provided us with about the assembly process, the creation of J2, and the casing requirements. Of course, your consultation on the re-design of the casing is essential."

"Good," said Hanson.

"Well then," Asseyev proceeded, "C-Special is the remaining topic on our agenda."

Janner leaned over toward Grubrick and whispered, "I hope today goes easier. I don't know, though."

Grubrick whispered back, "They're top engineers. They really know their stuff. At least that aspect has been very pleasurable. I wish we could talk with them alone. This would go much quicker."

Janner glanced across the table and smiled at her technical colleagues. Soviet engineer Kryukov, Transimport's chemical engineering expert, returned the grin, and began the day's questioning by asking, "What are C-Special's components?"

"It is composed of three chemicals combined to produce the right effect in the mixing of J2's chemical components," answered Greenberg. "At this stage, C-Special is the critical element in the production of J2. It is our protection on the process. You know its chemical contents. We have described the machinery needed to produce both J2 and C-Special. We have offered to provide you with C-Special as a guarantee of the license."

"Yes, but because it is the critical aspect of this whole deal, certainly you cannot expect us to forego discussion of it. Can you?" queried Asseyev. "Certainly, you appreciate that if there are any problems with C-Special, there is no point in proceeding with the license? It is simply a must! Proper planning requires this."

"As you know," Greenberg continued, "this ... " Hanson interrupted him, and the two conferred quietly.

Pittsburgh re-opened the discussions by listing C-Special's chemical components. Asseyev responded, "We also must know the production requirements. We can forego it on some of the other aspects, but here it is crucial. Both this and the process of fitting the element into the casing are our critical points. I am sorry, but that is the fact."

Asseyev's Stand. During a break in the discussions, Asseyev and Hanson met in the corridor outside the conference room. Asseyev summarized his view for Hanson:

It is our desire to obtain sufficient detail on the technology to assess properly its value and its adequacy to our needs. The technical information required to assess the convertor's suitability to our production resources and needs must be given us. It has to be in a scope that enables us to consider these points in comparison with counterproposals from other manufacturers. It is very simple: it has to be realizable in our facilities as well. C-Special is a critical piece of the convertor system. Therefore, its specifics and requirements are of great importance in considering your proposal. Why, you yourselves have insisted that it is J2, to which C-Special is the distinguishing agent, that makes the PX-17i special!"

Asseyev then excused himself for a brief meeting with his technical experts.

Hanson's Stand. Following his conversation with Asseyev, Hanson returned to his temporary office on the next floor of ATC's New York headquarters. While meeting with his team, he received a call from President Miller, who again wished to know how the talks were progressing: "It was mentioned at today's Planning Committee meeting. It seems that the director who attends those meetings, Donald Bhuel, is very interested in the progress of the talks."

Hanson told Miller that the talks had just become stalemated. "But then," Hanson continued, "it's not the first we've had to handle during this presentation. It's the longest technical presentation with which I've ever been involved prior to signing an agreement."

Miller asked Hanson what the point of contention was. In describing the obstacles to Miller, Hanson stated that he believed Pittsburgh had labored to demonstrate both the entire process as well as the suitability of the final product. Furthermore, Hanson believed Pittsburgh had provided considerably more information than it would prior to a normal contract signing.

We feel that we have disclosed everything necessary and then some. Anything more, particularly, the C-Special information, would be discussing our "home secret," as Greenberg calls these items. It is simply competitive information. And with it, I might add, they might not need our license. I feel we have offered alternatives which would be satisfactory. We even offered, in a generous moment, to assure a supply of C-Special for three years--if an agreement were signed. The C-Special would be provided on a low-cost basis.

End of the Morning. At 10:45 a.m., Hanson was still conferring with his team. Similarly, Asseyev was discussing the current deadlock with the Transimport staff. Morton was counseling Hanson's group. Asseyev was consulting the Ministry representative, Vakulinchuk. Each group was reviewing its stand on the information that remained to be discussed.

Two items were contended: (1) the process of fitting the particulated honeycomb into the casing, which had been left unclarified from Monday's discussion, and (2) C-Special's production details.

Prior to the conference break, both teams had agreed they would reconvene the session at 11 a.m. If an accord could not be reached, Hanson and Asseyev had discussed possible meetings just with Morton and Vakulinchuk. Each team leader pondered the technical discussions' prospects on the PX-17i convertor.

Exhibit 1

**THE AMERICAN TECHNOLOGY CORPORATION: THE PITTSBURGH GROUP**

**Negotiating Teams**

Selected Members of U.S. Team

"Stodgy" Hanson: General manager of the Pittsburgh Group.

Jimmy Greenburg: Chief engineer - Project manager - Pittsburgh Group.

Vinnie Morton: International lawyer, ATC.

Roger Frick: License-pricing specialist, ATC.

Bill Conrad: Engineer, Bureau of East-West Trade.

Jane Janner: Engineer, the Pittsburgh Group.

Ray Grubrick: Engineer, the Pittsburgh Group.

Selected Members of Soviet Team

Nikolai Asseyev: Vice-chairman, Transimport.

Grigory Alexandrov: Engineer, Transimport.

Nina Golikov: Engineer, Transimport.

Lena Kryukov: Engineer, Transimport.

Josef Vakulinchuk: Representative, Ministry of Transportation.



## METACOM CORPORATION (U. S. Version)

Snow was falling on the Kremlin's brightly illuminated red stars and flood-lit brick walls. John Howe, Metacom Corporation's vice-president for international marketing, had foregone his associates' offer to take an after-dinner stroll through Red Square. Instead, he sat alone in his room, staring out his window and meditating on Metacom's negotiations with the Soviet Foreign Trade Organization (FTO) Licensintorg. Metacom was engaged in an effort to sell the Soviet Union a license for the manufacture and exclusive Eastern European distribution rights to its automatic program generator (APG).

Metacom's president, Herbert Gray, was expected to arrive in Moscow from Los Angeles the following day. Howe was well aware that the decisions he would make prior to Grey's arrival would affect the final outcome of a negotiation that had begun two years ago and was currently stalemated over a pricing issue.

"Certainly," he thought, "the issue of payments can be resolved after two years' efforts!" Howe thought a logical beginning would be to recall for himself all events leading up to this present Moscow trip. Howe relaxed in his chair.

### Metacom Corporation

Metacom Corporation was a California-based maker of software and computer components with average annual sales of \$10 million. The company specialized in creating proprietary industrial software for use on mid-sized main-frame computers. Although it had extensive experience doing business in Western Europe, Metacom had never sold its products in East Bloc countries.

The APG was a device designed to be used in conjunction with IBM 360/370 computers. When connected directly to the computer's main frame, the mechanism, with the use of a few macro-statements, automatically constructed programs and prepared

reports. Its physical appearance resembled an augmented report program generator. Although the APG was a new technology, it was fully patented. Furthermore, businesses in both the United States and Western Europe had been incorporating the APG into their computer systems at a rapid pace. The APG unit was produced with an integrated circuit type available throughout the industrialized world, although APG circuit design was classified as proprietary information. The Metacom APG carried a \$25,000 price tag in the United States.

On the world market, besides Metacom, the main producers of these devices were the U.S. firm Texas Instruments, Sercelle of France, and Schlumberger AG of West Germany.

### Background

Howe became involved personally in the attempt to sell the APG to the Soviets in 1977. Metacom President Gray had read an article about Soviet plans to automate fully the U.S.S.R.'s railroad routing in *East-West Markets* (a Chase World Information publication). Gray forwarded the article to Howe, who perused it and agreed that this opportunity looked ideal for the APG. The Soviets evidently needed to proceed rapidly with the automation process. The U.S.S.R. Ministry of Transport's programming needs had grown exponentially and could not be met without a much larger programming staff which was needed for other activities. Over lunch, Howe and Gray calculated that the APG could permit the Soviets to fulfill Ministry objectives as much as two years earlier than without it. Both were excited about the prospect of expanding into a new market--Eastern Europe and the Soviet Union--as well as about the potential size of the deal.

Metacom's next step was to establish a link with the Soviets, so Howe contacted the U.S.-U.S.S.R. Trade and Economic Council in New York City.\* The council put him in touch with AMTORG, a New York-based Soviet trading company. Through AMTORG contacts, Howe learned whom to contact at the Ministry of Foreign Trade and at Elektronorgtechnika and Licensintorg (the Soviet FTOs responsible, respectively, for electronic components and licensing). Howe recalled his great sense of accomplishment at locating the right officials to contact so quickly. He had promptly made the initial inquiries.

Six months after Metacom extended its first "feelers," it received a Licensintorg request for a business proposal. Metacom responded with general descriptive APG literature and a letter outlining alternative commercial arrangements. Specifically, Howe and Gray discussed two customary transactions: (1) outright technology purchase with

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\*An organization of American firms doing business in the Soviet Union.



Metacom management assistance, or (2) a license to market and manufacture the APG within the CMEA (East Bloc) countries. Metacom placed a \$1.5 million price tag on the licensing deal.

Two months later, Howe received a letter from V.I. Efremov, a Licensintorg representative. The Soviets rejected the outright-purchase offer, but requested more detailed APG specifications. Howe and Gray again discussed the APG deal's implications.

Metacom decided that it would not explicitly release APG technical data but wrote the Soviets that it would be "more than happy" to conduct a technical seminar in Moscow. Metacom prepared to send four representatives: Howe, Cathleen Lewis (Metacom's vice-president for research and development), and two APG technical experts. As the date drew near, the group was hastily preparing for the seminar when Howe received another telex: The Soviets had postponed the seminar six weeks, with no explanation at all.

The seminar was finally conducted and three months after receiving the request for information, Howe made his first trip to the Soviet Union. Representatives from Elektronorgtehnika, the Ministry for Instrument Making, the Ministries of Transport and Foreign Trade, and the State Committee for Science and Technology attended. The Metacom and the Licensintorg representatives in attendance considered it successful.

In the ensuing three months, Howe became concerned about the deal. Although he had the impression that the Soviets were eager to acquire the technology, he heard nothing. "I wonder what is happening. For sure, at least some specific proposals should be formulated." he reflected.

A telephone call to a friend Howe had cultivated at the U.S.-U.S.S.R. Trade and Economic Council helped facilitate matters. Howe's friend got in touch with someone at Licensintorg, and soon Metacom received an inquiry for more data. The telex requested information on circuit technology, APG packaging and accompanying implementation programs. Although reluctant to disseminate such information, Howe now realized how happy he had been just to hear from the FTO.

Howe contacted Metacom's patent and contract attorney. The attorney suggested that Metacom respond to the FTO with a license contract draft. The letter mailed with the draft asked Licensintorg to provide some tangible indication of its intent to negotiate. Once the Soviets notified Metacom of its intent, the letter noted that the firm would gladly host a delegation visit to some of its production and research facilities. Two months later, Licensintorg accepted that proposal. The only snag was that the representative made no comment concerning eventual Soviet aims. Again, however, because of the contract's potentially lucrative nature and its prestige, Metacom

determined it was worthwhile to continue making presentations. The Soviet delegation visit was set for the end of May.

### **The First Protocol**

A 12-person delegation was slated to come to California for a 10-day visit. Just prior to its arrival, the U.S. Department of Commerce contacted Gray. The Commerce Department was anxious not to have the Soviets tour Metacom's California research facilities. After a series of meetings in Washington, the second of which involved Gray, Commerce determined that the site visit should be confined to a conference room adjacent to the research facilities.

Although the modified visit arrangement created some tension for both teams, a generally cordial atmosphere prevailed during the visit. Apparently, the last-minute change of venue did not alter business prospects; both parties affixed their signatures to a protocol committing them to negotiate a contract. Curiously, this signing occurred during the group's Disneyland excursion. Howe recalled celebrating that night and having the feeling that a ton of bricks had been lifted from his shoulders. He looked forward to Metacom's next Moscow visit.

### **Technical Negotiations**

As Metacom embarked upon the technical-negotiation phase, Howe felt confidently that matters would move quickly. "Now that they have agreed to negotiate, I am sure we will all want to tie this one up quickly," he had commented to Gray.

Two Moscow trips were required to conclude the technical negotiations. Not only did the excessive amounts of travel fatigue Howe and his associates, but then there were all the counter-productive distractions. For instance, during the first visit, Metacom asked to tour an integrated circuit factory, but that request was refused. In fact, the U.S. team spent most of its time answering Licensintorg queries about quality control for Soviet APG production. In order to be able to offer unequivocal assurances, Metacom's negotiators indicated they required greater knowledge of Soviet manufacturing systems. When the Soviets could not come across with such data, the talks halted. "I guess," he reflected, "they felt we were asking too many questions."

Before Metacom departed Moscow, Howe signed another protocol to confirm that negotiations would continue. He was reassured by the protocol, but drained by the process required to obtain it.

After returning to California, Howe fulfilled a Licensintorg requisition for further integrated-circuit production specifications. Shortly thereafter, another Soviet telex said

talks could again resume, and furthermore, the U.S. team could tour a manufacturing plant this time. Howe wondered why the visit was now permissible. When the Metacom team returned to the U.S.S.R. three months later, the production site they saw was in Minsk, Belorussia. The abbreviated visit resembled a "pit stop" more than a genuine data-gathering mission. It reminded Howe of the California tour the Soviets had received earlier.

During casual conversations between Metacom APG experts and Minsk factory engineers, serious doubt arose concerning the Soviet's technical ability to manufacture the APG. Despite official assurances, Howe felt increasingly ill at ease about how the negotiations were progressing.

### **Commercial Negotiations**

Despite his hesitancy, Howe concluded the technical phase of negotiations. He agreed to return to Moscow to iron out the deal's financial elements. Commercial talks then began "in earnest." After some minor haggling, the Soviets acceded to Metacom's \$1.5 million asking price. Howe actually hoped to "up the ante" in order to compensate for the impact the inflation rate had had on his production costs over the past two years. Unfortunately, it soon became apparent that such a maneuver was out of the question. The Licensintorg team offered to make payment in two parts: 20 percent hard currency (after testing the completed devices) and 80 percent buy-back of Soviet-manufactured APGs. Under a buy-back arrangement, Metacom would receive Soviet-manufactured APGs, which it could sell in other countries, as partial payment for the license.

Howe had been totally unprepared for a barter proposal. He stressed Metacom's desire to receive hard currency for the total deal. Again, the Licensintorg negotiator indicated this was not feasible. Metacom left Moscow without a signed agreement.

Howe seriously questioned what might happen next. Metacom had spent more than two years negotiating this contract. Furthermore, it had incurred considerable presentation and travel expenses in these efforts. Gray asked to review the potential deal.

Metacom's financial analysts proposed a new two-part payment deal: (1) raise the hard-currency amount to 60 percent and (2) work out a third-party buyer arrangement with a West European firm for the remaining 40 percent in buy-back. Howe thought that Licensintorg would not settle for less than a 50-50 hard-currency/buy-back split, but in order to bolster the attractiveness of the cash request, Metacom felt it could offer to extend the payment time schedule.

Gray considered two factors when he approved project continuation:

1. Metacom's "unique" advantage in APG technology was slowly dwindling; and,
2. the potential for future business deals with the Soviet Union still seemed possible.

Metacom telexed its new offer to Licensintorg and simultaneously applied for an export-control authorization. Howe had learned through industry associates that Licensintorg was negotiating with competitors who had devised a computer device comparable to the APG. A new meeting in Moscow was scheduled for four months later to discuss payment terms. Howe believed this would constitute the last negotiation round. Undaunted by the knowledge that Metacom's corner-on-the-market had nearly eroded, the U.S. team returned to Moscow.

### **An Export-Control Interlude**

Howe communicated his thoughts and reservations concerning the commercial negotiations to Metacom's contact with the U.S. Office of Export Control. (Export Control required licenses for most such technology transfers.) He was told that, although the process was "fraught with uncertainty, one must remain optimistic throughout." Then Howe's hope to conclude the APG deal speedily was served a potentially devastating domestic setback: the possibility existed that an APG export-control license might not be granted. The Commerce Department, in particular, had many questions regarding the APG technology's ascribed "uniqueness."

In order to satisfy official reservations about licensing APG, Metacom held a series of meetings in Washington between Gray and various U.S. government administrators. Several factors were proposed in Metacom's favor:

1. The APG technology would remain "unique" for only a limited period of time. Failure to conclude the license now might prevent the agreement from ever being consummated.
2. APG was purely a business-and-management technology. Metacom believed it had only civil applications and posed no potential national security threat.
3. To deny the license would only penalize U.S. competition with European companies.

Following the Washington discussions, Howe nervously awaited Export Control's verdict. After considerable deliberation, Howe and Gray were informed that the license application would be approved.

## Resuming Commercial Negotiations

Resolving the export-control issue allowed Metacom to return to the commercial-negotiation phase. In the interim, Howe obtained an agreement from an experienced trading firm to buy the Soviet-manufactured APGs on one condition: that the firm found the products met stringent quality-control standards. The firm would not agree to buy the items directly. Rather, the Soviet-manufactured APGs would first be sold to Metacom and then, subsequently, retailed to the traders.

During this round of negotiations, several "dead" issues were raised again. In particular, Licensintorg was dissatisfied with Metacom's payment percentages. The Soviets suggested that a more agreeable balance could be struck if the deal was valued at \$1 million. Metacom found a \$1 million package attractive if the cash-payment/buy-back percentages were 50-50. Licensintorg then countered with a new offer of 40 percent hard currency and 60 percent buy-back. Howe was unwilling to make this compromise.

Discouraged, Howe told Efremov during an after-lunch walk that his team was ready to return to the United States. "I don't feel," he told the representative, "that we will settle this issue!"

Efremov appeared greatly upset. He suggested Gray meet with the Transport Minister to attempt to break the deadlock. The representative further noted that the Automated Control Systems director had already promised the Minister that the railway automation would be completed in four years. "This," he continued, "would be totally impossible without the APG. Furthermore, I've heard that the Minister has taken a vital interest in these negotiations and the APG."

Howe asked why the payment terms had become such an issue. "I feel," Howe said, "we've made major concessions, like the buy-back agreement. The hard-currency amount is not that great if you're serious, is it?"

The representative explained that the Ministry was presently considering several very important projects. Many of these, he told Howe, would require hard currency. "It is not," he suggested, "in endless supply during a given point in time."

It was also pointed out that the Ministry for Instrument Making was interested in using APG devices as a source of hard currency. If sold among the CMEA nations, the Soviets could likewise require hard-currency payments. "The resistance," he added, "might only come from researchers interested in developing new technology."

Howe reviewed the few statistics about Soviet APG production and use he had (see Exhibit 1). After some hard thought, he decided to ask Gray to attend the next negotiation session. Howe breathed a sigh of relief when he received Gray's telex saying

that he would be arriving in three days. The telex also instructed Howe to prepare a summary report on:

1. what had happened in the negotiations;
2. what the contended issues were; and
3. what strategy Gray should pursue with the Ministry.

Thus, Howe was contemplating the last two years of activity. "What began as a flirtation with an idea," he thought to himself, "has ended up in a very expensive stalemate."

The snow was still falling outside the National Hotel. Howe got up, put on his coat, and left the hotel room for a walk in the fresh air. Question after question raced through his mind:

- If Metacom took a tough position with Licensintorg, would it lose a two-year investment?
- Was the potential for future trade worth the present costs of the negotiation and the final terms?
- Would it be better to scuttle the whole affair and chalk it up to experience?
- How much room could Metacom really allow on the pricing/payment issue?

As he stepped out into the wind on Karl Marx Prospect and turned up the corner toward Gorky Street, Howe felt certain he could sort out the many variables and questions.

Exhibit 1

**METCOM CORPORATION (U.S. Version)**

**John Howe's Production Assumptions**

Assumption No. 1: APG Sales

APGs accounted for 40 percent of Metacom's sales last year, equivalent to 160 units at \$25,000 per unit.

Assumption No. 2: Soviet Production Schedule

First year --	40 units
Second year --	50 units

(This schedule required to meet third year demand)

Assumption No. 3: Projected Soviet Use

First year --	20 units
Second year --	10 units
Third and subsequent years --	10 units

Assumption No. 4: Projected Sales to COMECON countries

First year --	00 units
Second year --	20 units
Third year --	40 units
Subsequent years --	Uncertain

Assumption No. 5: Western European Sales

Units available for sale to Western European countries to comply with contract. (Valued at \$12,500 per unit)

First year -- (equivalent to \$250,000)	20 units
Second year -- (equivalent to \$250,000)	20 units

Assumption No. 6: U.S.S.R.-COMECON relationships

Soviets can require COMECON countries to pay in hard currency.

Assumption No. 7: Invoice Value

Invoice value is \$12,500.

A Metacom negotiation team member prepared this data during the last round of negotiations. It was further assumed that the Soviet Ministry would need 15 APG devices for its automation effort. Quality control experts felt that, under new production conditions, approximately five units per year would break down and require replacement. Others might be needed if the scope of the Soviet project expanded.



## METACOM CORPORATION (Soviet Version)

V. I. Efremov, a negotiator for the No. 10 Office of Licensintorg, the Soviet All-Union licensing organization, sat at his desk and considered the status of his negotiation with Metacom Corporation, a U.S. computer software company. Licensintorg had been engaged in an effort to buy a license for the manufacture and exclusive Eastern European distribution of Metacom's automatic program generator (APG). Negotiations had begun two years before and were now stalled over the price of the license.

Herbert Gray, Metacom's president, was expected to fly to Moscow from Los Angeles in three days. Efremov's opposite number in negotiations, John Howe, had requested a meeting between Gray and the Soviet Minister of Transport to help resolve the pricing impasse. Efremov believed it was not necessary to bring in the Minister to resolve such a small problem, but, he needed to bring the negotiations to some conclusion.

### Background

In mid-1977, the American Metacom firm suggested to Licensintorg that the organization should buy the license for the technology to produce Metacom's APG. Not long before this, the Ministry of Instrument Making and Means of Automation had asked the State Committee on Science and Technology of the Ministry of Foreign Trade for authorization to buy a license for an electronic programming device intended to automate the U.S.S.R.'s railroad control system. The authorization was granted, and the Ministry of Instrument Making requested that Licensintorg Office No. 10 (which was in charge of license imports for electronic devices) buy the APG license. Thus, Licensintorg was interested in the Metacom proposition.

### Soviet Need for an Automated Program Generator

The APG device was designed to be used in conjunction with IBM 360/370 computers, but the Soviets believed the device could easily be adapted to fit their "RYAD" series computer, which was used throughout the U.S.S.R. and other

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This case was prepared by Leonard Schwartz, Jack Austin, Robert Grant of New York University's Management Decision Laboratory, Professor Myron Uretsky, Director. Revised by Professor Leslie E. Grayson and Sean M. Kelly, research assistant, University of Virginia. Copyright (c) 1990 by the Darden Graduate Business School Foundation, Charlottesville, Virginia. WP5638L

Council for Mutual Economic Assistance (CMEA) nations.\* When connected to a computer's mainframe, the mechanism, with the use of a few macro-statements, automatically constructed programs and prepared reports. Its physical appearance resembled an augmented Report Program Generator (RPG). Although the APG was a new technology, it was fully patented. It was produced with an integrated circuit type available throughout the industrialized world, but the circuit design was classified as proprietary information.

The Ministry of Instrument Making experts authorized the license purchase request on the grounds that, in past years, the Soviet transportation network had been strained beyond its intended capacity. Presently, a serious factor affecting the Soviet transportation industry's further development was the limited capacity for transmission, the shunting capacity of certain railroad stations and harbors, and the rolling stock's insufficient size.

The use of automatic and telemechanical systems built on the basis of computers was growing rapidly in the Soviet Union. These systems permitted the automatic control of trains moving on high-speed passenger tracks (the length of such tracks could be up to 5,000 kilometers) and also the integrated automation of the car-classification process at shunting yards. Compared with the 1965-70 period, the outfit of the U.S.S.R. railroads grew more than 1.5 times for electric centralized controls, and 30 percent for automatic blocking. The introduction of automatic blocking and electronic centralization during the period, Soviet railroads left the United States and other countries far behind.

Moreover, the high rates for introducing automation and telemechanics were to be maintained until 1990. The Ministry of Transport planned to equip more than 20,000 kilometers of railroad with automation and centralized traffic control, to include 55,000 switches in the electric centralization system, to automate about 100 shunting yards, and to carry out large reconstruction works of already operating automatic devices.

The railroad traffic of the U.S.S.R. made great demands on the systems: They not only had to operate reliably, but they had to ensure that traffic flow was safe. They could not allow accidents, breakdowns, or damage during functioning.

On the order of the Ministry of Transport, the Scientific Research Institute (NII) of the Ministry of Instrument Making and Means of Automation began a project to design a computer system for railroad-traffic control in 1973. After a year, it was apparent that fulfillment of the project would be delayed by the need to create an automatic programming device for the layout. Great quantities of time and resources would be required to test and apply the automatic programming device, devices of this kind designed to be manufactured in the Soviet Union had only recently begun to be developed in the country.

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\*CMEA is the political and economic organization which coordinates trade and investment among the Soviet Union and most Eastern European countries.

### Search for an APG

Having received the Ministry order, Licensintorg began the preliminary work for an APG license purchase. It was quickly apparent that the APG, as well as the requisite-sized computer, could be technology for which export to socialist countries was restricted by Cocom, the coordinating committee of Western countries that controlled trade with Soviet Bloc countries.

On the world market, besides Metacom, the main producers of these devices were: Texas Instruments (U.S.), Sercelle (France), and Schlumberger AG (West Germany). Texas Instruments and Sercelle did not send an advertising technical description of the APG to Licensintorg. Office No. 10's Director Efremov remembered that the office staff was surprised how the Ministry of Instrument Making's instruction coincided with Metacom's proposal.

During an Office No. 10 meeting, the responsibility for establishing a contract was assigned to Efremov. He fixed a meeting with the representatives of the Ministry of Instrument Making for a few days later. These representatives were responsible for evaluating the descriptive technical materials received and for determining missing information.

A preliminary analysis of Metacom's and of Schlumberger's APGs showed that, according to its main parameters, Metacom's was preferable for the licensee. Standardization was the most important factor for small railway-station areas.

Three months after the careful preliminary study of what the users required from an APG, Efremov realized that some specifications from the two APG patents were necessary. He sent a telex to Metacom and to Schlumberger asking for these details and soon received the requested data.

Six months after the first contacts between their representatives had been made, Licensintorg sent a request to Metacom for a proposal. The Soviet proposal disposed of all the necessary prerequisites for successful exploitation of the license:

- o The Soviet Union electronic industry had sufficiently qualified experts to produce APGs. Moreover, Soviet experts usually had a good knowledge of English and could, therefore, learn the specialized tasks efficiently at Metacom's facilities.
- o Economic and production technical capabilities in the Soviet Union were good, thanks to a well-developed electronics industry.

The U.S. technical experts confirmed that the U.S.S.R. Ministry of Instrument Making possessed sufficient technical capabilities to implement the APG license in accordance with the Metacom documentation. A number of American firms had previous experience in selling electronic production licenses to the U.S.S.R.

Some time later, a letter from Gray arrived at Licensintorg in which the Soviet purchase offer was accepted. Two possible types of sale were proposed: (1) outright (full) purchase of the APG devices with indirect management assistance from Metacom or (2) the purchase of the license. An asking price of \$1.5 million was placed on the licensing deal. There was a technical description enclosed with the letter.

Efremov took the proposal to the technical council in NII that was discussing the project of an automatic control system for railroad traffic. The technical council thought purchase of the American-manufactured APG would be of no purpose, because the program for automation was a long-term one and it was necessary to develop the U.S.S.R.'s own APG production. Licensing, on the other hand, would permit improving programming devices' production technology in the U.S.S.R. The experts did not have enough technical details on the Metacom APG, however, to start technical negotiations.

Efremov mailed a letter to Gray to thank him for the proposal. He informed Gray that Licensintorg rejected the outright APG purchase offer, because it felt that they had to defend their national industry, but intended to buy the APG license and the technology of its manufacture. It would, however, only be possible to determine the utility of the license purchase if the licensee also obtained detailed APG specifications.

Two months later, Efremov received a telex in which Metacom proposed to come to Moscow in mid-December to conduct a technical seminar on the APG. After consulting with the NII of automation, Efremov agreed that the seminar could take place in the Institute's building.

The situation changed shortly after, when Schlumberger sent an offer for the Soviets to visit its APG production facilities. Moreover, the West German firm informed Licensintorg that its permanent representative in Moscow would hand over to Licensintorg APG specifications, a detailed description of the technology of manufacture, and a draft contract.

Efremov decided to take advantage of the Schlumberger offer and sent a telex to Metacom asking them to delay its seminar for six weeks. During this time, he could carefully study the West German APG documentation.

### First Contacts

The American APG seminar took place from February 1 to February 3. Metacom sent four representatives: John Howe, vice-president for International Marketing; Cathleen Lewis, vice-president for Research and Development, and two APG technical experts. Efremov mailed invitations to the representatives of All-Union organizations of the Ministry of Foreign Trade, the Ministry of Instrument Making and Means of Automation, the Ministry of Transport, and the State Committee for Science and Technology.

The seminar provoked much interest among the programmers and the electrical engineers. The hall was over crowded because of the great interest in the American experts' lectures. Efremov concluded the Americans were able to "present well" the material, but they did not communicate the more

interesting details. The Soviet experts asked many questions, which enlivened the seminar, and had it not been for time constraints, the seminar could have gone on forever.

Efremov was pleased. He knew that the successful seminar meant a good scientific/technical foundation for the license purchase because of interest, not only in one department, but throughout the State. This interest was very important for resolving any commercial problems.

During the post-seminar cocktail party, Efremov said to Howe, "If the working day had not come to an end, we would not have to buy the license for the APG." Howe seemed to understand the joke and laughed warily. Apparently, he also was pleased. Efremov anticipated that, in the course of their conversation, Howe would begin to talk about the next steps in their mutual contacts. He waited patiently, since he knew by experience that the one who took the initiative showed the greater interest in the deal, so waiting would allow Licensintorg to negotiate a more favorable deal. To Efremov's surprise, Howe did not start a conversation on the next steps. Efremov was somewhat puzzled. He had anticipated that, being buoyed by success, the Americans would show more initiative. On the other hand, he had not yet received the final decision of the engineers from the NII concerning a comparison of the technical characteristics of Metacom's and Schlumberger's APGs. The program-generator department head had promised to submit the evaluation at the end of February.

On March 2, Efremov received the technical evaluation of the characteristics of Schlumberger APG. In order to compare details with the American APG data, more specific information from Metacom was necessary. Once more, apparently, Efremov would have to take the initiative to address Metacom. He was reluctant to adopt this strategy, however, and therefore delayed the step. As often happens, chance came to help. At a directors meeting of Licensintorg, Efremov learned that Metacom was having a new round of activity in its relations with Licensintorg and that Metacom was extremely eager to sell the APG license.

On the same day, Efremov sent a telex to Metacom asking them to mail some additional data. The telex required information on the technology of manufacture, the circuits, the assemblage of APG, and the accompanying implementation programs. Knowing how jealously licensors guarded information on manufacturing details, Efremov himself had little hope for a positive result. But with this step, he saw the possibility of reviving the contacts. Time began to worry him. The deal was dragging on.

To his surprise, instead of new data, Efremov received a draft contract. The accompanying letter suggested that Licensintorg provide some indications of its intent to negotiate. Based on such an indication, Metacom would be willing to host a delegation's visit to some of its production and research facilities.

At once, Efremov set about to study the draft contract and gave corresponding instructions to his engineers. At the same time, he began to work on the composition for a delegation to the United States and a program for technical negotiations with Metacom. As soon as the main problems were

solved, he mailed a letter to Metacom's president informing him that Licensintorg would be glad to visit Metacom's production facilities. He suggested a date for a ten-day visit at the end of May.

### The First Protocol

The Soviet delegation arrived in California with a certain feeling of nervousness. Each delegation member thought it was important to obtain as much information as possible--not only on the APG itself, but also on the technology and the operational procedures of manufacture. Their anxiety was understandable. The Soviet experts counted not only on purchasing the license to fulfill the Soviet railroad automatic control program requirements on time, but also to use this visit to adjust the manufacture of their most competitive programming devices. For the latter, many operational-technological problems had to be solved in order to reduce production costs in Soviet enterprises. This demanded that the Soviets become acquainted in detail not only with the product's technology of manufacture, but also with its operational procedures. Streamlining production would, in turn, make possible lower prices for export. Thus, during their first visit, the Soviet experts hoped to make a detailed study of the APG's manufacturing operations. In fact, it was one of the most important aims of their visit. Consequently, they were very upset when the U.S. government refused a visit to the research departments and facilities where the APG was manufactured.

Moreover, although they understood that the given licensing deal would be linked to the delivery of materials and equipment for the implementation of the production by the licensee, they also knew through experience that some subtleties of production and operational procedures ("secrets") were of major importance for ensuring the efficiency of the manufacture. The subtleties, however, are often not mentioned in the documents on the manufacturer's technology and could only be obtained through personal contacts and individual observations. Russians even had a saying that "to see is better than...." Unfortunately, Metacom outlined well overall technical and manufacturing abilities (the Soviet experts had little doubt about that), but the company did not allow them to become acquainted with the actual APG manufacture in its facilities.

The Soviet delegation signed a protocol of their visit, in which they expressed the wish to start technical negotiations in Moscow as soon as possible. Efremov was worried which strategy to select for the next Metacom negotiations. He was fed up with getting nowhere.

### The Technical Negotiations

A month later, the Metacom delegation arrived. In a telex, they had expressed their wish to visit the plant where electronic parts and printed circuit cards for program generators were manufactured. Efremov got in touch with the Ministry of Instrument Making. They rejected the American delegation's request. Efremov was not surprised. He believed, "They still feel some bitterness about the rejection of a similar request at the time of the visit to the U.S.A." He did not insist since, by and large, the refusal

was in accordance with the new strategy he himself had chosen for further negotiations with Metacom.

The NII appointed two experienced engineers (a designer and a production engineer) for the negotiations. On the day before the American delegation's arrival, Efremov had a conversation with the engineers and advised them "how" and "what" to do.

Efremov anticipated that the Americans would, first of all, be eager to discuss the draft contract. But he was wrong. The American experts were, as in their telex, mostly interested in whether or not the U.S.S.R. could produce high-quality APGs with the American license. "In principle, this is logical," Efremov reflected, "but to do this we must propose that they visit our factories. It is too soon for that."

At the end of the negotiations, a protocol to continue commercial negotiations was signed. In its appendix, Metacom agreed to provide all technical and technological data of the APG license which was reviewed a few weeks later.

Two days of negotiation were spent discussing the merits of Metacom's APG and on convincing Metacom officials that the Soviets genuinely had the technological capability to produce high-quality APGs. With this assurance, a protocol to confirm that negotiations would continue was signed. It carried the condition that Metacom send technical information on the manufacture of printed circuit boards for commutating the APG with other devices. The data came within a week, as Efremov anticipated. He now had to decide whether to pursue negotiations with Metacom or switch over entirely to Schlumberger.

Based on the potential broadening of licensing trade between the United States and the U.S.S.R., the directors of Licensintorg decided during a meeting to make the first "gesture of good will." Licensing trade was beneficial for the Soviet Union and was an important factor in the solution of many technical and commercial problems. In particular, it led to a reduction in the expenditures of time and means for scientific research, for projects, and designing. It promoted improvement in the U.S.S.R.'s general technical level, and it contributed to the creation (based on the knowledge and the experiences acquired with the licenses) of original designs and processes that, according to technical and economic indices, were not only not inferior, but, experience showed, were often superior to the foreign ones. Analysis of the adaptation of foreign licenses in the U.S.S.R. showed that the economic effect of their use during the period of the license contract exceeded many times the license expense. For the U.S.S.R., license purchases complemented its own research work, because licensing deals allowed the country to concentrate on its own efforts and resources on primary research work, the scale of which was enormous: increase its scientific/technical potential of a country that is building a communist society.

The consideration of all these advantages of the licensing trade and of the endeavor to strengthen commercial and economic connections with American firms on a mutually beneficial basis, led to the "good-will" decision to authorize an American visit to a manufacturing plant for program generators. Efremov sent a telex to Metacom suggesting that the negotiations might again

resume. Licensintorg anticipated, and not without reason as future events showed, that the Americans would respond with the same kind of good-will actions.

Three months later, when the Metacom team arrived, they were allowed to visit a production site in Minsk. The visit was short and reminded Metacom members of the Soviet team's visit in California. During conversations between the Metacom experts and Minsk factory engineers, the Americans expressed serious doubts as to the production capacity at the disposal of the Soviets to manufacture APGs. The official representatives of the Ministry of Instrument Making assured the Americans that there were, however, other facilities in Tbilisi, Soviet Georgia, for the production of program generators.

### Commercial Negotiations

The two groups finished the technical discussions and agreed to return to Moscow to begin commercial negotiations. After some initial haggling, the Soviets agreed to Metacom's \$1.5 million asking price, but offered to make payment involving 20 percent cash (after testing the completed devices) and 80 percent in the form of a buy-back of the Soviet-manufactured APG devices. Under this arrangement, Metacom would receive Soviet-manufactured APGs as partial payment for the license. Efremov stated during the negotiations that Metacom's proposal of full payment for the license in hard currency was absolutely not acceptable for Licensintorg. Efremov was aware that the most important moment of the negotiations had been reached. He knew by experience that, in licensing trade, determining the licensing price was a complicated problem; it was inherent in a license that its actual commercial value could only be established in the process of direct exploitation of the license by the purchaser.

Usually, the determination of a license's price began for the purchaser with an attempt to assess the potential profit after bringing the invention into production. The determination of the profit dimensions allowed the buyer to establish whether the license's purchase was advisable, as well as to estimate the size of the regard the licensor will receive. The licensor was interested, first of all, in ensuring that the profit from the license sale should not be less in total than the profit from other forms of the invention's exploitation.

The economic advisability of buying a license depended on the proportion of the profit the licensor and the licensee would receive. The licensor's part could vary widely, from one-tenth to one-third of the profit the licensee made from the licensed production. This proportion was determined by taking the following factors into consideration: (1) the number of products produced under the license, (2) the extent and the nature of the rights incorporated into the license, (3) the technical help of the licensor, (4) the territory licensed for production, use, and sale of the licensed product, (5) the duration of the license contract, and (6) the forms of payment. (For commercial assumptions used to determine license value, see Exhibit 1).



A few days after the departure of the American delegation, a telex came from Metacom proposing a payment of 60 percent hard currency and 40 percent buy-back. Efremov was aware that this was a step forward on Metacom's part, but he believed it was necessary to exert still more pressure. The only possibility he saw was the competition between Metacom and the West German firm Schlumberger AG to obtain a contract.

### Resuming Commercial Negotiations

During the new round of negotiations, the Licensintorg representatives insisted on a 40 percent cash payment and a 60 percent buy-back with a deal value of \$1 million. Efremov knew Metacom would not easily agree to these new percentages, and the lower deal value.

An important element of Metacom's position was the question of the technical help the licensor's experts should give to the purchaser for implementing APG production. The licensor would hand over experience, knowledge, and manufacturing secrets for the licensed production in the form of technical literature and by sending its experts to the licensee's facilities. The licensor would also train the licensee's specialists at its own plants with the aim of transmitting to them its experience, methods, and skills. In both cases, Metacom would have to disengage a part of its experts for some time from their usual work, which would create "a definite financial loss for Metacom". Metacom's representative stated that it was willing to agree to a deal value of \$1 million only if payment came in 50 percent/50 percent portions.

However, in the course of the negotiations, Licensintorg's representative stated that it was international licensing practice for the licensee (i.e., the Soviets) to compensate the licensor for such losses incurred. They would assume all expenditures linked with the mission of Metacom's experts, namely: transportation expenditures, hotels, medical help, daily allowances, etc. Licensintorg's opinion was that, on the given question, Metacom's position was not justified, and they insisted on the deal value of \$1 million, 40 percent hard currency, and 60 percent buy-back.

After lunch, Howe said to Efremov that the Americans were ready to return to the United States.

"I feel that we cannot settle this issue!" he said. Howe suggested that perhaps a meeting between President Gray and the U.S.S.R. Minister of Railroad Transport (as the most important customer) could break the deadlock. The Licensintorg representative expressed his doubts that such a meeting would be possible. He explained that the Minister of an industry in the U.S.S.R. does not usually get involved with the solution of such "small" problems. The level of the Chairman of the All-Union Organization Licensintorg was quite sufficient for this problem, since he was empowered to make decisions in the name of the country on these kinds of commercial questions. "Moreover," he said, "I understand that the Ministry of Foreign Trade is also interested in this merchandise as a future potential starting point for broadening our export."

Howe inquired why the payment terms had become such an obstacle. "I feel," he said, "that we have made major concessions, like the buy-back arrangement. The hard currency amount is not that great that you cannot make a concession on this point if you are serious."

Efremov explained that the Ministry was considering several very important projects, many of which would require hard currency. "Our resources are not in endless supply," he added. "We, like other States, try to make the most of the advantages in foreign economic connections in terms of mobilizing additional capabilities in order to solve our economic problems successfully, and to gain time for improving our production efficiency and for speeding up science and technology progress. In particular, we have in mind compensatory agreements where the enterprises, wholly owned by our state, adjust their production output with the collaboration of foreign firms. We receive credits, equipment, licenses, and in turn, we pay with part of the goods that are produced in these, or other, enterprises. In Soviet foreign trade, the practice of compensatory agreements has been widely developed.

"In the case of a successful adaptation of the APG license, we wish to sell them not only in the CMEA market, but also on the market of developed capitalistic countries in Western Europe. But to do so, Metacom must widen the territory of its license agreement for the Soviet side."

In the evening, after his talk with Howe, Efremov analyzed once more the events and looked through his notes. In three days, the negotiations would be resumed. How must he conduct the further negotiations?

Exhibit 1  
Production Assumptions

Assumption No. 1: Soviet Production Schedule

First year --	40 units
Second year --	50 units

(This schedule required to meet third year demand)

Assumption No. 2: Projected Soviet Use

First year --	20 units
Second year --	10 units
Third and subsequent years --	10 units

Assumption No. 3: Projected Sales to COMECON countries

First year --	00 units
Second year --	20 units
Third year --	40 units
Subsequent years --	Uncertain

Assumption No. 4: Western European Sales

Units available for sale to Western European countries to comply with contract. (Valued at \$12,500 per unit)

First year -- (equivalent to \$250,000)	20 units
Second year -- (equivalent to \$250,000)	20 units

Assumption No. 5: U.S.S.R.-COMECON relationships

Soviets can require COMECON countries to pay in hard currency.

Assumption No. 6: Invoice Value

Invoice value is \$12,500.

Assumption No. 7:

The Ministry of Transport would need 15 APGs for its automation effort and 5 replacements would be needed each year, beginning in year 2.



## PHARMACAL CORPORATION (U.S. Version)

George Maxwell slouched back into the big black swivel chair. He tossed his pen forward onto the yellow lined writing pad lying on the conference room table. The Techniport Associates consultant thought "a familiar sounding story." The vice-president of research of Pharmacal Corporation, Dr. Victor Elliott, had just related the incredibly complex and frustrating story of his firm's 34-month effort to obtain a license from the Soviet Union to manufacture and market a cardio-vascular drug called "Corydon." Pharmacal Corporation was a major United States pharmaceutical firm, based in Philadelphia and it was approaching Techniport because it hoped to use the consultants' expertise to get the talks moving again. "I hope," Elliott commented, "we can sort out all of this with your advice. We are not yet ready to abandon the talks--although some at Pharmacal have suggested such a move."

Maxwell rose from the chair, hands in his pockets, and glanced at the distraught Elliott, and smiled: "Where do I find your legal counsel?"

### Background

Elliott had initially read about the drug Corydon in an August 1976 issue of a British medical periodical. Corydon was reported to be effective in the treatment of cardiac-arrest patients. Pharmacal's research laboratory had been working on a similar product, but the journal article reported that test results suggested Corydon was more effective than Pharmacal's potential product.

Elliott clipped the article and sent copies to several colleagues. He did not immediately entertain notions about obtaining a license to produce Corydon, however. In fact, he began to consider that possibility only a few days later while contemplating Pharmacal's own progress. After several consultations with his technical staff, Elliott recognized the utility of acquiring this license. His first step was to create a small task force to investigate the situation.

After some deliberation, the task force recommended that Pharmacal seek to obtain the license and reinforced its recommendation with two clear-cut arguments: (1) Corydon could potentially reduce Pharmacal's cardiac-arrest treatment research and development costs, (permitting Pharmacal to devote resources to seeking other medical breakthroughs) and (2) licensing Corydon would elevate Pharmacal to the state-of-the-art in the area of cardio-vascular drugs.

### **Initial Contacts**

Pharmacal's marketing vice-president, Mort Geller, was assigned to locate the Soviet organization having jurisdiction over Corydon. Geller first sought guidance from the U.S. Department of Commerce, which suggested that Licensintorg's "food and drug" department would be the proper Soviet agency to contact. Armed with this knowledge, Geller sent a letter of inquiry on February 18, 1977.

Three months after Geller's original dispatch, he received a response. Licensintorg forwarded some general literature describing Corydon's effects in Soviet laboratory tests. Elliott reassembled his task force to consider and assess the new materials. The consensus of the group was that much more information was needed to make a decision on whether to pursue a licensing agreement.

Pharmacal thus again wired Licensintorg to request more Corydon information. The Soviets did not respond until September. In that telex, Licensintorg indicated that the requested information could not be made available. However, it did invite Pharmacal to meet with the Soviets in Moscow. A December 3 target date was eventually set.

In late September, Pharmacal determined that it needed further background data in order to prepare for the December meeting. So it sent a telex to its Licensintorg contact, Dr. Tatyana Kravchenko. Licensintorg did not respond, however. Following this incident, Elliott commented to Geller, "Salesmanship?" At that time, Geller felt likewise: "So much time, so much correspondence, and so little result--and all to set up a meeting."

### **The December Meeting**

On December 2, the Pharmacal team arrived in Moscow. Elliott, Geller, Roger Bentel (head of Pharmacal's legal department), and Adam Tabor (one of his staff) were the four representatives Pharmacal sent to Moscow. Although the latter was new to the legal staff, Elliott believed that Tabor's previous East European experience would give him insights into "the way things worked in Moscow." In fact, Tabor was the only executive at Pharmacal with any experience doing business with Eastern Bloc countries.

Each member was excited about the prospects of "finally" learning more about Corydon's effects and production process. At 9 a.m. the next day, the Pharmacal team and their respective Soviet counterparts all assembled around the conference table at the Institute of Pharmacy. The host was Dr. Yuri Kozlinsky, Director of the Institute of Pharmacy's Chemical Division. Licensintorg's Kravchenko and several researchers involved in Corydon production accompanied Dr. Kozlinsky. An interpreter sat adjacent to Elliott. Also in attendance was a Pharmacy Institute patent office official, who sat in the far corner of the room.

Elliott and Kozlinsky greeted each other warmly. Elliott experienced a sense of professional camaraderie; one of his first questions to Kozlinsky concerned the institute. Elliott expected to visit production facilities like those at Pharmacal. Kozlinsky responded by explaining the Institute's relationship to the enterprises engaged in medicine and drug production. The Institute only did research and development of new drugs; production was done under the auspices of another ministry.

The cordial atmosphere carried over into the first phase of the ten-day discussions, but as soon as the Pharmacal team requested a five-kilo sample of Corydon for test purposes, an air of tenseness permeated the room. Kozlinsky leaned over to one member of his research staff and uttered a sentence or two in Russian. "This will not be possible, Dr. Elliott," said Kozlinsky. "But perhaps," he added, "we can talk about this later on when it might be more appropriate."

The Pharmacal team reflected Kozlinsky's comments. Then, Tabor leaned over to Elliott and whispered, "But these are the amounts the FDA requires. Perhaps they don't realize that we'll pay for the sample? All they have to do is take it out of the lab stock." "Well, certainly," Elliott responded to Kozlinsky, "we must have more test data available to us to continue talking about Corydon." Kozlinsky concurred with his U.S. counterpart.

Having reached an impasse regarding the size of the sample required by Pharmacal, the two sides agreed to adjourn until the next day. That night, the Pharmacal team sought refuge in the National Hotel's only watering hole. As they sat around one of the bar's tables, they outlined the necessary information. "I realize," Tabor told the group, "that we are going to get very little information that is not already in their patent for Corydon."

Elliott asked, "What do we do about the sample?"

Roger Bentel suggested, "I don't particularly feel trusted. How do they expect us to be able to make a good economic determination?"

Pharmacal's need for more information was the top agenda item when discussions resumed the following morning. Kozlinsky began, "I have further researched the possibilities for obtaining a large sample of Corydon for your tests. According to my

staff, it would be impossible to produce such a large sample at this time."

Bentel and Tabor looked at each other. Elliott reiterated his stand: "Five kilos is not a large sample. And, furthermore, it is a required sample for our government's tests!"

"We can send Washington, D.C. the results from our tests at the Institute if it will help," Kozlinsky offered. "Five kilos would be like going into commercial production for us. Look, Corydon is produced from the glands of specially bred animals. This requires great amounts of time and staff and resources. Without Soviet production of Corydon, we could give you maybe half a kilo of the drug on which to run tests."

Elliott leaned toward Bentel, "I am getting frustrated with this."

Bentel responded to Kozlinsky, "Half a kilo is not enough to meet the standards of the Food and Drug Administration in the States."

Elliott meditated on a new strategy. He spoke up, "I think we'd be willing to bear the costs of the tests if you were able to provide Corydon for them."

By the fourth day of talks, no agreement had been reached concerning provision of data, samples, or tests. During that day's lunch, Elliott broached the possibility of disengaging from the talks to Kravchenko: "I think we may have to leave Moscow. As much as I had felt inspired to obtain this license, I cannot risk bringing something back which is this uncertain."

Kravchenko acknowledged that she understood his feelings.

Later that afternoon, Kozlinsky announced to the Pharmacal group that some additional tests could be run and that a one-kilo sample of Corydon could be made available. Bentel thought this suggestion showed "they were just holding out--negotiating tactics."

The Soviet and American representatives agreed to break from the talks for a couple of days. Their next get-together was December 9. For the morning, the Soviets arranged a short visit to the laboratory where Corydon was developed. In the afternoon, the Pharmacy Institute's officials hobnobbed over drinks with their U.S. guests. Tabor excused himself from the socializing and went to visit the Kremlin.

#### **A Telex in May**

Several months later, in May 1978, Elliott received a telex from Kravchenko informing him that the supplemental clinical data agreed upon in December had been



prepared. The Soviets wanted to present Pharmacal with new test results and to discuss certain of the license's commercial aspects. In order to take this next step, the Soviets were sending a team to Pharmacal's Philadelphia offices in late August. The group would include Pharmacy Institute Director Dr. Krabentsov, Kozlinsky, Kravchenko, and a representative from Medexport, the Soviet medical Foreign Trade Organization, (FTO).

As the impending August meeting date drew closer, Pharmacal's task force commenced mapping out a strategy with which to enter the next round of talks. Then, two weeks prior to the Soviet delegation's anticipated arrival, Elliott received another telex: "Talks to be held in October. Will contact further."

When the task force pressed Elliott to explain the delay, he could only say, "I have utterly no idea. I felt sure they would arrive with the information."

### **An October Meeting**

The Soviet delegation did arrive in October. It was augmented by an unexpected fifth member, Nikolai Andreyev. Bentel presumed Andreyev was his legal counterpart.

Before the two groups actually got down to business, Pharmacal took the Soviet contingent around to visit many of Philadelphia's historic sites. Elliott felt a great deal of pride as he escorted the visitors through autumnal Philadelphia. He also felt good about the up-coming talks. He was certain they could clarify any issues left dangling from the Moscow meeting. Kozlinsky also informed Elliott that the Pharmacy Institute director was interested in visiting various U.S. production facilities. Geller arranged three visits for later in the week.

During the Philadelphia talks, Krabentsov revealed that his Institute had developed more efficient Corydon production procedures than were previously used. When Krabentsov explained what these improvements were, Elliott manifested great pleasure. He told Krabentsov, "I hope this means that further tests will be possible. We believe that Corydon will perform very effectively when the tests are conducted."

Kravchenko interrupted and said she would investigate the possibility of providing Pharmacal with another half kilo.

On the following day, the Soviet and U.S. teams discussed some aspects of the commercial arrangements. "Pharmacal," Bentel proceeded, "is of course interested in obtaining the license for North, Central and South America for Corydon production and distribution."

"I am afraid," Kravchenko told him, "that a Cuban enterprise has nearly completed licensing talks with us for South America. I believe we might start these talks with a

license covering the United States. Perhaps the U.S. and Canada. We might," Kravchenko added, "allow a division of South America in return for your assistance to the Cubans in building their manufacturing facilities."

"Absolutely not!" responded Elliott. "This is not allowed in our law, and we would not be interested in such a deal even if it were," he continued.

Pharmacal again emphasized its desire to obtain distribution rights for all of North and South America. "We might be willing to give up the Central American nations though," Elliott noted.

Bentel suggested that the group return to this item at a later point in time. "Why don't we move on to another point for now," he suggested to the group.

Geller proposed they talk about the type of payment for the license. "We would like to see an up-front payment for a small percentage and the bulk of the payment to come in the form of royalties," Geller offered.

Kravchenko indicated that Licensintorg would prefer a larger up-front payment.

"I think," Geller added, "if we can solve the territory issue, then we will have little problem coming to an agreement. I am convinced we should continue our technical discussions." He thought to himself, "Perhaps they will be less reluctant to talk now."

When the Soviet contingent headed home to Moscow from Philadelphia, numerous issues were left unresolved. In particular, the need to meet FDA standards remained. The issue had not burdened these meetings as it had the Moscow talks, but it nevertheless was a matter with which they would have to deal at some time. Elliott believed the additional data the Soviets had now supplied was useful, but not sufficient to satisfy Pharmacal's needs. The data showed that Corydon had withstood some testing, "but not enough to pass FDA standards."

### **Following Up the October Meeting**

Four months elapsed with no further word from either Kravchenko or Kozlinsky. Elliott told Geller, "I'm beginning to wonder what's going on."

Geller suggested that Pharmacal wire Kozlinsky again to request that he send some of the information that was supposed to be forthcoming. That telex was transmitted in early March 1979. Still, there was no official Soviet response.

When the Soviets did make contact in June, they notified Pharmacal that they would make available one kilo of Corydon. Licensintorg said it could be submitted to

the FDA for tests. The telex further indicated that this would be the greatest quantity with which they could provide Pharmacal. The telex's conclusion stated that, in order to protect the license's value, the U.S. drug company could not publicly release further data concerning Corydon.

### **Elliott's Response**

Elliott sat back in his office chair to read the telex. He wondered in which direction the negotiations were headed. As if this state of affairs was not enough pressure, later that same day Pharmacal's president zapped off a memorandum to him to ascertain the point at which the talks now stood.

Elliott met with President Miller the next day to clarify the situation. During the discussion, the president suggested it might be a good idea to retain a consultant to expedite the deal. Elliott concurred with his chief. During initial legwork, several colleagues from other firms recommended Techniport Associates, a small firm specializing in licensing transactions.

In the meantime, Elliott notified the Soviets at Licensintorg that he remained interested in conducting tests on the sample. He added, however, that he required at least one extra kilo of Corydon to conduct the tests.

### **Maxwell's Assignment**

Elliott asked George Maxwell, Techniport's East-West transactions expert, to his office in late July: "We want your assistance in understanding what is going on over there and in loosening up the information we need. Although we are interested in Corydon, it is becoming very expensive to continue these talks. If nothing else, the time involved discussing the same points is frustrating. Frankly, George, I don't feel as if we are making ourselves clear to them. What do we do?"



## PHARMACAL CORPORATION (Soviet Version)

Dr. Tatyana Kravchenko, a director of Licensintorg, the Soviet Union's industrial licensing agency, thought about the impasse in negotiations with Pharmacal Corporation, an American pharmaceutical company. Kravchenko was a graduate of the All-Union Academy of Foreign Trade and had ten years' experience dealing with West European and American firms. Negotiations with Pharmacal on licensing the U.S.S.R. drug Corydon, which had lasted more than two years, now seemed to be bogged down by difficult requests from the Americans. She wondered about the events that had brought her to this point and how the parties could restart negotiations.

### Background

The U.S.S.R. Institute of Scientific Research for Pharmacology had sought for ten years to create an effective cardio-vascular drug. "Corydon" was the result of long, expensive work by a highly qualified staff in sophisticated, modern Soviet research facilities and laboratories. Tests gave evidence that Corydon was a more effective drug than other similar ones existing either in the U.S.S.R. or abroad. With the help of the Institute's patent bureau, the invention of Corydon was officially announced, and the drug was registered with the U.S.S.R. Committee for Inventions and Discoveries. The drug's information was published, first in the patents and inventions bulletins, then in Soviet and foreign scientific periodicals.

In February 1977, Licensintorg's drug and medical equipment department received a letter from the American Pharmacal firm asking to buy the Soviet license for U.S. Corydon production. Kravchenko had been sincerely pleased with the proposal. From her experience in dealing with West European and American firms, she knew that finding a purchaser for a license was a tedious task fraught with laborious preliminary work. In the case of drugs, it was complicated by the fact that advertising, except for publication of information in specialized medical periodicals, was impossible.

Kravchenko assigned preliminary study of the proposal to engineer Mikhail Sidorov's team, which specialized in the export of cardio-vascular drug licenses. The team also was busy studying another contract to license Corydon for export, but that one was already in the commercial-negotiations stage. Kravchenko asked to be informed of the investigation results in two weeks.

The next day, Sidorov called the chemical division at the Institute of Scientific Research for Pharmacology, which had developed Corydon. The director, Dr. Yuri Kozlinsky, was away on business. When Kozlinsky's substitute heard what the matter was about, he suggested waiting for the director to return in five days, because the substitute was not authorized to handle such questions. The meeting took place the next week.

Kozlinsky was interested in Pharmacal's proposal. He was also flattered that the laboratory's many years of work had won international recognition. After the meeting with the Licensintorg representatives, Kozlinsky met with the heads of his Institute and the patent bureau. They approved Licensintorg's proposal to sell the Corydon license. The Institute would derive important foreign currency revenues from the license's sale that could be used to buy necessary foreign equipment for scientific research. The Institute director feared only that it would be necessary to disengage some experts from their current work in order for them to attend the meetings, to prepare the necessary literature and carry out additional tests. Their absence would make it difficult to fulfill important planned work on time. Moreover, because summer vacations would soon begin, it was decided that correspondence with Pharmacal should begin at once, with the Institute patent bureau's assistance. Other questions, requiring the use of further resources, would be delayed until fall.

Kozlinsky informed Licensintorg of the decision and, at the same time, mailed copies of all the Corydon literature published in Soviet medical periodicals to Pharmacal. Sidorov prepared an accompanying letter. A month had passed since the original inquiry.

The Committee for Inventions and Discoveries was contacted at the same time, because it had to approve the potential sale of the Corydon license. A month later, Pharmacal's answer thanking Licensintorg for the literature and requesting more information was received. At a meeting between Sidorov and department head Kravchenko, they decided that additional information could reduce the license value. The licensee was notified accordingly.

By May 1977, the license deal correspondence had reached the point at which a meeting of experts had become necessary. The drug's quality, the clinical test results, and the technological procedure in its production had to be discussed. Kravchenko was in no hurry to send the telex fixing the meeting with the Americans, however, because

she knew that their reaction would be immediate, and negotiations during the summer were undesirable for the Research Institute of Pharmacology.

At the end of September, the Institute received a telex from Pharmacal requesting background data on Corydon to be used in preparing for a meeting. Kravchenko interpreted the telex to imply the Americans felt the necessity of direct negotiations, not that they really desired data, because the Americans already knew everything that could be communicated. She began to discuss a desirable date for the negotiations with Kozlinsky. She had no reason to hurry, because Sidorov's team was busy preparing for another contract signing in October. She did not think it advisable to pass the Pharmacal deal to another team, because the trade specialization of Sidorov's team would allow them to conduct the most successful negotiations. The meeting was fixed for early December 1977.

### **Negotiations Begin**

Four American experts representing Pharmacal--Dr. Victor Elliott, Morton Geller, Roger Bentel, and Adam Tabor--arrived in Moscow, and the meeting took place in Kozlinsky's office. Kozlinsky had a great deal of experience in laboratory work and international exposure from attending scientific conferences, but this was the first time he had participated in trade negotiations with a foreign firm.

Also present at the meeting besides Kozlinsky were two senior Institute researchers (a man and a woman), a patent bureau representative, Licensintorg Director Kravchenko, and an interpreter. The main panelist of the negotiations was Kravchenko, who was aware that the success of further negotiations depended on how certain interrelated questions concerning trade policy, scientific/technical problems, trade finances, and patent laws would be solved. All the researchers were directly related to the process of synthesizing Corydon. The meeting's beginning was kept to an official tone. There were many silences, which Kravchenko had to fill with general questions on the weather and how things went at Pharmacal. After the Americans had been introduced, Kozlinsky relaxed somewhat: he felt his superiority in age and experience would compensate for his lack of experience in trade negotiations. Kozlinsky was, above all, interested in the following question: did the licensee have the necessary production and technical capabilities for manufacturing according to the documentation that was currently available. Of secondary importance was: did Pharmacal employ sufficiently qualified specialists to manufacture Corydon initially under laboratory conditions. Would it be necessary either to train Pharmacal's specialists at his Scientific Research Institute, or for his laboratory to give scientific technical assistance directly at Pharmacal's laboratories? Kozlinsky was alarmed by the latter possibility.

These opening technical negotiations lasted six days. The first day, the negotiations agenda was established and approved. Mutual agreement on the program

eased the tension between the participants, and the subsequent events had a less official character.

The next day, the Americans said that additional information about the pharmacological characteristics and the results of clinical tests should be given to them, as well as a sample of five kilograms (kilos) of Corydon. From the very beginning, these requests threw the Soviet specialists into confusion. They did not have the right to give more information than was described in the patent. The representative of the Institute's patent bureau was present at the meeting for this purpose.

The American side brought into discussion the issue of the standards and norms existing in the United States--in particular, the norms determined by the Food and Drug Administration. They said that they could not rely completely on the Soviet results when buying the preparation, because these did not correspond to American standards. (Americans have to make the toxicological tests on clean lines of animals, and the number of patients used in U.S. clinical tests would be increased by four or five times in comparison with the Soviet Union.)

The Americans said, that for their part, they would be ready to help with more testing, since they could conduct additional clinical research, but aside from this aspect, they needed auxiliary chemical tests for which they would require five kilos of the preparation as a sample. They assumed the sample would not be difficult to get, since the production of Corydon was already adjusted.

The Institute had only five kilos of the substance available, and the American request took the Soviets by surprise. To produce five kilos at the Institute would be too complicated: neither the necessary equipment for synthesizing such a large quantity, nor the raw materials, nor the required manpower were available. Kozlinsky replied that small-scale production was underway, but that the Institute could not produce such a large quantity of Corydon, which would require almost factory-scale production. Corydon had not yet been put into factory production, and the Institute was only a scientific research institute, not a factory. They could not cope with such a task, having neither the necessary funds nor the facilities. Besides, they had already conducted clinical tests for quite some time and had no doubts about the preparation's effectiveness or its side effects. The Ministry of Public Health had authorized production of the drug; its technology was already developed, although the factories where it would be produced were not yet equipped with the necessary technical means for Corydon production.

The prospect of losing the license by failing to fulfill the American request was a question of prestige for Licensintorg, the Ministry of Public Health, and the Institute. On the other hand, they did not really believe that such a large quantity of the preparation was needed. Doubts arose about American intentions to use the preparation in the way they had stated. Time was needed, on the one hand, to dispel these doubts and, on the other hand, to find reserves for producing a half a kilo of the drug.



Later that evening, Kozlinsky met with Kravchenko, and mentioned his concern over the Food and Drug Administration. "We have reliable tests," he told her. "I believe our tests are accurate, and so must the Americans, or they would not be here."

"So why all this trouble over the FDA?" Kravchenko asked. "Is it really impossible to produce their request? Suppose the talks hinged on this?"

"I would not be able to meet other internal requests, things we have planned to accomplish," he responded. The maximum available to the Institute was three kilos of the drug. He pointed out to her, "We still need some for our own tests."

Kravchenko realized that Corydon production was a slow process using parts of specially bred animals. However, she told Kozlinsky that their offer of half a kilo might not be sufficient. "It is necessary for them to register the drug with the FDA; they have no choice," she insisted. Kozlinsky agreed to review the possibilities.

On the fourth day of negotiations, after a one-day break, the Americans were once more told that to fulfill their request for a five-kilo sample of Corydon was practically impossible. The Americans replied that, instead of such a quantity of the preparation, they could be provided with additional technological data that would enable them to produce the sample themselves.

Kravchenko realized at once that the Americans were beginning to bargain over advantages; therefore, she advised Kozlinsky not to hurry. Kozlinsky agreed that the issue was not the five kilos of Corydon, but that the Americans wanted to obtain more advantageous business terms. The negotiations were interrupted for two days.

At the end, an agreement was signed stating that the Soviets would conduct the auxiliary clinical research with a larger number of patients and more toxicological tests in order to meet American standards. The meetings finished with a visit to the laboratory.

### **Follow-up**

Early the next morning, Kravchenko asked one of her collaborators to study the potential license conditions. Problems of determining the license's pricing range and the factors influencing it, such as territory, etc., were investigated.

In May 1978, several months after the Americans had left, the additional clinical test data were ready. The Institute had improved the Corydon synthesis method, releasing it from accessory ingredients, and had done more clinical tests to fit American standards. Kravchenko sent a telex informing Pharmacal that a Soviet delegation was to come to the United States.

## The Second Meeting

Institute Director Dr. Krabentsov, Kozlinsky, and Kravchenko went to Philadelphia. Kravchenko arranged for Nikolai Andreyev to be included in the team. Andreyev was the senior department engineer and was preparing the commercial decision on the licensing sale. He would be able to establish the duration of the licensing agreement and the forms of payment. He could also ascertain the expected U.S. production volume of Corydon over the course of the agreement's duration in order to begin evaluation of the license's value.

The Soviets believed that the Americans were in no hurry to begin the official part of the negotiations and that they were trying to arouse positive emotions in the members of the Soviet delegation. Kravchenko guessed from experience that the "psychological attack" of the negotiations would be difficult.

As Kravchenko watched the talks progress, she realized they were heading for a stalemate over the sample size issue. In the course of the negotiations, the request for a five-kilo sample of Corydon "flared up" once more. It was apparent to the Soviets, however, that this request was not justified, since the clinical tests of Corydon had been conducted on the number of patients requested by American standards and the Americans could not give other plausible reasons for their request.

Kravchenko also realized that the issue of further clinical and laboratory tests was beginning to become a thorn in the discussions. When Victor Elliott, Pharmacal's vice-president for research and the American team's chief negotiator, told her that Pharmacal might break off the talks, she grew concerned.

That afternoon, before the talks recommenced, she contacted Krabentsov, and, stressing both the contract's prestige and the hard-currency potential, suggested that any increment in the available information might help the talks progress. He agreed. Krabentsov and Kozlinsky met briefly to discuss what options the laboratory had. Kozlinsky said that he felt "as if Pharmacal just wants to know our information and has no interest in obtaining the license." He nonetheless agreed to offer one kilo (double the original quantity) of Corydon for testing. This concession eased the tone of the talks but did not appear to satisfy the Americans.

The next day, a preliminary discussion on some commercial questions took place, which helped lead to a "detente" in the situation. The issue of the license territory was brought up. Licensintorg already had some obligations to Cuba for licensing production and distribution of Corydon in South America. Therefore, the licensing territory could basically only be the United States and Canada. As to the conditions of payment, Kravchenko had firm instructions: she must bring home to the Americans that the Soviets preferred an up-front payment with periodic payment on the basis of royalties.

During preparation for the U.S. negotiations, some initial calculations had been made on the duration of the licensing agreement and the potential volume of the scientific and technical documentation. However, the Soviets decided that the Americans were not yet ready to discuss these commercial issues, and Kravchenko decided not to show her "trump cards" as long as the basic technical questions were not solved.

The delegation left without signing any agreement.

### **Aftermath**

On her arrival in Moscow, Kravchenko reported to Licensintorg's vice-director about the mission's results. He was responsible for the negotiations that Licensintorg conducted with Pharmacal. The American firm was obviously interested in buying the license for Corydon production and sale, but, in Kravchenko's opinion, Pharmacal conducted the negotiations in a somewhat strange way.

Kravchenko reflected on the possibility of continuing the negotiations, which had begun more than a year earlier. In her opinion, the main problem was the American request for large amounts of the preparation. "As a matter of principle, this is not unreasonable," she thought. "But they ought to understand that the preparation is not produced on an industrial scale."

Hoping there was a way out of the situation, Kravchenko went to see Krabentsov. He too was worried about their failure. The Institute had already spent large sums for additional clinical tests: the Institute's resources had to be reallocated. Krabentsov realized that this deal had high prestige value for the Institute, but he told Kravchenko that considerations of prestige were "insufficient to make such important rearrangements" of his staff for the Americans.

Kravchenko agreed and suggested that they should seek other license purchasers in Western Europe. She thought that Pharmacal's competitors were already informed of the negotiations and would readily respond to Licensintorg's proposal. Meanwhile, in their relations with Pharmacal, the Soviets would adopt a firmer stand.

At the beginning of March 1979, the company sent a new telex requesting a Corydon sample. The Soviet side sent one kilo of the preparation and additional information on the clinical and toxicological research, with an accompanying letter expressing the hope that this would satisfy the Americans.

Having received the sample and the information, the Americans expressed their satisfaction. Some time later, however, they suddenly requested a new sample of at least two kilos for additional U.S. tests. The Institute's chemical laboratory had exhausted its

resources and capabilities, however, and was in no position to meet Pharmacal's requirements. The Institute's chemical department and Licensintorg were upset that the negotiations had reached a blind alley and wondered how they could get back on track.

# OPERATIONS

## NUMERICALLY CONTROLLED MACHINE TOOL PRODUCTION IN HUNGARY

Pal Nagy, director of Numerically Controlled Machine Tool (NCMT), considered the current situation of his enterprise. The last ten years had seen major changes and new opportunities in Hungary. His own company had attempted to move to the cutting edge of machine tool technology in Eastern Europe and taking this risk now put NCMT in danger of being merged with a larger, stronger enterprise, or being forced into bankruptcy. Nagy thought about his predicament, an unusual one in a country with a centrally planned economy, and wondered what steps he should take to save NCMT.

### Company Background

NCMT was a medium-sized machine-tool producer established in early 1950 by separating a provincial unit of a large enterprise based in Budapest and merging it with several smaller workshops within a 70 kilometer radius of the unit. The company produced semi-automatic machine tools for the domestic market and export to CMEA countries.<sup>1</sup> Demand for NCMT's products outstripped company capacity from 1960 to 1964, followed by a minor downturn in orders in 1965-66. In response to weak demand, the company introduced several new products for exclusive CMEA export. For their production, NCMT acquired a small factory in Debrecen that was experiencing major sales and operational problems. After production of the new machines was moved to this factory, factory designers there created several innovations, resulting in the introduction of two more new products, Z-65 in 1967 and Z-66 a year later. As a result of the new products, production of earlier models was moved to other companies and local cooperatives.

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<sup>1</sup>CMEA stands for the Council for Mutual Economic Assistance. It is a political and economic union of the East European countries, except Albania and Yugoslavia, and the Soviet Union, which controls trade and investment between the members.

Within CMEA, NCMT was considered to be quite advanced in the field of mechanical engineering and design. Although a large percentage of its output was exported, NCMT did not have the right to deal directly with its foreign customers. It was only allowed to export through a state foreign trade company. The company had no problems exporting its newer products to the CMEA countries, despite the existence of competitive products, because NCMT machines tended to be more versatile than other machines; for instance, the Z-66 model could be used in several different industries. On the other hand, the company had been unsuccessful in several attempts to export to Western countries. Management had also wanted to set up a joint venture with a Western company, but NCMT's machines could not meet the accuracy and quality demanded by potential Western investors.

NCMT's products were strictly controlled by the Hungarian government before 1968. The New Economic Mechanism (NEM), introduced in 1968, removed controls on production and sales of many products including those of NCMT, and demand grew sharply. Therefore, management of the company decided to expand production.

Because of its success, NCMT acquired significant political influence in its industry. The managers had good contacts with the supervising committees; for instance, the director, Pal Nagy, had excellent relationships with the State Committee for Technical Development (OMFB) and the ministry of Metallurgy and Mechanical Engineering (KGM). Relations with the local branch of the Hungarian National Bank (HNB), the only source of investment funds, had improved substantially. Finally, NCMT was the second largest company represented in the county executive committee of the Hungarian Workers (Communist) Party. Through these contacts, the company was able to obtain a great deal of political and financial assistance in its production and expansion plans. For a glossary of organizations, see Exhibit 1. Also see the "Country Note on Hungary," UVA-G-365.

### **Company Structure**

NCMT had a complex and somewhat confusing organizational structure. There were three top executives: Director Nagy; the chief accountant, Ellen Gorski; and Laszlo Grosz, the head engineer. Andras Kadar, Grosz's deputy, was also important to the organization. Nagy supervised most of the staff and operations functions, such as sales, personnel, investments, and quality control. Gorski was responsible for finance, accounting, and material procurement. Grosz nominally ran the production, product development, and technical development departments, but in reality, he concentrated on product development and left day-to-day factory supervision to Kadar, who informally reported to Director Nagy. Exhibit 2 gives an organizational chart for the enterprise.

NCMT was a medium-sized company with a staff of about 1500. The work force composition reflected the relatively advanced production techniques and continuous

product development performed at the company. Engineers and designers made up about 10 percent of the work force, and the company had more technicians and skilled workers than the average Hungarian firm.

The management of NCMT was very stable. Most of the top managers, including Nagy and Gorski had joined the company when it was created and had been in their positions for several years. Most were 40 to 45 years old. The younger managers, on the other hand, had arrived at their positions by climbing the company ladder. This group included the head engineer, the heads of the technology and sales departments, and many lower-level managers. A few managers got their jobs through social and political connections: the head of direction department had been the secretary of the (state-organized) union at the company, and the head of material procurement had once been the secretary of the Communist Youth Organization (KISZ). Three managers, the head of the marketing department, the leader of the ergonomics laboratory, and the finance director, were hired directly from outside the organization.

### **New-Product Development**

After many of the economic controls were lifted in Hungary in 1968, the management of NCMT hoped to boost production by improving capacity utilization rather than by investing in more plant and equipment. Manufacturing NCMT's products required highly skilled labor, which was in short supply, so the company needed to improve labor productivity. To achieve this goal, Nagy introduced a piece-work compensation system. Workers initially were unenthusiastic about the system, because they believed their wages would not go up proportionately to the extra work required to increase output. Eventually, workers found that their wages did increase substantially; some began to earn more than lower-level managers. Productivity increased by the planned amount, and production increased 40 percent between 1969 and 1970.

During that period, however, the domestic machine-tool market became quickly saturated, and orders fell substantially, which cut sales and profits. Gorski suggested that the company lay off workers to cut costs and restore profitability. Several managers opposed this move, including the production managers, the trade union, the local Party organization, and Nagy. Not only did Hungarian social policy made layoffs difficult, the managers feared that the laid-off workers would not return when production rebounded, because of the tight labor market in the area. Rather than lay off workers, Nagy worked closely with the head of the sales department to increase orders and keep workers fully occupied. Although it increased export orders for machine tools, the company was also forced to take orders for almost any product because of low capacity utilization and was forced to expand the number of products manufactured.

In this situation, the problems with the piece-work system became apparent. When orders grew rapidly and supplies were tight in boom times, the system encouraged



workers to increase output at the cost of rapidly deteriorating quality. When orders fell, there was not enough work, and workers incomes fell. Managers tried to improve quality by reorganizing quality control, but this move failed, and the piece-work system was eventually abandoned.

### **Development of the OKE**

After NCMT began full-scale production of the Z-66, designers at the Debrecen plant began a project to develop numerically controlled machine tools. Under the development program, formally called the OKE program, they produced one unsuccessful design and finally succeeded in designing a product called the OKE.

The impetus for its development came from a team of researchers, engineers, and technicians formed around the chief designer, Sandor Nemes. Nemes had been a professor at a nearby university, and after joining NCMT continued to lecture there for several years. Most of the development-team members were his former students. Nagy supported the project and fought for its implementation with the bureaucracy; most of the managers also eventually supported the project.

The technology of automatic machines in Hungary was about 15 to 20 years behind that of Western countries. After some questioning of NCMT's ability to develop the machine successfully, government support was made available in the form of official approval and subsidies for the development project as in the "interest of the national economy." Such development fit with Hungary's import-substitution strategy, which sought to displace hard-currency imports with domestic production. There was a shortage of advanced technology in some CMEA countries. Other, more advanced CMEA countries were willing to forgo development of this type of machine, convert their manufacturing capacity to other products, and buy the OKE from NCMT.

### **Development Problems**

NCMT soon ran into problems with commercializing the OKE, however. Development was slow, and the company missed the target dates to begin production for the domestic and CMEA markets. The OKE design did not meet specifications for the export market. Because of this failure, NCMT, with the assistance of the state foreign trade company, bought a license to manufacture and distribute an Italian-designed machine tool for the Hungarian and CMEA markets under the name OKE-2. The managers decided to continue manufacture of NCMT's design for the Hungarian market under the name OKE-1. Managers thought that the introduction of OKE-2 would solve the production and profitability problems for the company.

Product development and manufacturing start-up required a large one-time investment that could not be recouped unless the product performed well and could be produced economically. The first-year results for the OKE department were not encouraging. Return on investment in OKE development was behind projections because of start-up problems, and as a result, the OKE branch of NCMT lost money in the first year of production. Production of OKE required more sophisticated production techniques, longer production time, and larger parts inventories than other NCMT products. As a result, taking OKE-1 into production increased working-capital needs sharply, which the company covered in part with internal cash reserves. NCMT also got additional government subsidies, although not as much as requested.

The company produced its first run of 70 units of OKE-1 in 1970, but about one-third had to be repaired before shipping. The company was unable to produce any OKE-2 products successfully.

A major problem in producing the OKE was getting and keeping a sufficiently trained work force. The company was located in a rural area, and management was unable to induce engineers, technicians, or skilled workers to move to such a remote location. It was therefore forced to train production workers in ad hoc courses and retrain its own engineers, many of whom left for larger towns within months of completing their training.

An even bigger problem was the lack of competent management. The chief designer was unable to organize commercial production of the OKE; manufacturing proved different from building a prototype in the laboratory. Producing the licensed design for OKE-2 was even more difficult, because NCMT did not have the manufacturing experience of producing advanced-technology products.

Even if NCMT had managed to produce the OKE-2 successfully, it would have made neither forint (the Hungarian currency) nor convertible-currency profits. Many of the parts for the machine were hard-currency imports subject to heavy customs duties. The OKE-2 was sold in the CMEA countries, which paid in nonconvertible rubles. As a result, the product could only be sold for a loss. Established products that were exported at a loss often received state subsidies, but the government was seldom willing to subsidize new products. The best that NCMT could hope for was to negotiate lower duties on its imported material.

Often missed deadlines forced the development team to make irresponsible and impossible promises about the OKE. Documents and inventories were lost, and workers were asked to implement technical advances beyond their abilities.

### **Conflict In NCMT**

Buying the license for OKE-2 changed the focus of NCMT and the OKE department. The main task changed from development of a new product to adaptation to the manufacturing specifications of the license. This change pushed the development team under Nemes to the sidelines. Conflict arose over the allocation of the production capacity in NCMT.

The technical and financial failures of the OKE development project threatened not only the OKE branch, but also the entire company. The company lost its leadership in the county and its ability to get additional allocations of capital resources from the state. The company was asked to revise its operating plan, and rumors spread that NCMT would be merged with a large Budapest firm. These rumors and the failure of the original OKE project increased conflict within the company.

The majority of employees still manufactured NCMT's older, less advanced products. These employees--line workers, first-level and middle managers--believed that their contribution to the company was being wasted on the development of the OKE. Their interests were being sacrificed in the name of technical advancement, the "interests of the national economy," and the aspirations of the OKE development team. The engineers and production managers of the traditional products feared losing their influence in the company.

The OKE development-team members were more highly trained and highly paid; they worked under better conditions and were allocated more of the company apartments, which were in short supply in the area. This was a significant benefit, since most other workers were forced to commute.

In addition, many of the financial managers decided that the company would be unable to meet the capital requirements of OKE production even with state subsidies and credit, and that CMEA exports would never produce a profit. Faced with danger to the company and their jobs, many workers and managers opposed continuation of the OKE project. Party and trade union officials believed the conflict over the OKE was so disrupting the company that it was better to discontinue the product. It was now up to Nagy to find a way to balance the competing interests within NCMT and keep the company independent and operating.

Exhibit 1

**NCMT: DEVELOPMENT OF THE OKE**

Organization Definitions

OMFB	National Committee of Technological Development
KISZ	Communist Youth Organization
OKE	Formal name of the machine tool development program
CMEA	Council for Mutual Economic Assistance
KGM	Ministry of Metallurgy and Mechanical Engineering
HNB	Hungarian National Bank





### PIZZA HUT MOSCOW

"**Pizzastroika**" was the term coined to commemorate the September 1990 opening of the two Pizza Hut restaurants in Moscow. The opening was the culmination of five years of negotiation, planning, and training involving Pepsico and its joint-venture partner Mosrestoranservice, the restaurant-operating division of the city of Moscow.

In May 1991, after nine months of operation, the Pizza Hut restaurants were averaging 20,000 customers each week. One of the restaurants was capable of producing 5,000 pizzas each day and had the distinction of being the largest pizza kitchen in the World. Lines of people were always waiting to gain entrance, and although many problems had arisen, the joint venture had generated more sales than anyone had predicted.

Andy Rafalat, regional director of Pizza Hut's operations in Eastern Europe and the Soviet Union, had managed the Moscow venture from its inception. Rafalat, 39, was faced in May 1991 with difficult decision. During initial negotiations with the city of Moscow, Pizza Hut had agreed to transfer management of the joint venture over to the Russians eventually. Were the Russians prepared to take the helm?

### **History of Pizza Hut**

On June 15, 1958, Dan and Frank Carney, two college students from Wichita, Kansas, opened the first Pizza Hut restaurant. It was a sterling success. By the following February, the Carney brothers had opened two more restaurants and had begun to develop plans for the first franchised outlet. The chain grew rapidly: 43 restaurants opened by 1963, and 296 by 1968. Pizza Hut went public in 1969 and in 1977 was acquired by Pepsico, Inc. In 1971 Pizza Hut had become the largest restaurant chain in the world in both sales and number of restaurants. Sales reached \$1 billion in 1981 and \$13 billion in 1988. In 1990 Pizza Hut, still headquartered in Wichita, had over 7,000 units and 125,000 employees worldwide.

Pizza Hut restaurants usually displayed a distinctive freestanding design and characteristic red roof. Until 1985 all Pizza Hut restaurants were full-service, eat-in/carryout, family-style operations seating about 60 to 90 customers and normally open from 11 a.m. to midnight. In 1985 Pizza Hut began opening delivery-only units to meet rising competition from such pizza delivery restaurants, as Domino's.<sup>1</sup>

### **History of Russian Joint Ventures**

In January 1987 the Presidium of the USSR Supreme Soviet authorized the establishment of joint ventures between Western companies and Soviet entities such as factories and government organizations. President Mikhail Gorbachev envisioned that this joint cooperation would satisfy Soviet requirements for certain industrial products, raw materials, and foodstuffs; attract foreign technology, management experience, material, and financial resources; and develop the export base of the country.<sup>2</sup>

When the law was first introduced, a foreign partner was entitled to a maximum of 49 ownership in a venture.<sup>3</sup> The decree required that all joint ventures be self-supporting and established a two-year tax holiday, after which profits would be taxed at 30 percent. No limitations existed on the number of partners or composition of the joint venture's capital structure. Foreign companies were not allowed to "repatriate" their profits, that is, they could not convert ruble earnings into hard currency. Therefore, Western partners often attempted to formulate strategies through which the joint ventures would generate more hard currency than they used.

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<sup>1</sup>Kaufmann, Patrick J., *Pizza Hut, Inc.*, Harvard Business School case, 1987.

<sup>2</sup>Jeffrey M. Hertzfeld, "Joint Ventures: Saving the Soviets from Perestroika," *Harvard Business Review*, January-February 1991, p. 85.

<sup>3</sup>In 1991, there was no ceiling on foreign ownership of joint ventures -- in effect, joint enterprises could be 99% foreign-owned. In addition, President Gorbachev authorized the establishment of 100% foreign-owned companies in the Soviet Union.

## History of the Pizza Hut Joint Venture

During 1987, Anatoly Dobrynin, then Soviet Ambassador to the United States, and Donald Kendall, the chairman of Pepsico, discussed the possibility of opening a Pizza Hut in Moscow. Pepsico had been doing business in the Soviet Union since 1972, when it signed an agreement to provide Pepsi-Cola concentrate in exchange for Stolichnaya vodka. Dobrynin and Kendall, believing that the time was right for introducing a restaurant business, decided that the Pizza Hut operation would be a component of a \$3 billion commercial countertrade pact between Pepsico and the Soviet Union.

The pact involved the creation of 26 new Pepsi plants in the Soviet Union; Pepsico retained exclusive rights to the sale of Russian vodka in the United State. The deal also included the construction by the Soviets of ten commercial-shipping vessels that would be sold or leased. Foreign-exchange credits generated for the Soviets from the sale and lease of the ships would be partly used as investment in the Pizza Hut restaurants.<sup>4</sup> Kendall commented at the signing of the deal:

*This latest agreement further strengthens a highly successful and long-standing trade relationship between Pepsico and the Soviet Union. Equally important, as trade between nations expands, so does the level of understanding and cooperation among those nations' citizens. This agreement reflects increasingly closer ties between the US, the Soviet Union, and other Western interests, and the expressed optimism for a shared future. It expands even further the positive collaborations which can help bring the two superpowers and their people closer towards the universally shared goal of world peace.<sup>5</sup>*

Altruism and improved relations were not the only reasons for the trade agreement. Business rationale was also strong. The Pizza Hut joint venture was viewed by some as a symbolic "toe in the water," for both Pizza Hut and Western businesses planning to start joint ventures. Recent political changes suggested that the East European market would soon open to capitalist operations. Eastern Europe was the largest untapped base of consumers in the world and according to Rafalat the thinking at the time was that Pepsico's experience with both Soviet consumers and long-standing trade relations with an East European government would provide

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<sup>4</sup>"Pepsi will be Bartered for Ships and Vodka in Deal with the Soviets," *The New York Times*, April 9, 1990, p. A1.

<sup>5</sup>"Pepsico Signs Largest-Ever Commercial Trade Pact with the Soviet Union," *PR Newswire*, April 9, 1990.



the company with considerable leverage and a strong "calling card" in this emerging market.<sup>6</sup>

The decision to begin USSR operations in Moscow was a reasoned one. Moscow, with a resident population of 9 million, was one of the largest cities in the world.

Pizza Hut would be 49 percent partner in the joint venture and was required by the terms of the pact to source the majority of its food requirements locally, to engage in the transfer of both financial and technological expertise, and to train a Russian management team for eventual on-site management. The technology transfer included management and distribution training and training on the state-of-the-art equipment to be used in the restaurant.

Many business analysts believed that the joint venture had symbolic importance to the future of business in the Soviet Union. Kendall waxed philosophic: "We are not, however, just bringing pizza to Moscow. Nor are we just helping to satisfy the local Soviet appetite for consumer goods. We're helping to meet the changing needs of the Soviet economy."<sup>7</sup>

### **Culture Clash**

Managing this joint venture was not an easy task. Many times the problem was just getting each side to understand what the other wanted. Many of the Pizza Hut team's preconceived notions about doing business didn't apply. Rafalat commented:

*Don Kendall gets the request and passes it down on our side. We can't be sure it is always passed down on the Russian side. The first people we met here were construction people. They simply wanted to build a pretty restaurant. We said, our job is not about buildings, it's about a system of management. It all dragged on and on, and after 18 months we were told there was no real interest in developing Pizza Huts at all. They had no concept of the difference between a small Vietnamese restaurateur and a multinational chain. We had to work out a book of rules. That took time. The words we were using had totally different meaning to these guys.<sup>8</sup>*

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<sup>6</sup> Abdo, Geneive, "Pizza Hut Opens its First Restaurants in Moscow, *Reuters*, September 11, 1990.

<sup>7</sup> Pizza Hut News release, *Pizza Hut Opens First Two Restaurants in Moscow*, September 11, 1990.

<sup>8</sup> Peel, Quentin, "Pizza Hut Gives Food for Thought to Soviets," *Financial Times*, September 21, 1990, p. 18.

This communication problem was the largest barrier in the early days. Interpreters seemed unable to help. For instance, the Soviet staff protested operations running 365 days a year. They believed, given a need to close for "hygiene days" that it was impossible. Pizza Hut had to explain the concept of cleaning as a part of routine, daily business operations.

During these times, Mosrestoranservice provided as much assistance as it could. Assistance was limited, however, because of the difficulties and changing environment in Moscow at the time.

### **Construction of the Restaurants**

Senior Pizza Hut managers wanted to have two restaurants in Moscow located in high-traffic areas. They finally signed contracts to build restaurants at 12 Gorky Street, near Pushkin Park and only minutes from the Kremlin, and at 17 Kutozovsky Prospekt, one of Moscow's busiest streets. Taylor Woodrow International was chosen to manage the construction of the Pizza Hut restaurants using design and construction standards similar to those found in the West.

Taylor Woodrow, based in England, assembled an international team to construct the restaurants. Some 100 laborers including skilled craftsmen from Britain, Italy, Sweden, Portugal, Poland and Russia worked at the two sites. In the demonstration of how to accomplish individual tasks, the spoken and written word often took second place to sign language. The work encountered supply problems, as Taylor Woodrow, divisional director, Ian Greenwood, pointed out: "We had no local builders' merchants on hand, even for basic things like nuts and bolts, so we had to import just about everything in the way of tools and equipment - - even down to screwdrivers." As a result, costs of production were three to four times higher than they would have been in Western Europe.<sup>9</sup>

### **Finding and Creating Supply Sources**

Pizza Hut managers soon found that the establishment of internal supply sources would be a significant challenge. Although McDonald's had created an entire food-production facility to supply its restaurant, Pizza Hut decided to source 70 percent of all supplies from existing local suppliers within the Soviet Union (see Exhibit 1), in order to help them improve their quality and standards. Rafalat believed that this approach would ensure the long-term viability of the operation and provide benefits to the growing class of Soviet entrepreneurs. "We are not food producers," he explained. "Our expertise is in restaurants. Where possible, we're happy to share know-how and technology that enables the Soviets to make what we need, sell it to us at a profit, and also meet local market needs."

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<sup>9</sup>"Taylor Woodrow Creates a Slice of Western Living for Muscovites,' *Origin Universal News Services Limited*, September 10, 1990.

At the same time, however, Rafalat realized that Moscow's long and extreme winters would make internal sourcing especially challenging. The city often experienced shortages during the winter months and some Muscovites were known to survive entirely on pickled vegetables. Moreover, Rafalat could not expect to purchase supplies from the warmer, southern republics of the country, which were refusing to send supplies to Moscow because of the escalating political and ethnic tensions.

Pizza Hut faced other supply problems. Cheese, one of the main components of pizza, was common in the Soviet Union, but not mozzarella cheese, which, was unavailable. Rafalat visited numerous cheese-processing plants around the country but with little success;

*We couldn't find anybody even interested in supplying us. Finally, we found one in Motensk, 300 kilometres from Moscow, somebody who had been touched by Western thinking. He was happy to give it a try. We would provide the equipment and expertise, he would make the cheese.*

Pizza Hut flew the Russian to England to see how the cheese was made and brought cheese-making experts to his plant to provide training on the modern process and equipment. Nevertheless, the mozzarella produced was unacceptable, because the domestic milk did not contain enough butterfat. Cheese had to be imported until a sufficient number of cows could be raised on a strict diet of Western grain.

The search for a supplier for meat toppings also met with no success. Both quality and reliability were missing from every meat plant Rafalat visited. Finally, Pizza Hut's Swedish meat supplier agreed to set up its own joint venture with a partner in Moscow and guaranteed that Pizza Hut would receive the lion's share of its output. Unfortunately, the plant would not be ready for at least another year, so another key ingredient had to be imported.

Pizza Hut also needed to find a way to transport supplies to the restaurants. Because refrigerated trucks were virtually nonexistent in the Soviet Union, Pizza Hut had no choice but to import two trucks to form its own distribution system. The trucks were painted with the distinctive Pizza Hut logo so that they might also serve as a traveling advertisement for the joint venture.<sup>10</sup>

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<sup>10</sup>Reuters, September 11, 1990.

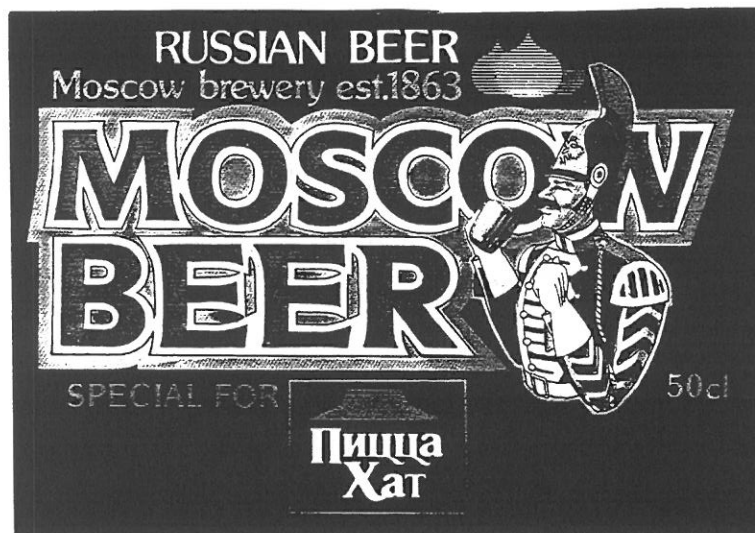
## Market Research

In many ways, the Moscow restaurants were an experiment. Because of the novelty value of the Pizza Hut product, typical marketing-research methods and tools were useless for establishing market size and taste preferences. Pizza Hut managers observed, however, as McDonald's opened a restaurant in the city's Pushkin Square in January, customers in the thousands lining up to taste Western-style fast food. They believed the same novelty value would play a strong role in bringing Russians into Pizza Hut restaurants. Pizza, however, was not an unknown food in the Soviet Union; it had been served by Italian and Canadian joint-venture restaurants. It was even prepared by some Russians at home. In addition, a traveling pizza truck offered customers individual slices of pizza. These pizza foods were of varying quality and taste; thus the Soviet consumer had come to view products termed Pizza as having a varying quality.

Pizza Hut scheduled bake-offs to allow Muscovites to sample and compare its product with others. The company received rave reviews. Rafalat believed the Soviet consumers were easily able to discern quality and would communicate their findings quickly through word of mouth.

Pizza Hut would also be different because it would offer both fast- and full-service meals. Rafalat thought that a dinner at Pizza Hut could be viewed as a trip to an expensive restaurant, while McDonald's would still offer only fast-food. Rafalat wanted to combine speed with service and offer Soviet consumers something entirely new: quick table service geared for the entire family. "The market is not consumer driven at all," Rafalat said. "... there is a real lack of consumer choice. Pizza Hut will immediately be ranked as a four- or five-star restaurant in the city."

Pizza Hut decided to offer a menu comparable to that found in Western Pizza Huts - with Pepsi soft drinks, a newly brewed Soviet bottled beer, and wines from Hungary and the Soviet Union. They also developed a "Moscow Pizza" with a salmon-based topping designed to fit with the fish-heavy Soviet diet. (See Exhibit 2)



### **Pricing, the Ruble, and Hard Currency**

The restaurants would also differ from other Moscow restaurants in that customers would be able to purchase pizza in either rubles or hard currency. The Gorky Street restaurant would have a walk-up window for ruble customers and a full-service restaurant for hard-currency customers. The restaurant at 17 Kutozovsky Prospekt would actually be two separate full-service restaurants. Both ruble - and hard-currency customers would receive full service, but they would never interact with each other.

Rafalat had attempted to determine who would visit each type of restaurant based on customer's incomes. The average monthly income for a Soviet citizen at the time was 250 rubles. Recently, however, a burgeoning middle class of entrepreneurs had found a higher standard of living than the government employees. Rafalat believed that this middle class enjoyed an average monthly salary of approximately 2,000 rubles. He hoped to serve these entrepreneurs in the ruble restaurants. He also thought that Westerners and black marketeers would visit the hard-currency restaurant. His initial estimates were that the foreign customers would be 40 percent Americans and 30 percent Japanese with Germans, Australians, and British making up the balance.

Ongoing changes in the currency exchange rate complicated pricing decisions for the restaurants. At the time the joint venture was being negotiated, the official government rate was 1.6 dollars per ruble, although most people believed that the ruble was worth far less. It was against the law for Soviets to hold hard currency, which over the years had led to the creation of a black market. In the late 1980s, many Soviets were illegally purchasing hard currency on the black market at a rate of approximately 10 rubles per dollar. By the time the Pizza Hut restaurants were ready to open, Soviet President Gorbachev had acknowledged that the ruble had been artificially propped up and he had introduced a mixed exchange rate. He set an official rate of 2 rubles per dollar and a tourist rate of 6 rubles per dollar. At the same time, however, because the poor quality of Soviet goods had been recognized around the world, the black-market rate had fallen to nearly 30 rubles per dollar.<sup>11</sup> This trend suggested that the Soviet government still had a long way to go before reaching an equilibrium between its fixed exchange rate and the free market rate established by the black market.

After studying these fluctuations in the exchange rate, and attempting to set reasonable prices for restaurants' food, Rafalat decided that the restaurants would offer identical menus, but that the prices would differ. Prices in the ruble restaurants would be roughly comparable to those found in some of the better full-service Soviet restaurants. Prices in the hard-currency restaurants would be similar to those found in Pizza Hut restaurants in the United States. For instance, a large pepperoni pizza in the ruble restaurant would cost 18.20 rubles, while it would cost \$6.90 in a hard-currency establishment. At the tourist exchange rate in September 1990 (6

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<sup>11</sup>"Soviet Banks to Set Market Rate for 'Tourist Ruble'", *Reuters*, November 29, 1991.

rubles per dollar), an American student would pay more than twice as much money to eat in the hard-currency restaurant as he/she would pay to eat in one of the ruble restaurants.

Why then would an American choose to pay in dollars? The answer was simple: Pizza Hut planned to maintain a standing line of at least 30 minutes in front of the full-service ruble restaurant. Therefore, foreigners would be paying extra for the quick service. (The long line was also intended to serve as a testament to the value of the Pizza Hut product.) The mixed-pricing decision was key to Rafalat's strategy: Pizza Hut would gain a source of hard currency, which was important because foreign companies could not repatriate ruble profits, and be able to hedge the extreme exchange-rate risk.

### **Human Resources**

The requirement that the management of the joint venture would eventually be 100-percent Soviet made the hiring of management personnel a critical task. "Our experience is that, to make joint ventures work, you have to give the local management team the responsibility for running the business," Rafalat said. "I will be called the deputy general manager. I will be like the coach, training the people around me, not taking an active part in the business."<sup>12</sup> This Pizza Hut strategy differed widely from that of the McDonald's joint venture.

In addition to the legal requirement, another rationale for emphasizing Soviet management of the joint venture was the sometimes contradictory Soviet view of Westerners, particularly Americans. Westerners were loved because of the economic and technical assistance they could provide but hated because of the elite status their knowledge and finances afforded them.

Rafalat decided that the best way to find managers was to visit restaurants in Moscow. At one particular establishment, he noted that the staff smiled (a rarity in Moscow) and that the interior was clean. When Rafalat and representatives from Mosrestoranservice spoke with the manager, Alexander H. Antoniadi, they found that he also knew his sales and profit figures. Highly impressed, they offered him the job general director of the Pizza Hut restaurants. He accepted.

Antoniadi, 46, had managed five different restaurants in the Moscow system, including one full-service restaurant, two fast-food restaurants, and a bakery. Born in Georgia and of Greek descent, he was one of few Soviets who had visited the West. He considered his exposure to Western management practices and service levels a significant factor in his past (and potential future) success. "You can't compare Western and Soviet restaurants," Antoniadi said. "You [Westerners] are used to taste, quality, and far higher worker discipline. Moscow restaurants employ people who are not used to Western service standards."

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<sup>12</sup>Peel, *Financial Times*, September 21, 1990.

After Antoniadis was named general director, Pizza Hut still needed two on-site managers for the restaurants. They approached Alexander Youdin and Boris Paiken, both 36, who ran a Georgian-style fast-food cafe called the Pancake, after its famous main dish as a joint venture. Both were known for their commitment to quality and their democratic form of management. Initially, Paiken resisted leaving his joint venture, because he believed Pizza Hut would not allow Soviets to manage the operations. He called them "stables," meaning that he thought Russians like livestock, would provide little more than physical assistance. After lengthy discussions with Pizza Hut managers, however, he joined the team.

Pizza Hut also needed a financial specialist. Olga Ignatova, 27, was a former member of the Moscow Finance and Planning Department. Rafalat and members of the Pizza Hut team were so impressed with her work during the initial phases of the joint venture that they offered her the opportunity to come aboard as a member of the staff.

Valery Ginsberg, who held a doctorate in steel and alloys from the Moscow Institute, was hired as director of technical services. Ginsberg had initially been hired by Taylor Woodrow International during the construction phase. His knowledge and exacting work ethic earned him an offer to join the management of the joint venture.

The entire management staff was flown out of the country to train in a Pizza Hut restaurant in the United Kingdom. The goal was to establish an understanding of the Pizza Hut philosophy, not necessarily standard procedures. "We wanted people to understand both systems," Rafalat said.

*We told them to take a look at the UK system, and then decide how it could best work in Moscow. Taking people out for training meant they come back totally different people. Telling them the same thing here had no meaning. It was only when they went to London and saw our restaurants working that the penny really dropped.*

### **Hiring and Training Staff**

In hiring staff for the joint venture, Pizza Hut found it had an extremely strong group of applicants from which to choose. In an attempt to hire 300 kitchen and wait staff, Rafalat placed an advertisement in the Moscow Communist Youth daily newspaper. The text of the advertisement read:


18 мая 1990 г. • «МОСКОВСКИЙ КОМСОМОЛЕЦ» • 3

Совместное  
советско-американское  
предприятие  
**«МОСКОВСКАЯ ПИЦЦА»**

предлагает вам попробовать себя в новом деле.  
Вы приобретете опыт работы в системе ресторанов «Пицца Хат», распространенной на 55 стран мира.  
Мы приглашаем к сотрудничеству молодых людей в возрасте от 18 до 25 лет, желающих работать с энтузиазмом.  
Если ваши данные удовлетворят нашим требованиям, вы будете приглашены на собеседование.  
Просим выслать открытку по адресу: 121019, Москва, Калашный переулок, 9.  
В открытке должны быть указаны:

1. Фамилия.
2. Имя.
3. Год рождения.
4. Адрес, телефон.
5. Знаете ли вы иностранный язык.
6. Ваше предыдущее место работы.

Приложите, пожалуйста, фотографию.  
**СРОК ОТПРАВКИ — 10 ДНЕЙ С МОМЕНТА ПУБЛИКАЦИИ.**



*Joint Soviet-American venture invites you to test yourself in a new job. You will gain great experience in the Pizza Hut system of restaurants, developed in 55 countries. We invite young people, 18-25 years old, who are ready to work with enthusiasm. If you meet our needs, we will be glad to speak with you.*

The small advertisement elicited 3,500 responses. The applicant pool was the most qualified one Pizza Hut management had ever encountered.

The two basic requirements were that applicants speak at least one foreign language and have some experience working in restaurant joint ventures. Many applicants had college degrees, while some had masters and doctorates. Another characteristic Pizza Hut deemed important in hiring was that an applicant have as little experience as possible working in government-owned establishments. Rafalat believed that individuals became accustomed to a low-productivity work ethic in typical Soviet enterprises, because in general, such enterprises were characterized by lax discipline and almost total job security.

Many of the applicants were former staff of the McDonald's joint venture. Two reasons were cited for their leaving McDonald's: (1) they viewed Pizza Hut's full-service restaurant as being a prestige environment in which to work and (2) McDonald's management had hired so many to staff their restaurant that individuals were actually referred to by numbers, not by their names.



Three hundred people were eventually hired to staff the two restaurants, three times the number for a Western Pizza Hut with comparable output. Rafalat believed that the oversize staff was necessary because of the expected low productivity and unique Soviet employment laws that gave workers two days on, two days off. "As for finding the right people, we had to turn our personnel rules upside down," Rafalat said. "All the good English speakers are academics, so that was no good. Instead, we chose people who were as near to street-wise as possible."

The staff that was eventually hired could only be termed eclectic. For instance, the 16 cashiers all had banking diplomas, many of the members of the wait staff were young mothers with little or no academic training, while some of the kitchen staff held doctorates in engineering. Although many employees were extremely academically advanced, their experience with Western service levels and productivity standards was limited.

A staff of trainers from Britain, Australia, Belgium, Canada, Egypt, and the United States flew into Moscow two months prior to the openings. Their goal was to establish an understanding of and commitment to service unseen in the Soviet Union at that time. One of the ways Pizza Hut attempted to create that understanding was to establish standards of performance relative to each person's job. These standards involved both actual job activities and general work-place attitudes and demeanor.

Rafalat believed that an understanding among workers of a "democratic" work-environment would also be needed. "Unfortunately, a part of the Soviet mentality is to maintain the minimum of your potential. This is a consequence of the autocratic management system. Many think that you can forget about standards." For this reason, he created the first standards incentive program in the Soviet Union. The system was unique in that employees were given full incentive payments to start, but amounts were debited as employees failed to meet standards. For example, each worker contracted to work 173 hours per month and would receive a salary of 600 rubles. If an individual were tardy or failed to show up for work, an established amount of his or her monthly salary would be subtracted. If a waitperson failed to smile or deliver food on time, she or he would have an amount subtracted from salary.

Waiting tables presented unique problems and required equally unique solutions. Waiters and waitresses in Pizza Huts would be allowed to receive tips, although tipping was an unfamiliar practice to Soviet consumers. Customers would have to be educated about both the practice of tipping and the amounts appropriate to various service levels.

The restaurants were to have two separate, wait staffs. The ruble restaurant was viewed as the training department for waitpersons; the more experienced and efficient staff would work in the hard-currency restaurant. Because holding hard-currency was illegal for Soviet citizens tips received by waiters/waitresses in the hard-currency restaurants would be held by management in an account. The staff would be given a catalogue (covering many goods that could not be found in the Soviet Union) from which they could then choose items. Management would use funds from their accounts to purchase the goods on the staff's behalf.

## Opening

Despite the many hurdles faced by Rafalat and the joint venture, the two restaurants opened as scheduled in September 1990. The opening was as much an event as any international summit. VIP's from Pepsico and Pizza Hut, Soviet and United States government officials, and the international press were all on hand. Kendall and US Secretary of Commerce Peter Mosbacher, and former Soviet Ambassador to the United States Anatoly Dobrynin--all sat down with Rafalat to sample the first pizzas to come from one of the world's largest pizza kitchens. (The capacity was twice that of a normal Pizza Hut restaurant.) (See Exhibit 3). The training team serenaded the trainees with a song specially written for the occasion.<sup>13</sup> (See Exhibit 4)

Lines of customers formed on the first regular business day, but they were not as long as those seen during the launch of the McDonald's restaurant. About 100 people waited for the doors to open that morning. Some expressed a desire to be among the first in the Soviet Union to try Pizza Hut. Others gave more pragmatic reasons: "I ate pizza recently in New York, and I wanted to have a taste," said one young woman. "I came today because in a few months it's likely to be like McDonald's, where some of the ingredients, like tomatoes and lettuce, are always missing."<sup>14</sup>

## The First Several Months of Operation

As business continued, Rafalat, Antoniadi, and the management staff found that the skill most necessary in managing operations was flexibility. The only thing they could count on was the unanticipated:

*Only a few days after opening, the regional government temporarily closed both restaurants ostensibly for not having a sanitation permit. In reality, however, the closures resulted from a power struggle between the radical Moscow City Council and the conservative District Council. The incident left Rafalat wondering what the country's worsening political situation would mean for the two restaurants and for any expansion plans. But one thing he knew for sure: He would need to cover his bases*

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<sup>13</sup>"Pizzastroika," , pp. 1-4. Coincidentally, the Moscow restaurants were opened the day after an opening in Beijing. The Beijing opening was viewed as one of the first steps in renewing Western business interests in China following the Tianamen Square protests and subsequent supporters of democracy crackdown.

<sup>14</sup>Ibid.

*with all levels of the Soviet government; federal, republic, and local.*<sup>15</sup>

Another problem that presented itself not long after the opening was an increase in the prices of supplies. The Soviet government raised prices on basic foodstuffs by an average 300 percent. Soviet wages rose, but only by about 20 percent, making Pizza Hut prices less accessible to ruble customers. This problem was compounded by Pizza Hut's decision to raise prices by 40 percent to make up for the increased cost of supplies.

On the positive side, Pizza Hut found new sources for supplies. When supplies from the government were unavailable, black marketeers proved to be quite ingenious at locating new sources. The Soviet government had recently allowed private farmers to grow and sell excess crops. Once, during the middle of the winter, a private farmer showed up at one of the restaurants' back door with a truck full of tomatoes. Whenever Pizza Hut used these sources, however, the prices were considerably higher than government goods.

Employee turnover was low in the Pizza Hut restaurants relative to other joint venture such as like McDonald's. "Low," however, in the Soviet Union still meant hiring one new person each day. If that rate continued, the entire staff would turn over in a year's time. The turnover made ongoing training a necessity and resulted in sizable lost productivity. Moreover, the ongoing training did not yield the same results as seen with the original staff. New employees did not have the same level of respect for standards or the same level of enthusiasm regarding working at Pizza Hut. Thus, overall quality and service levels began to fall.

The establishment of a team ethic among employees was one of the goals of the managers, but employees believed that their management had made little progress toward this end. "McDonald's does team building," a kitchen staff member said. "They took all of their employees on a cruise. They also took them to dinner and they gave them a Christmas and New Year's party. They have a soccer team that is composed of former Olympic athletes; we do too. Perhaps our management could arrange a game in one of the Moscow city stadiums."

Moreover, other factors began to cause tension between the ruble and hard-currency staffs. Different service requirements and the greater level of gratuity compensation in the hard-currency restaurant created resentment among the ruble staff. Staff turnover in the hard-currency restaurant was also slow, which opened up a few slots for the many ruble waitpersons wanted to move up. On the other hand, while the hard-currency waiters and waitresses were receiving larger tips, the catalogue from which they could order goods was strangely absent. They began to wonder when they would be able to make use of the tips they were saving in their accounts. One waitress said, "I get a receipt for the tips that I turn in. I have been

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<sup>15</sup>"Wanna Make a Deal in Moscow?" *Fortune*, October 22, 1990, p. 13.

saving these receipts, but I still haven't been able to use them. The catalogue? I have no idea when it will arrive or what is in it."

The standards incentive program created by Rafalat had been successful in rewarding workers who maintained standards, but, it did not penalize those who did substandard work, nor did it award exceptional service. Compensation could not fall below a floor of 300 rubles. Because this salary level provided an income that was greater than that of the average Soviet, many found little reason to maintain standards. Absenteeism, particularly among the kitchen staff, became a daily problem. Employees who worked overtime to cover absenteeism received no benefit from their additional work.

Not only did many employees work overtime, but they also were often required to do jobs that they were not hired to perform. They became proficient at all functions within the kitchen operation, but again, they received no incentive for their contributions. Employees who maintained standards felt cheated not only by their peers, but also by a management staff that did not recognize their efforts.

Even without absenteeism, the shift arrangement created stress for many employees. Employees were scheduled 12 hours a day, 2 days on, 2 days off. Soviet managers believe this schedule was necessary to give employees time to stand in line for food and other supplies. The employees, on the other hand, believed they would prefer a Western-style 8-hour, 5-day schedule. Schedules were a source of frequent discussion, and the policy had been changed at least four times since the restaurants opened. Rafalat had been told by Soviet managers that the employees voted on the scheduling policy. Employees said that management simply handed it down.

The long hours caused problems in the personal lives of the wait staff. Some 80 percent of the wait staff were married, and 60 percent had children. The long hours caused many to feel that they were being negligent regarding their parental responsibilities. Furthermore, many did not complete their shifts until after midnight, which prevented them from leaving in time to use Moscow's subways. Many had to use taxis, which were quite expensive. Commutes were long, and some employees traveled as much as 90 minutes one-way each day.

Communication between management and staff was limited. Many employees believed that, when they voiced their concerns, these opinions were not welcomed and fell on deaf ears. "There is a difference between words and deeds," a cook said. "They never take our claims seriously. In fact, we don't even know if they receive them. If you can substantiate your suggestions, then and only then can things change." Another said:

*Many people would like to see a union. However, it is very difficult to organize one. This is because of the philosophy in this country. Unions that support a specific group of workers really don't exist. The government controlled our working conditions*

*until now. They were supposed to act in our interest. Many feel that, if they voice their complaints, they could lose their jobs. They are not happy about voicing their complaints.*

Despite their expressed dissatisfaction, most staff believed that they would suggest seeking employment at Pizza Hut to others. One waitress summed up the feelings of the staff: "The work here is much more exciting and pays much better than anything you might be doing while working for the state, though it has not proven to be what we dreamed capitalism would be like."

### **Conclusion**

Andy Rafalat smiled and looked from the dining room at the line of customers reaching around the block. His "toe in the water" was being called a success. It had exceeded expectations in sales and profitability.

Rafalat knew there were critical problems: employee turnover was high, quality was diminishing, and employee discontent was rising. Soon the Russian managers would take over total management of the operation. Would they be able to turnaround the growing problems? What could he do to better prepare them for the management transfer?

On a different level of worry were the rumors of growing discontent with the Gorbachev government. If Gorbachev's reform policies fell out of favor, what would be the result for the Pizza Hut joint venture?

Exhibit 1

PIZZA HUT MOSCOW  
Weekly Food Requirements Purchased Locally

French bread	8,000 loaves
Garlic puree	320 lbs
Flour	8,800 lbs
Mushrooms	680 lbs
Onions	6,640 lbs
Tomatoes	5,000 lbs
Cucumber	5,000 lbs
Carrots	5,000 lbs
White cabbage	2,600 lbs
Beetroot	5,000 lbs
Pickles	5,000 lbs
Ice cream	2,000 lbs
Pepsi syrup	264 gallons
Beer	1,000 bottles

Exhibit 2

PIZZA HUT MOSCOW  
Full-Service Menu



Добро пожаловать в Пицца Хат!

Дом пиццы. В наших ресторанах Пицца Хат каждая пицца готовится по заказу клиента и только из продуктов высшего качества. Выпека пиццы займет некоторое время, и пока Вы ждете, почему бы Вам не попробовать нашего отменного супа, салатов, десертов или салата. Наши официанты и официантки всегда готовы Вам помочь, если Вам нужна помощь, пожалуйста, обращайтесь к ним.



**Закуски**

Каждый день мы предлагаем Вам один из наших фирменных супов. Вы можете узнать о нем подробнее у Вашего официанта или официантки.

Ирминский суп 3.00

**Чесночные гренки**

Основные гренки – это специированные ломти хлеба, покрытые чесночным маслом. Специальные гренки Суарим – это чесночные гренки, покрытые сверху джелингованным сыром "Монстерелла", что придает им особую мягкость. Чесночные гренки идеально подойдут к вашей пицце. Вы можете укомплектовать отдельно, как закуски.

Соусные гренки (4 куска) 2.50

Соусные гренки Суарим (4 куска) 3.50

**Салат-бар**

Салат-бар организован по системе самообслуживания. Вы можете составить салат по собственному выбору из имеющегося в нашем ассортименте свежих овощей. Закажите салат, официантка принесет Вам тарелку для салата и Вам останется всего лишь составить салат на свой вкус в салат-баре самообслуживания. Казанная цена дает Вам право только на один посещение салат-бара.

4.00

**Пан пицца и тонкая и хрустящая пицца**

Пицца Хат мы предлагаем выбор пиццы, которая может удовлетворить любой вкус. Все наши пиццы приготавливаются из свежих ингредиентов в каждом ресторане ежедневно, и покрываются специальными соусом и двумя слоями сыра моццарелла. Наши пиццы выпекаются на заказ. Вы можете заказать пиццу с начинкой Суарим, которая выпекается до хрустящей корочки. Пицца Хат предлагает Вам также отведать Тонкую и хрустящую пиццу. Пицца Хат предлагает Вам также отведать Тонкую и хрустящую пиццу.

**Фирменные блюда – "ПИЦЦА"**

В ассортименте имеются десять фирменных пицц, трех размеров. Вы можете заказать пиццу на одного или на несколько человек. Мы можем предложить Вам пиццу трех размеров:

Маленькая (18 см) Средняя (27 см) Большая (33 см)  
идеально подходит идеально подходит идеально подходит  
для одного для одного для одного или  
двух человек двух человек четырех человек

Маргарита Особый томатный соус и сыр 6.20 10.00 14.00

Пепперони Колбаса "Пепперони", шампиньоны 7.85 13.00 18.20

Вегетарианская Лук, зеленый перец, шампиньоны 8.40 14.00 19.60

Гавайская Ветчина, ананас 8.70 14.50 20.30

Московская морская "Москва", лук 9.50 16.00 22.40

Рыбное ассорти "Москва", лук 9.80 16.50 23.10

Европейская Ветчина, говяжья пачинка, шампиньоны 10.05 17.00 23.80

Мясной пир Начинка из говядины, начинка из свиной, лук 10.30 17.50 24.50

Суприм Начинка из пепперони, говядины, свиной, шампиньоны, лук, зеленый 11.15 18.00 25.60

Супер Суарим Начинка из пепперони, ветчины, сырной свиной, свиной, говядины, шампиньоны, лук, маслины 11.15 18.00 25.60

**Напитки**

Идеально с Вашей пиццей – заказывайте освежающий напиток из нашего богатого меню напитков.

Милый (330 мл)

1.20

4.80

1.20

4.80

1.20

4.80

3.50

20.00

4.00

1.00

1.50

**Десерты**

Лучше всего закончить трапезу одним из наших десертов.

Мороженое Шоколадное, ванильное или на выбор из многоцветного ассортимента, подробности вы можете посмотреть у Вашего официанта 4.50

Мороженое Сафед Молоко, мороженое, подается с десертными соусом, посыпано особым составом 6.50

Яблочный пирог Кусок традиционного яблочного пирога, приготовленного из свежих яблок и теста 4.00

**Пицца для дома**

Служба торговли на вынос ресторанов Пицца Хат предоставляет Вам возможность насладиться превосходной пиццей у себя дома. Сделайте свой заказ у стойки службы торговли на вынос в ресторане Пицца Хат по адресу: Кузнецовский проспект 17, к когда

Exhibit 2 (continued)



Welcome to Pizza Hut

Home of the Pan Pizza

Here at Pizza Hut every pizza is made fresh to order using only the finest ingredients. Baking your pizza may take a little time, so while you wait why not try some garlic bread or salad. Our waiters and waitresses are here to help so please ask if you require any assistance.

Garlic Bread

Garlic bread is the ideal complement to your pizza or on its own as a starter.  
 Garlic Bread freshly yeasted slices of bread, covered with garlic butter.  
**Garlic Bread Supreme**  
 Garlic Bread with melted Mozzarella cheese on top, a special treat.

Garlic Bread (4 pieces) 3.00  
 Garlic Bread Supreme (4 pieces) 4.00

Salad Bar

We have a salad bar where you can choose your own salad from the fresh selection available. All you have to do is ask for a salad. Your waiter or waitress will then give you a salad bowl. You simply choose your own salad at the salad bar. This price is for one visit to the salad bar only.

4.00

Pan Pizza

At Pizza Hut we offer a choice of pizza to suit everybody's taste. All our pizzas are made from dough prepared daily in each restaurant and covered in a delicious tomato sauce and two layers of mozzarella cheese.

All of Pizza Hut's pizzas are baked fresh to order. Our world famous **Pan Pizza** is light and fluffy inside with a crisp crust and baked in its own pan to a delicious golden brown. We also have our **Thin'n Crispy** pizza, prepared and baked to perfection with a thin and crispy crust.

Speciality Pizzas

There are nine different speciality pizzas to choose from in three different sizes. The choice is yours. You can order a pizza for one person or share between a few people. Our pizzas come in 3 sizes:

**Small** Medium perfect for one person  
 ideal for two to share

**Large** for three or four people to share

**Small** Medium Large

**Margherita** Special tomato sauce and cheese 5.00 8.00 11.00

**Pepperoni** 6.00 10.00 14.00

**Hawaiian** Ham, pineapple 7.00 11.00 14.00

**Vegetarian** Onion, green pepper, mushroom 7.00 12.00 15.00

**European** Ham, beef topping, mushroom 7.00 12.00 15.00

**Moskva Seafood** Moskva fish selection, onion 7.00 12.00 17.00

**Meat Treat** Beef topping, pork topping, onion 8.00 13.00 17.00

**Supreme** Pepperoni, beef, pork topping, mushroom, onion, green pepper 8.00 14.00 18.00

**Super Supreme** Pepperoni, ham, spicy pork, pork topping, beef, mushroom, onion, black olives, green pepper 10.00 16.00 22.00

Beverages

Ideal with your pizza's - Choose a refreshing drink from our wide selection of beverages.

<b>Minerals</b>	<b>Small (330ml)</b>	<b>Pitcher</b>
Pepsi	2.00	6.00
Diet Pepsi	2.00	6.00
Fiesta or Tanquets	2.00	6.00
<b>Beer</b>	<b>3.00</b>	
Local Beer	4.00	
Imported Beer		
<b>Wine</b>	<b>Local</b>	<b>Imported</b>
Red or White Wine by the bottle	12.00	16.00
by the glass	3.00	

**Hot Drinks**  
 Tea 1.00  
 Coffee 2.00

Desserts

The best way to finish your meal is with one of our desserts.

**Ice-Cream** Chocolate or vanilla 3.00

**Apple Pie**  
 A slice of traditional apple pie, made with chunks of apple, specially prepared pastry and served with ice-cream 4.00

Takeaway Service

With Pizza Hut you can enjoy great pizzas at home with our Takeaway Service.

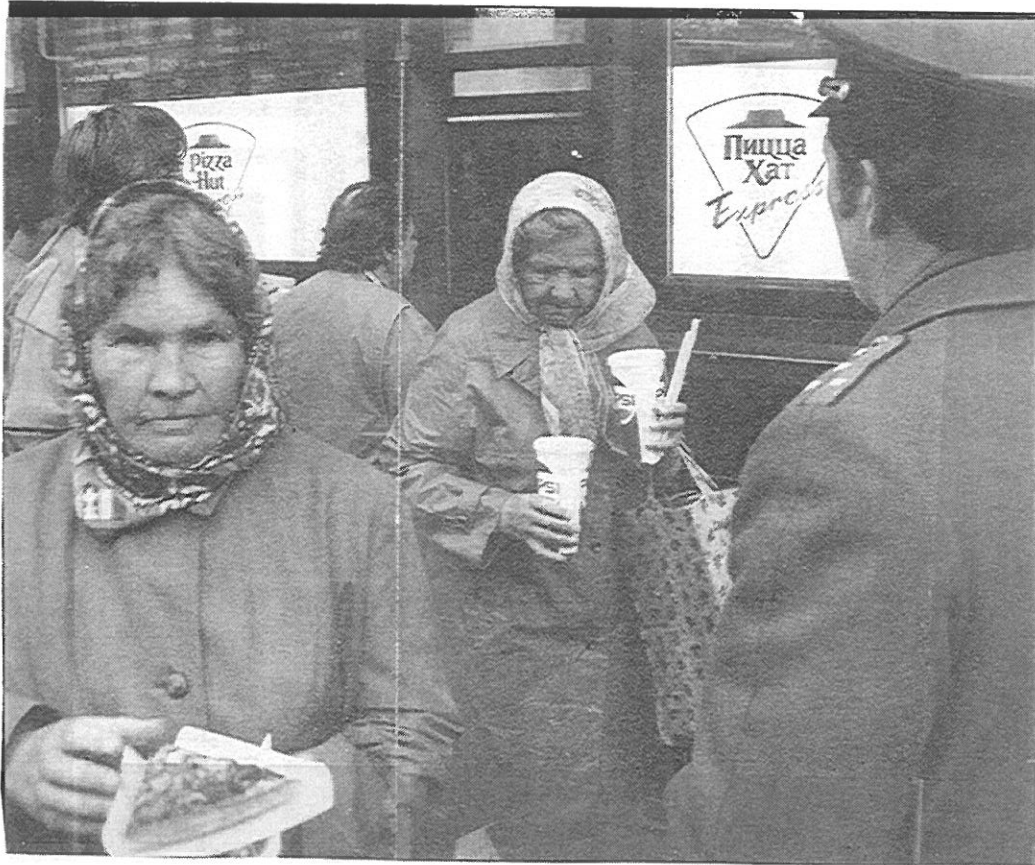
All you have to do is place your order at the Takeaway counter in the hard currency Pizza Hut restaurant, Kutuzovskii Prospect, 17.

Then just pick up your pizza when its ready and take it away!

The prices on this menu are for US Dollars, payment can also be made in Pounds Sterling, Deutschmarks or Finnish Marks. We also accept the following credit cards: American Express, Diners Club, Mastercard, Visa and J.C.B.



PIZZA HUT MOSCOW  
Opening Day



Above, the slice bar attracted all sorts of customers: left, Donald M. Kendall (left) with Andy Rafalat (right) and US Secretary of Commerce Secretary Mossbacher; Right, Ex-Soviet Ambassador to the US Anatoly Dobrynin, Donald M. Kendall, Andy Rafalat and Secretary Mossbacher. Below left, the interior of one of the new restaurants



Exhibit 4

PIZZA HUT MOSCOW  
Serenade for the New Trainees

## With a song in their hearts

**THE training team launched their trainees into action with a specially devised song, set to the melody of 'Those Were The Days' ...**

*Once upon a time there were two brothers  
Frank and Daniel Carney were their names  
They lived in Wichita which is in Kansas  
And they started up the biggest pizza chain*

*They named it Pizza Hut  
They named it Pizza Hut  
It grew and grew all over this great land  
It grew so wide and far  
Into the USSR  
At Pizza Hut you know you've got it made*

*The training team was captained by a Belgian  
She sent for reinforcement global wide  
From around the world the Training Team were  
comin'*

*With an assistant called Ivan by her side*

*They came from Canada and America  
Egyptians too were not left out of the crew  
There were some Brits and Welsh  
They needed someone else  
So they threw in an Aussie too*

*Now all of you take heed to what we tell you  
The future of success is in your hands  
So remember all the things that we have taught you  
And you'll make the greatest pizzas in the land*

*You all are Pizza Hut  
You all are Pizza Hut  
The way you smile  
They'll come from near and far  
You've all worked very hard  
You're held in high regard  
You are the pride of the USSR!*



**The training team in full song (left to right): Noella Dressen, Bruce Buchanan, Melissa Horner, Judith Rae, John Kinslow, Lisa Williams, Steve Voels and Rita Renth**



## **ORDER INFORMATION FOR SINGLE CASES**

### **LISTED IN CASES IN MANAGEMENT IN EASTERN CENTRAL EUROPE AND RUSSIA**

**Placing an Order:** Orders may be placed:

by fax - 1-(804) 924-4859, seven days a week, 24 hour a day;  
or by mail - Darden Educational Materials Services  
Darden Graduate School of Business Administration  
University of Virginia  
Box 6550  
Charlottesville, VA 22906, USA

**Prices:** UNIVERSITIES AND NONPROFIT ORGANIZATIONS: \$1.95 PER CASE, OR TEACHING NOTE.

Prices are effective July, 1992, are subject to change, and apply only to orders filled by the Darden School's U.S. distribution site (see below for information regarding international orders).

**Minimum Order:** The minimum order is \$5.00.

**Returns:** Please order carefully; **returns cannot be accepted.** Every order is processed individually, and no inventory is stocked.

**Shipping & Handling:** Orders are regularly shipped via UPS or U.S. Postal Service. For regular delivery, add 10%. Rush orders are shipped by two-day express via UPS or Federal Express. For rush delivery, add 15% (minimum charge of \$7.00). **For orders outside the continental U.S., shipping is billed at cost.** The shipping & handling charge should be added to the total of all orders.

**Forms of Payment:** Payment may be made by Visa, MasterCard, check, or money order payable in U.S. currency only, to "Darden Educational Materials Services." Terms available by submission of an authorized purchase order are net 30 days with a 10% late fee added after 30 days.

