

Integration into the World Economy: Companies in Transition in the Czech Republic, Slovakia, and Hungary

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**INTEGRATION INTO THE WORLD
ECONOMY: COMPANIES IN TRANSITION IN
THE CZECH REPUBLIC, SLOVAKIA,
AND HUNGARY**

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Part I

Discussion

Introduction

This report analyzes the behavior of firms and managers in the Czech Republic, Slovakia, and Hungary during their integration into the world economy. The conclusions are based on 23 case studies conducted in 1995. We found a rapidly transforming mosaic of managerial behavior which both changed over time and varied from firm to firm in all three countries. We found no one pattern of behavior that could be labeled as prototypical. This may be intellectually inelegant, but we wished to avoid the media's practice of reporting on the initially successful entrepreneurial stars – and quite often their subsequent failures – as possessing *the* recipe for success or failure. Indeed, one can learn from the stars as well as from those who crave anonymity at all cost. If we must draw a conclusion it is this: Success was determined, to a large extent, by the managers' flexibility to adapt to rapid – and always uncertain – changes. The obvious hypotheses that small companies are likely to be more adaptable than large ones and that young managers are necessarily more successful than middle-aged ones are not conclusively borne out by the case analyses.

We also attempted to put the observed managerial experience of the three countries into historical and comparative contexts. The experience of companies in Western Europe, Japan, South Korea, and Taiwan suggests that successful economic performances were largely determined by the success with which the companies integrated themselves into the world economy. This was also true for Malaysia, Thailand, and Indonesia in the early 1970s and for Mexico, Argentina, and Chile in the mid-1980s. Conversely, managers in countries that did not oversee this integration process well – India (until recently), Pakistan, Brazil, and virtually all of Africa – were left behind in terms of economic performance. A reminder: One of the great impediments to managerial success is unrealistic expectations. Many, if not most, entrepreneurs and managers in the target countries crave instant success. The fact is that it took West European and Japanese managers 20 to 25 years after the Marshall Plan and the Korean War, respectively, to bring their enterprises to prosperity.

In this paper we first sketch the macroeconomic and political environment for Central and East European (CEE) enterprises in mid-1995 and analyze the financial sectors in the target countries. The marketing, operations, and financial challenges to these companies are illustrated in case examples. Next, we characterize managerial behavior within various types of enterprises and comment on the relationships between these behaviors and success or failure.

Table 1. Type of industry and ownership of Czech and Slovak companies in the case examples.

Type of industry	Privatized companies	Joint venture
Agricultural processing (dairy)	Mlekarna Klatovy, a.s. (Czech Republic)	
Manufacturing	Biotika, a.s. (Slovakia) Botana, a.s. (Czech Republic) Solo, a.s. (Czech Republic)	Považské Strojárne, a.s. (Slovakia)
Services	Elektromontážní závody, a.s. (Czech Republic) Metrostav, a.s. (Czech Republic)	

Microeconomics, managerial behavior, and case studies that illustrate them are keys to understanding how economics work. Macroeconomics, fiscal and monetary policies, and stabilization are indeed very important but, by a long shot, they don't tell the whole story. The transformation and integration literature is full of macro studies; far too few micro projects have been undertaken because they are so labor intensive. We hope that there will be many more micro studies, and we are pleased that we are among the first.

The valuable case studies were made possible, to a large extent, by the contacts of the National Member Organizations of the International Institute for Applied Systems Analysis (IIASA), especially in Hungary. Managers in the three target countries are usually reluctant to open up to outsiders for a host of seemingly good reasons, originating in the uncertainty and rapid changes in their situations. IIASA's affiliates – and the skill of the case writers – managed to assuage their apprehensions.

We attempted to produce four categories of case studies: new firms, joint ventures, privatized companies, and state-owned enterprises (SOEs). *Tables 1* and *2* present matrices of industries and ownership of companies for which case analyses have been prepared.

The Macroeconomic and Political Environment in Mid-1995

The credo in the target countries is that the guidance of the invisible hand of the market will maximize economic welfare. This is an expression of “spirit” and should not be taken literally, as the *visible* hand of the government is still considerably more prevalent in CEE business than, say, in Western Europe or North America. However, the grip of the government's hand

Table 2. Type of industry and ownership of Hungarian companies in the case examples.

Type of industry	Modified SOE ^a	Privatized companies	Joint venture	New enterprise
Utilities & associated companies	Hungarian Telecommunication Co., BHG Híradástechnikai Vállalat			
Engineering			Ganz-Ansaldo	
Pharmaceuticals, textiles, & home improvement		Senior Vaci Kötöttárugyar	Chinoi Graboplast	
Food		Pick Szeged, Zwack Unicom		
Technology				Duna Elektronika Műszertechnika
Services				Budapest Stock Exchange, High-Tech Consulting, International Management Center, New World Publishing, Price Waterhouse, SBG&K Patent and Law Offices

^aSOE = state-owned enterprise.

is, obviously, a great deal more relaxed today than it was prior to 1989. This is just as well, as government policymakers and implementors also face (and sometime create) uncertain situations in which they have neither the experience nor the education to operate effectively. There has been a fair amount of vacillation in the implementation of budgetary and monetary policies that deal with rising unemployment in the absence of an established safety net and cope with inflation, trade policy, and in the case of Hungary and Slovakia devaluing currencies. In this respect CEE governments must deal with the same sort of problems as private-sector organizations.

The macroeconomic factors of life in Central and Eastern Europe may be summarized as follows:

- Because of the unfavorable economic legacies left by the respective Communist regimes, the post-Communist governments had to adopt restrictive economic policies which caused recessions in the domestic markets; the recessions most unfavorably impacted companies such as those selling home improvement or other postponable consumer goods (Graboplast in Hungary, for example).
- The collapse of the Communist regimes coincided somewhat with cyclical recessions in Western Europe and North America.
- The Soviet bloc markets collapsed in 1991.
- In addition to the recessions in Western Europe, export possibilities were harmed by the tariffs and quotas erected by the European Union (EU), especially in industries where CEE countries had spare capacity such as agricultural products, steel, and textiles.
- Successive devaluations of domestic currencies, vis-à-vis US dollars or Deutsche marks, raised the prices of imported inputs; for domestic producers the degree and timing of the devaluations added to already existing uncertainty and for the foreign joint-venture partners devaluations worsened their income statements.
- As the target countries reduced their tariffs and quotas – in an effort to liberalize – foreign companies (many with deep pockets) entered the markets causing domestic companies giant headaches.

In Hungary, Graboplast, Müszertechnika (computers), Zwack (liquor and beverages), and the strong domestic pharmaceutical industry were particularly hard hit. For instance, the share of foreign pharmaceuticals increased from 26.3% in 1990 to 46.6% in 1993. *Figure 1* gives the variables impacting on CEE companies' efforts at integrating themselves into the world economy.

Financial Sectors

A prerequisite to any smoothly functioning economic activity is an effectively functioning financial sector. As of mid-1995, this was simply not available in the Czech Republic, Slovakia, or Hungary. The balance sheets of most, if not all, banks were burdened with nonperforming loans. Further, banks in the Czech Republic and Slovakia were still managed by former Communist Party officials, not exactly banker types! In Hungary, the situation has improved in recent years. This has not been the case in the Czech Republic where in the summer 1996 the sixth largest bank collapsed and several of its

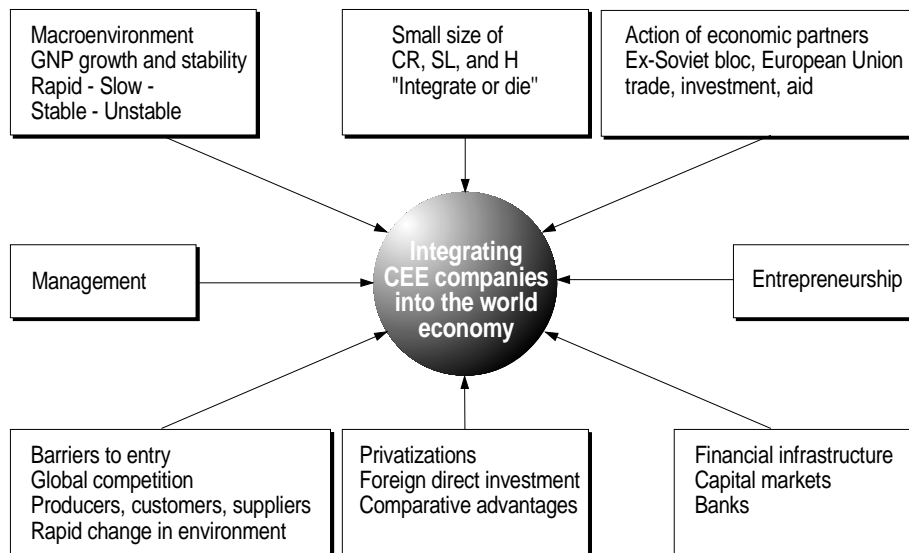


Figure 1. Variables determining integration into the world economy.

executives were arrested and charged with fraud (*Financial Times*, 1996). These managers were accustomed to lending to governments or government-owned businesses; they had little experience in lending to the private sector, which did not exist until recently. The new business scene, combined with the state of the banks' balance sheets, made the already risk-averse loan officers even more reluctant to lend – especially to mid-size or small companies where most of the growth occurred. The exceptions were companies featured in the media. The banks continued to lend to state-owned enterprises on the assumption that firms can and do go bankrupt but countries do not. These banks were no different from the multinational banks that threw plenty of good money after bad money in the developing world during the 1970s and 1980s.

By avoiding lending to mid-size and small firms, many of them with manager/owners, banks were likely to miss profitable opportunities. They did not consider the example of the overseas Chinese, primarily in Southeast Asia. Their firms started small, and as their enterprises grew into multinational, multibillion-dollar entities, the owners stayed loyal to the banks that helped them at the start. In CEE countries, which are much smaller in several ways than the countries in Southeast Asia, such lending is still possible.

Stock exchanges are not filling the gap left by banks. Founded in the early 1990s, they list only a few companies; a dozen or so companies on each exchange account for the bulk of the trading volume and equity prices have

been volatile as trading is thin, in line with the behavior of the stock markets in most emerging countries. Generally, banks proved to be uninterested in equity investing or in creating mutual funds. There is evidence that foreign banks lend directly to Hungarian enterprises; for instance, in the first three months of 1995, the influx of foreign credit amounted to \$1.5 billion (Csermely, 1996).

As the banks were holding nonperforming loans in SOEs, many of them exchanged these loans for equities in the respective SOEs. These equities were not a source of wealth as, by default, banks became investors in a string of losers. This arrangement created a web of bank-SOE cross-holdings along the lines of Japanese *keiretsu* and German-type bank-industrial complexes. The difference between the Japanese and German models and the CEE companies is that the *keiretsu* banks and the German banks take an active managerial interest in the companies in which they hold significant shares. Similarly, it is up to the CEE banks to check on the management of companies of which they are part owners. In mid-1995, they were not doing that. It is difficult to determine whether they lack the ability to take a more active stance or, as they are themselves in deep trouble, they are preoccupied with their own problems. Also, the behavior of the banks reflects the uncertainty of the macroeconomic environment in which they operate. Banks had difficulties in calculating returns on investments or cash flows because of inconsistent economic policies, high inflation, and devaluing currencies. They consistently advised clients to “stay liquid and short term.” This is the recipe that they themselves followed.

As indicated earlier, the Czech, Slovak, and Hungarian stock markets are not yet providing liquidity to the respective business sectors. The market solution to this problem has been the Global and American Depository Receipts (GDRs and ADRs) on Western stock exchanges. In 1985, 390 ADRs were traded on US stock exchanges; by mid-1995 the number had risen to 1,300 (*Fidelity Focus*, 1995). A GDR is a US dollar-denominated certificate issued by a multinational bank, stating that the issuing company has deposited shares with the bank. GDRs and ADRs can be traded, and clearance is *via* Cedel or Euroclear and only in convertible currencies. GDRs and ADRs widen the base of investors that may be attracted to a company’s equities, and this is likely to reduce the cost of capital to the issuer. FOTEX, a diversified retail company in Hungary, had two GDR issues in 1992 and 1994 for a total of \$70 million; Pick Szeged, a meat-processing company in Hungary, also had two issues in 1992 and 1994 for a total of \$22 million; and Pharmavit, Hungary’s third largest drug company, received a 1994 issue for \$24 million. Richter Gedeon, the largest pharmaceutical firm in Hungary, issued an Austrian DR in 1994 for \$50 million arranged by Schroders and Creditanstalt Investment Bank. Other investment houses active with

GDRs in CEE countries are CS First Boston, Samuel Montague, and James Capel. Of the target countries only Hungary had companies that where issued GDRs and ADRs as of 1995.

Some of the Hungarian companies in our sample are listed on the Budapest Stock Exchange (BSE): Chinoin, Graboplast, Pick Szeged, and Zwack Unicom. One precondition of BSE listing is that the company adheres to international accounting standards and has one of the Big Six American accounting firms as an auditor.

Among the companies in our sample there has been some budding merger and acquisition activity, such as Pick Szeged purchase of competing Herz in 1994. The purchase was financed by retained earnings and bank loans. A further role in the financial sector has been played by foreign institutions such as the European Bank for Reconstruction and Development (EBRD), which invested in Microsystems, and the US Congress, which appropriated funds to the Hungarian American Enterprise Fund, and invested in Duna Elektronika and Microsystems. Finally, a secondary market appears to be emerging. For instance, Creditanstalt resold 25% of its Graboplast stake to other investors.

A viable financial sector is also needed for restructuring domestic debt. Foreign debts have been held by multinational banks in US dollars, Deutsche marks, and other convertible currencies. Repayment of foreign debt has been made increasingly difficult by the devaluations of domestic currencies. Sometimes domestic banks have provided loans to prime customers in domestic currencies to service foreign debt. However, the role of domestic banks has been more crucial in the restructuring of domestic debt than in that of foreign debt.

The restructuring of domestic debt owed by SOEs has proved to be easier than the restructuring of debts owed by private enterprises because banks correctly believed that governments would meet their financial obligations. The restructuring of private debts has been cumbersome to banks. These debts were primarily owed to private vendor/suppliers who wanted to get paid either by SOEs or by the privatized successor. In a few cases, banks were successful in trading short-term losses, i.e., settle on $X\%$ of the debt for the sake of the long-term viability of the enterprise and that of the vendor's business.

Marketing

Prior to 1989 virtually all foreign trade was conducted by means of specialized foreign trade organizations (FTOs). Individual companies, with a few exceptions, had no foreign market intelligence, conducted no foreign market

research, had no distribution channels, and, indeed, did no foreign marketing. This situation represented a significant barrier to CEE firms trying to enter the world market. There is no substitute for doing one's own marketing, learning the market and trading practices, familiarizing foreign vendors with the company, its products or services, and so on. Selling in the Soviet bloc market was not marketing. Firms were told which goods to produce and sold their goods in markets for which their production was intended.

After 1989 marketing became a new *game* not only because the economies moved from producer orientation to consumer orientation but because, domestically, the economic transformation altered the channels of distribution. Much of the retail sector was privatized, and this called for frequent deliveries of small quantities to the retail outlets. Smaller retailers had neither the space to carry inventories nor the capital for financing them. New vendors appeared to fill the need, and old channels of distribution had to adjust or go out of business.

As the economies in the Soviet bloc collapsed, exports had to be reoriented with regard to destinations, commodity compositions, quality, after-delivery service, reliability of delivery, terms of delivery, and so on. These are major adjustments. Botana, a.s., a Czech company, exported 600,000 pairs of shoes to the Soviet Union in 1989 and not a single pair in the following year.

Foreign investors viewed CEE countries as export bases because of their low labor costs. These costs, of course, will rise in the future, but by that time CEE companies may have gained market shares in international markets. CEE companies regarded many joint ventures as vehicles for entering these markets, including reentering those in Eastern Europe and the former Soviet Union.

Of the Hungarian companies in our sample, at least three major enterprises adopted, as of 1995, a "look East" strategy. These include Zwack Unicom (a liquor producer and distributor), Chinoin (a pharmaceutical firm), and Graboplast (a textile firm); sales of this last company to East European countries rose from 9% in 1992 to 26% in 1994 partly owing to sales offices in Moscow, Warsaw, Prague, and Bratislava. Chinoin's exports accounted for 54% of its total sales in 1994, and 35% of the total went to the former Soviet bloc. The French firm Sanofi, owner of 51% of Chinoin, stated at the start of the joint venture that it considered Chinoin a vehicle for expansion into "Eastern markets." Richter Gedeon, exported 57% of its total exports to "Eastern markets" in 1994. Ganz-Ansaldo, a Hungarian-Italian joint venture in the engineering industry, lost most of its traditional Eastern markets (and Western ones) as well. In 1995, Ganz-Ansaldo attempted to reenter the markets in the former Soviet bloc and Eastern Europe: "The company is actively developing export structure in the East, especially in

the former CIS” (*Taking Stock*, 1995). Gyori Keksz, bought by the English United Biscuits in 1990, exported the bulk of its snack-type products to the Commonwealth of Independent States (CIS), especially after recovery began in 1993.

In Slovakia, Považské Strojárne (PS) developed a marketing strategy that, true to Slovakia’s vision, bridges the gap between East and West. Its products range from aircraft engines for the Russian Air Force to moped engines for Puch of Italy. The company’s widely varying customer base serves to exacerbate the problem of a large number of disparate products in PS.

A number of other marketing issues have surfaced. Franchising, for instance, was unknown in CEE countries. One franchisee, Duna Elektronika, found it difficult to get off the ground. Also, many CEE products have the deserved reputation of being inferior. Quality became a major issue after imports became available, and products had to be improved to meet export standards. In our sample Chinoin, Pick Szeged, and Zwack Unicom, as well as Ganz-Ansaldo, all in Hungary, went to great efforts to earn ISO-9001 classification.

Since the collapse of the closed, centrally planned system, adjusting to the supply of exports has proved to be a formidable task. To illustrate, Pick Szeged found that salami tastes differ from country to country and product/market adjustments had to be made. At Chinoin, staff training for the export and domestic markets was mainly undertaken by the French joint-venture partner, Sanofi. Sanofi trainees first lived in Hungary before the educational process began.

Duna Elektronika had two marketing surprises. One was that, while US consumers liked brand names, Hungarian consumers preferred low-priced clones. The second was that the sales-incentive system introduced by Duna was not well received. The American owners of Duna, including the Hungarian-born majority owner and the CEO who lived in the United States all his adult life, discovered that the sales staff preferred job security and structure and were not particularly motivated by the incentive system.

Operations Management

One function of management is to oversee the resources required to provide a product or a service. Based on our case analyses we tentatively conclude that in the 1989–1995 period there was relatively little fundamental change in management behavior. Specific instances of change can be found, but they are more the exception than the rule. Many managers still act as the corporate bureaucrats that most of them previously were. They tend

Table 3. Number of employees in selected companies in the Czech Republic and Hungary in 1990 and 1994.

	1990	1994
Chinoín, Hungary	4,500	2,842
Elektromontážní závody, Czech Rep.	2,500 (at peak)	1,400
Ganz-Ansaldo, Hungary	3,150	1,425
Graboplast, Hungary	2,284	1,383
Metrostav, Czech Rep.	5,300 (1989)	3,500
Richter Gedeon, Hungary	5,654 (1991)	4,623
Zwack, Hungary	1,400	740

to speak good English or German and have a repertoire of management buzzwords, but seem unable to develop a medium-term business plan, to design a system for coordination and implementation, to manage people, or to keep to budgets and schedules. There is a general aversion to taking risks, to assuming responsibility, and to making decisions. The French finance director of Chinoín, Philippe Vergnaud, remarked: “People here [in Hungary] tend to hide problems, hoping that they would go away” (Private interview, Budapest, Summer, 1995).

One factor prevalent in our sample of companies was the drastic reductions in employment. *Table 3* provides some examples. Despite reductions in personnel and direct labor costs, CEE companies were still not in a position to compete in the world economy. They were now in striking distance, and the addition of a combination of good management, better products, and improved marketing could bring them to the level of world competitiveness.

The decline in economic activity in the 1989–1994 period in the target countries introduced a new anxiety to managers: the fear of losing one’s job. This possibility made managers even more cautious. Behavioral modification, if at all possible, is a long-term process and six years in a turbulent economic, political, and social environment is too short for a major behavioral change.

There are other attributes. Managers and workers alike showed little loyalty to their firms. Nonconstructive criticism of one’s firm is a much-enjoyed pastime. In addition, the producers’ logic has not given way to the consumers’ logic. One manager complained about high overhead costs and then announced the solution: increase production, without seemingly having considered whether there is a demand for his increased production. This strategy if pursued by every company in a sector can result in disastrous overcapacity. For example, Mlekarna Klatovy, a West Bohemian dairy, is one of 100 dairies in the Czech Republic, where an economically reasonable number is closer to 25.

There are more hypotheses for the relatively little change in managerial behavior. Many managers asked why make changes as long as the enterprise is not bankrupt? The new players on the scene – investors, employers, the media, and government entities that are changing at the top, but not much elsewhere – are not used to change. Managers are also reluctant to change as they, obviously, value their economic and social power; with change they risk losing their positions. But what is most important, managers frequently do not know what to do, and who can blame them. They are in a new ball game; the rules of the game keep changing, and rapidly at that.

There are exceptions, of course, a prime example being Graboplast. A consultant working at one of the Big Six American accounting firms said:

The most important element which made this company turn around is the attitude of the CEO, Mr. Péter Jancsó. It was the fact that he admitted that he had a problem, and that he did not know everything about running a company and looked for outside help. This is contrary to other companies where they “don’t have any problems.” Without the manager’s support to bring in outside consultants to cut the fat around the company, Graboplast would not be where they are today. This attitude is contrary to managers at other companies, where they do not ask for help and they are not willing to change since they know everything and they can solve any problems on their own. [Private interview, Budapest, Summer, 1995]

Financial Management

Financing a firm is a new task for CEE managers. In one Czech company, the managers bought the company on a 90-day note in January 1993. When the note came due it was renewed for another 90 days. In June it came due again, but this time the bank that made the loan did not renew it, and attempted to take over the company with its own management. With less than a week to come up with the financing or risk losing the company to known rivals, the owners had not yet developed a plan to raise the needed capital. During the emergency discussions an outsider from the USA asked about the value of the company’s assets, including real estate. The company was using its own expensive real estate in the center of Prague for its major operations, even though it had about three times the property it needed in the outskirts. So why not sell the city plant and move operations outside the city? Through this action the company would secure more than enough to pay off the note. While not particularly innovative to those living in free financial markets, this approach never entered the minds of this Czech company’s managers.

Many firms are underfinanced, particularly in the long term. This is exacerbated by the fact that the need for funds for working capital are ignored or grossly underestimated (cf., for example, Biotika, a Czech company). Mlekarna Klatovy needed to raise between Kč150 and Kč200 million in working capital for purposes beyond its vast receivables, which were almost of the same magnitude. This predicament is not just part of the legacy of the centrally planned regimes, but it is a common situation in the emerging countries of Latin America, Asia, and Africa, areas where capital is scarce and real interest rates are high.

Given the large amount of secondary insolvency, the bane of CEE economies, financial soundness is even less frequent than one might think from the numbers in the financial statements. The underfinancing issue is exacerbated by forecasts of cash flows that are overestimated or costs that are underestimated.

A group of managers that knows how to work in strong financial markets is as sorely needed as an effectively functioning financial sector in CEE countries. The financial sector imposes a sorely needed discipline on businesses, and managers are not fully ready to conform to this discipline.

Strategy

Many of the firms in our sample have clearly pursued new strategies since 1989. For instance, in Hungary, Graboplast shed a number of its product lines and concentrated on home improvements. Müszertechnika diversified its line to respond to market changes and to take advantage of opportunities to form as many joint ventures as its resources could support. Pick Szeged discovered that, while it could increase its salami production (including exports), it was seriously hampered by insufficient supplies of pork. So, Pick is now heavily involved in pig farming – a new activity. In Slovakia, Považské Strojárne has outpaced some businesses, yet it must still consolidate a diverse product line and disparate market groups. The Czech Botana has been placed in a position where it must reduce its wide product line and concentrate on the production of winter shoes, where it has a competitive advantage.

Some companies are being forced to use new strategies but have not fully determined what these strategies should be. Metrostav, a.s., the Czech tunnel construction company, seemingly faces the end of its tunnel work with the completion of Prague's metro system. It must alter its strategy to survive, probably moving into environmental and industrial construction. Solo, a.s., a 159-year-old Czech match company, is busy finding ways to expand its product line beyond matches, a shrinking industry, focusing on products such as hardwood panels and I-joists.

A number of the firms in our sample do not yet have a cogent strategy. Some companies are reluctant to think about a strategy, and even more reluctant to actually execute a carefully developed one. Perhaps the lucky ones are those firms that were forced to create new business strategies from whole cloth.

Managerial Behavior

Having examined the challenges in various areas of business – marketing, finance, operations, and strategy – in this section we explore how managerial behavior has developed in CEE countries since 1989. Problem areas relate both to bad habits developed in the previous environment and to newly acquired nonproductive behavior.

The inertia of state-owned enterprises

SOEs will continue to play an important role in CEE economies for the following reasons, among others:

- They tend to have a large number of employees.
- They have huge, fixed, single-purpose assets and are capital and energy intensive.
- The environmental cleanup costs are likely to be sizable.
- They generally employ out-of-date technology and equipment that governments cannot afford to replace.

The exit strategy that the governments may have regarding SOEs is certainly limited.

Just as they have done over the past 45 years, managers of SOEs must continue to extract as many government concessions and as much support as possible. These efforts are perhaps more important than ever in this age of fiscal stringency. Important managerial skills are the maintenance of contacts in the right places and fostering relationships to acquire import licenses, to obtain foreign exchange or bank credit, and sometimes to get a license to obtain a license for yet something else. These skills have some importance in the private sector also, but their significance in the SOEs is paramount. In this respect the managerial behavior in CEE countries is similar to those in the economically emerging countries of Latin America, Asia, and Africa.

In a discussion of SOE managerial behavior two issues must be kept in mind: the state still plays a significant role in running large companies, even after they have been privatized; and the government acting as owner behaves differently than a set of private shareholders acting as owner.

SOE managerial practices carry over into foreign direct investment (FDI) practices. Most privatized firms preferred foreign partners for their needed capital, markets and marketing, technology, and management. After the capital was provided, many of these firms were not particularly aggressive about obtaining other items. However, an even greater motivation for picking a foreign investor was the stipulation that the existing management be maintained. In virtually all cases, the foreign investor knew no other local management. Keeping the existing management suited the foreign investor because it frequently meant that the terms of purchase were more favorable than the “market” would have suggested. Such investors may pay the price of their sweet deal with stodgy management later.

Under the guise of restructuring, managers acted as one might expect entrepreneurs to act; they transferred their companies’ good assets to separate firms and then either bought out the new company or entered into a joint venture with foreign investors. Even under these favorable conditions, virtually all enterprises were seriously underfinanced. These firms needed (and still need) substantial investments to make them internationally competitive.

Joint ventures took a number of forms. In Hungary, Graboplast had an agreement with an Austrian bank that was a financial – not strategic – investor. Ganz has an Italian state-owned company as a strategic partner, and a French private pharmaceutical company is Chinoin’s strategic partner. Müszertechnika had four different joint-venture partners – with the expectation that the arrangements would not last longer than five years. Zwack’s joint venture with German and British companies covered only export marketing. The largest Hungarian joint venture was between the state-owned telephone monopoly, MATÁV, (70%) and a German (Deutsche Telecom) company and an American (Ameritech) company as strategic investors. In Slovakia, Považské Strojárne’s approach was to own a number of subsidiaries that were joint ventures with partners in France and Germany.

The legacy of the SOEs is not only their endurance but the longevity and intensity of the counter-productive behavior that they have fostered in companies in Central and Eastern Europe, even when the SOEs have been transformed into different kinds of enterprise.

Dysfunctional entrepreneurship

We now turn to entrepreneurial management activity that can best be described as dysfunctional entrepreneurship. Part of the origin of this activity was established under the regime of central planning. Under this system – and its producers’ logic – it was economically advantageous for firms to be involved in as many activities, industries, and sectors as possible. This is how opportunities were created by the SOEs, resources attracted from the

state, and control exercised. Frequently head offices and their sizable administration staffs functioned as a holding company; they reviewed reports but were not involved in the day-to-day running of the firms. Since 1989, deteriorating economic conditions have necessitated that managers – who wished to maintain their standard of living – have multiple positions, often in multiple enterprises. Exclusive full-time employment does exist, but it has become rather uncommon. This is another similarity between CEE countries and many emerging countries of Africa, Asia, and Latin America; managers in the latter countries are also often involved in multiple enterprises. Further, in CEE and other emerging countries, some entrepreneurs lose interest in running businesses and prefer to make deals and pyramiding deals.

This environment produced a group of young urban entrepreneurs, characteristically in their 30s, energetic, generally well educated, and well traveled. This group emerged from the SOEs or, in Hungary, from a private sector that had begun by the 1980s. Its motivation was simple: money and the independence that money can and does buy. This philosophy was derived from Darwin's theory of survival of the fittest, and lacks a social conscience. The credo was growth and not necessarily profitability. Hence, even in the absence of smoothly functioning capital markets, merger and acquisition activity occurred financed primarily through bank loans to the enterprises' various affiliates. The growth in size (even without profitability) attracted favorable media attention. This, in turn, induced banks to continue lending and, consequently, resulted in high indebtedness of these firms.

The predictable end came between 1994 and 1995 when a series of high-flying firms went bankrupt. These included Microsystem, Control, and Kontrax in Hungary. All of these firms were established in the early 1980s under central planning by smart, young entrepreneurs. For a decade, they experienced phenomenal growth but beginning in 1990 they encountered considerable diversification financed by banks and many conflicts between founding partners. Microsystem's investors, for instance, included the EBRD, the Hungarian American Enterprise Fund (HAEF), and Data General; Microsystem filed for bankruptcy in 1994. The EBRD and the HAEF received investment advice from Salomon Brothers and Arthur Andersen. Microsystem's fate is rather typical of the companies in this group. Rapid expansion, extreme diversification, and insufficient adjustment to the changed market situation after 1989 were all present. These conditions included the emergence of foreign competition and, therefore, the fight for market share when, until 1989, expansion was a major objective. The other issue, which was noticeable in all these examples, was that personal conflicts developed between the founding partners. In the case of Microsystem the conflict involved

Peter Maros and Peter Vadasz: Vadasz quit, and Maros admitted to “insufficient management skills.” Personality conflicts are difficult to avoid in entrepreneurial situations; in this situation, however, the problem was exacerbated by the rapidly changing business culture and corporate governance issues that have arisen since 1989.

FOTEX in Hungary has become a celebrated case. Founded in the mid-1980s by Gabor Varszegi, 45, reported to be the richest person in all of the CEE countries, FOTEX is a diversified retail company that started as a one-hour photo-developing shop. By mid-1995, FOTEX had a string of shops, some of which also sold contact lenses, cosmetics, household goods, furniture, consumer electronics, and appliances. In today’s considerably open business scene, compared with that of five years ago, FOTEX faces competition in a number of these markets. Institutional investors (including George Soros) hold 76% of the stock and Varszegi, the largest single shareholder, holds 24%. Between 1994 and 1995 FOTEX share prices declined. In a dramatic move in May 1995, Varszegi bought back 4 million shares and the price jumped nearly 50% in one day.

Some analysts believe that the buy backs are due to unrest among shareholders amid reports of [Varszegi’s] dealings with Blackburn International [Varszegi’s private, fully owned Panama-registered company]. Mr. Varszegi insists that the shares were bought because they were undervalued. [*The Wall Street Journal*, 1995]

Personality conflicts also arose between partners – including foreign investors – on diversification and expansion. Some founding partners were distrustful or weary of “being taken”; others less so. Obviously, taking on a new partner meant giving up control and some partners were more hesitant than others to swallow this pill. This is a problem that exists everywhere; however, the reluctance to share control is more prevalent in Latin American, South and Southeast Asian, and African countries, as well as CEE countries, than it is in Western Europe, North America, or Japan.

Table 4 summarizes some of the managerial challenges presented in earlier sections and captures some of the dysfunctional entrepreneurial behavior described in this section. Viewing the challenges and the new behavior in the same frame, one might become discouraged and conclude that CEE countries have inherited only the problems and bad habits of a free-market system. Our assessment would be that these characteristics are growing pains in the early stages of a long developmental process.

Managerial transfer

A major motivation for CEE companies to participate in joint ventures is the acquisition of managerial know-how from foreign partners. For a host

Table 4. Managerial challenges and dysfunctional entrepreneurial behavior.

Managerial challenges	Dysfunctional entrepreneurial behavior
<i>Marketing</i>	<i>Short-term perspective</i>
Undifferentiated products	Trade away what you have
Unclear product niche	Quick action
Unsettled target markets	No long-term development
Threat of new entrants	<i>Deal-making</i>
Evaporating Eastern markets	Manipulation of immature markets
<i>Financial</i>	Acceptance of huge bank debt
Huge debt	Emphasis on growth
Secondary insolvency	Profitability not a consideration
Circle of debt	<i>Culture</i>
Undercapitalized	Yuppie
Lack of working capital	Money, greed, power, consumption
<i>Human resources</i>	Media conscious
Old values	<i>Style</i>
Former skills	Personality conflicts
Mixed motivations	Question of control
Former organization structure	
Relationships with SOE managers	
Overstaffing of industries	
<i>Operations</i>	
Producers' logic	
Poor (improving) production quality	
Availability of qualified labor	
Low productivity	
<i>Strategy</i>	
Widely disparate products/businesses	
Ill-defined core competencies	
Inadequate competitor analysis	
<i>Joint ventures</i>	
Transfer of managerial know-how	

of reasons, such managerial transfer was accomplished only in a limited number of cases in our analysis. In some instances, the foreign investor bought the privatized enterprise and basically shut it down. For example, Siemens purchased Telefongyar (Hungary), a manufacturer of telecommunication equipment, and essentially shut down manufacturing, kept a fraction of the original labor force, and turned the heavily scaled-down facility into a sales organization for Siemens products. Another reason why managerial expertise has not been transferred involves the interaction between government shareholders and foreign investors. The successful Chinoin-Sanofi (Hungary-France) pharmaceutical joint venture experienced a withdrawal of 100% of the firm's profits by the Hungarian government (then 60% owner) in 1993

to improve the country's budgetary situation. Chinoin's CEO resigned over this action, citing that without R&D expenditures the future of the company was in jeopardy. As the departing CEO remarked: "The state, by its nature, is a bad owner" (Voszkva, 1995).

For Ganz, a Hungarian firm manufacturing power-generating equipment founded in 1844, a joint venture was a *must*. Ganz's plant, equipment, and technology were obsolete and the government owner had no capital to invest. In 1991, Ansaldo of Italy acquired 51% of Ganz and in the next four years sales increased 50%, export sales rose from 40% to 66% of total sales, the work force was reduced from 3,000 employees to 1,500, yet losses increased from Ft600 million to Ft2 billion by 1994. The company recorded losses every year. Transfer pricing by Ansaldo may well have been the explanation to this problem; at the corporate level Ansaldo was profitable. As Ganz-Ansaldo's losses mounted, Ansaldo made them up and in the process acquired, as of mid-1995, 82% of the joint venture with the government holding the rest. All the top executives are from Ansaldo: the general manager and the commercial, production, and financial managers. The president is a Hungarian, but the position is a part-time and representational one – and he views it as such. In an interview he said: "While president sounds very nice, this is not my main job. I kept my own enterprises – trade in Russia, the Ukraine, Moldavia, and the Baltic states. At Ganz-Ansaldo the management is Italian, I am 'the Hungarian' " (*Heti Világazdaság*, 1995). There has been little management transfer at this company.

A large joint-venture project that seems to be a commercial success, though it went through a rough period, is Volkswagen's investment in Skoda in the Czech Republic. In 1991 Volkswagen acquired 31% of Skoda from the Czech government, the owner; by mid-1995 Volkswagen had acquired a 70% majority holding. The joint venture was essential for Skoda, as it had large debts and its profit was not sufficient to cover debt payments, let alone needed productivity enhancement. Skoda's labor force was reduced from about 20,000 employees in 1991 to less than 16,000 in 1995. Skoda expects to further reduce its work force by 500–1,000 employees per year between 1995 and 2000. In late 1995, Skoda announced that it plans to assemble cars under license in Russia and Belarus and also increase production in its Polish factory. In Russia, Skoda expects to assemble 100,000 cars annually as a start. Further, Skoda plans to build up a network of component suppliers to its various operations in Russia and in Belarus.

In the 1993–1994 period Volkswagen and the Czech government had a series of disagreements over Skoda. Volkswagen started scaling back its ambitious plans to modernize Skoda; earlier these plans had helped Volkswagen win a stake in the Czech car manufacturer over Renault of France. In 1993, Volkswagen's CEO pulled out of the nearly \$1 billion project designed to

raise productivity and capacity at Skoda, including the underwriting of loans from International Finance Corporation and the EBRD. These actions were done without prior notification to the Czech government, then the majority owner. A passage in the renegotiated agreement of December 1994 stipulates that the minority shareholder (the Czech government) will have veto rights until 2000 in all key decisions, including production and modernization.

A much more satisfactory outcome was observed in the Graboplast (Hungary)-Creditanstalt (Austria) joint venture; in 1991 Creditanstalt controlled 30% of the company. Graboplast, a producer of home improvement materials, transformed itself from a money loser into a competitive enterprise. Creditanstalt, though only a financial and not a strategic investor, undertook to teach management skills, and it brought in productivity consultants; the entire Hungarian management accepted this guidance. Graboplast has since become internationally competitive.

Many companies without joint-venture partners have made strides toward improving management. Elektromontážní závody, a Czech contractor of electrical projects, for example, has implemented new management methods utilizing weekend retreats and training.

Summary and Conclusions

There are many different methods for successfully integrating into the world economy. Managerial transfer, adoption of world-class technology, penetration of world customer markets, and acceptance in world capital markets are just a few ways. Clearly, some CEE companies have integrated into the world economy using one or more of these methods. However, many more have not integrated and fewer still have integrated on more than one front.

Between 1989 and 1995 the private sector grew dramatically in the Czech Republic, Slovakia, and Hungary. In appraising the impact of this change on managerial behavior, analysis should distinguish between new private enterprises and privatized SOEs. Our evidence suggests that the new enterprises – in terms of managerial behavior – tend to behave like their counterparts in the market economies. The same cannot be said for the privatized SOEs, at least, not to the extent that this can be attributed to the post-1989 established firms. Those privatized SOEs that have foreign joint-venture partners have, not surprisingly, adopted their managerial practices to market standards better than those that are without such partners. This was the case in many, but not all, joint ventures. Overcoming inherited managerial practices is a task that still lies ahead for many privatized CEE companies.

An effectively functioning financial sector is key to the further development of companies in CEE countries. Healthy banks that lend money and

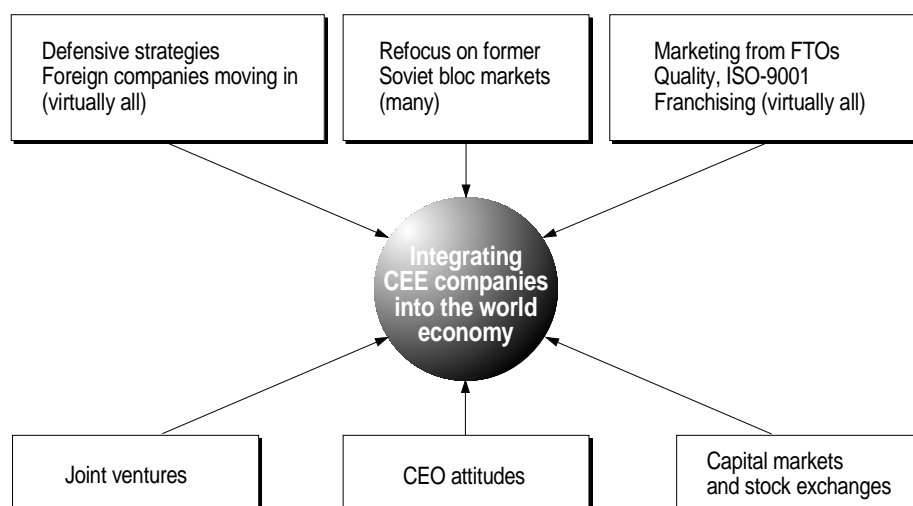


Figure 2. Company factors affecting integration into the world economy.

financial markets that provide long-term capital based on actual risks and returns are sorely needed. A smooth and stable financial sector provides both the *foundation* for growth and the *discipline* that management and companies need.

From discussions about wanting to trade with the European Union and wanting to be admitted to the EU, one might conclude that CEE companies should look to Western Europe for trade. Instead, it appears that several companies have successfully refocused on East European markets. Other companies have approached both the East and the West, looking for different things from each, which, on reflection, makes a great deal of sense (*Figure 2*).

The financial sectors in the Czech Republic, Slovakia, and Hungary are still far from being efficient. We observed that it was easier to liberalize and deregulate product markets (by removing price controls, subsidies, import restrictions, barriers to foreign companies, and so on) than to liberalize the financial markets. This seems counterintuitive given the global nature of financial markets coupled with the telecommunications revolution which introduced flexibility in this market. The reason for the lag in making the financial markets not as rapidly efficient as was the case in many product markets was political reluctance to opening up the financial sector to foreign investors. To be sure, branches of foreign banks have been established and joint ventures in financial institutions have been formed. Still the pace of opening up this sector was slower than the liberalization of products and services. However, steps taken toward liberalizations and deregulations, coupled with privatizations and foreign direct investments in this sector, and

international finance corporation assistance all point to improvements in the functioning of the capital markets in these countries.

In our opening paragraph we stated that managerial behavior during the integration of CEE firms into the world economy largely depends on the managers' flexibility to adapt to rapid and uncertain changes. The managerial group that learns the fastest is the one that comprises what we call dysfunctional entrepreneurs. They are not managers as the term is understood in Western Europe, North America, and Japan, as they are not particularly interested in running a business. They trade (rather than "make"), taking advantage of macroeconomic instability and market imperfections caused by partial liberalizations and deregulations. Considering how much money has been made by some of the dysfunctional entrepreneurs, their flexibility to adapt must be judged a huge success.

Surprisingly we found few fundamental changes in what we call operations management. We observed a perception gap in what looked like change and what was actual change. The former includes managers' foreign language ability and the competent use of business jargon. When we examined actual performance, and certainly there were exceptions, we found that business plans and systems for managing budgets, people, schedules, and financial, operational, or marketing targets were lacking. Nor was taking responsibility for decision-making or risk-taking high on the managers' agenda. We conclude that flexibility to adapt to change was somewhat a function of the degree of competition in the particular product or service market. This is hardly surprising. We were most interested to find out that, based on our case analyses, middle-aged managers were not likely to be more flexible than older ones. A Slovak manager told us "dinosaurs" can be found in all age groups. Further, some of the larger companies in our sample proved to be more adaptable than smaller ones. Managerial transfer was characterized by start-up difficulties; subsequently it was unsuccessful at Ganz (Hungary) but successful at Skoda (Czech Republic) – both large companies. The purpose of operations management is to keep the long-term objectives of the firm in mind, while optimizing available resources. Management over the long term will likely require modifications in managerial behavior that have not yet been identified in the six years that have elapsed since the collapse of the centrally planned regimes. Our comments suggest that managerial behavior has a way to go before CEE companies become internationally competitive.

The 1989–1995 years may be characterized for the CEE companies and managers as a period of survival and transformation. We conclude that, in the post-1995 years, managerial behavior must change in many ways to make CEE companies internationally competitive. There are considerable opportunities available to CEE companies. Those companies that recognize these opportunities and make the requisite changes will be rewarded.

Part II

Case Studies

Biotika, A.S., Slovakia

In the years since the revolutions of 1989, the pharmaceuticals market in the Czech Republic and Slovakia has changed beyond recognition. Where once the state controlled imports and organized approved drugs lists, these are now more or less left to the market. Insurance-based compensation for drugs makers is the norm, replacing a system of set prices to hospitals and consumers. The acceptance of international standards in intellectual property law has meant that Czech and Slovak manufacturers now rely less on “copy-cat” versions of patented, branded drugs and more on licensing. To compete, domestic producers are finding or entrenching their niches. One such company is Biotika, a human and veterinary pharmaceuticals manufacturer in Central Slovakia.

At the end of 1994, Biotika produced goods in four main product groups: penicillin (prepared as various salts for treatment of infections in humans and animals); chlortetracycline (for therapeutically medicated animal feeds); pre-mix (animal feeds); and antibiotics (dry injections and veterinary powders). Biotika has no domestic or Czech competitor in these products.

Under the former Czechoslovak regime, pharmaceuticals manufacture was dominated by Leciva (Czech), Slovakofarma (Slovak), and Galena (Czech). The first two specialized principally in solid preparations, the last in liquid pharmaceuticals and fine chemicals. In turnover terms, Biotika is a second-tier manufacturer. Annual sales were Sk1.47 billion in 1994, versus Kč3.85 billion for Leciva. (For financial information see *Biotika Exhibit 1* and *Exhibit 2*.) But, whereas the larger pharmaceutical makers are oriented toward domestic sales, Biotika is seeking its fortunes outside its borders. In 1994, exports as a percentage of total sales stood at 57% (compared with 20 to 25% for its larger competitors).

The majority of Biotika’s domestic customers are farmers. Biotika sells through Polnonakup, an agricultural trade company whose principal customers are cooperative farmers. On the health care side, where domestic sales account for less than 10% of total health-related sales, Biotika works with a group of trade representatives, each responsible for sales to clinics and hospitals in various regions of Slovakia.

Unfortunately for Biotika, farmers and clinics/hospitals are two of the country’s most financially forbidding sectors. Slovak farmers operate at a collective loss, despite generous subsidies and price intervention by the state. Privatizing agriculture has proved devilishly difficult, and the sector as a whole remains bloated and less efficient than competitors to the West.

This case was written from public sources with some cooperation with Biotika executives who wish to remain anonymous. It does not have the official approval of the company.

Health care presents an even greater challenge. There are nine health insurance companies licensed in Slovakia, but one main company, majority owned by the state. Across the industry, premium income is not covering costs, a fact which threatens the solvency of all the players. "The sector has a shortage of money," says Krchnavy, Biotika's Vice-President of Finance and a member of its board of Directors, noting that "during the first quarter of 1995, the state health insurance company spent half of its annual budget."

Although the majority of drugs prescribed by doctors are reimbursable by health insurance companies, many doctors prescribe the most expensive (imported) drugs, according to Krchnavy. "Doctors get 'presents' from the international drug companies," he says. They are under no pressure from insurance companies to prescribe less-expensive alternatives, although this is slowly changing as insurers band together. Domestic producers are fighting back and are asking the Ministry of Health to draw up a new list of reimbursable drugs – without many of the more expensive imports.

The firm's business strategy calls for an increase in the production of drugs in final – that is, non-bulk – form. This will be an uphill battle, since Leciva, Slovakofarma, and Galena hold the dominant positions in this market. Biotika has begun to produce final-form penicillin and, in cooperation with Galena, dry antibiotic syrups. Krchnavy recognizes that cracking this market will be difficult, mainly due to history and geography: the big producers already have good contacts with local distributors, and Leciva, the largest manufacturer, is located in the largest market, Prague.

According to Krchnavy, there is a gentleman's agreement among European penicillin producers on the amount of penicillin to be produced. Biotika commands a comfortable one-third share of the European market, a statistic which is perhaps deceptive. "Penicillin is the antibiotic of poor people," says Krchnavy, implying that a substantial share of, say, a large Asian market would be much more beneficial. Exports to non-European markets are growing, says Krchnavy. Trade is handled through Biochem, a London-based joint venture.

In agricultural trade, Biotika is in the process of registering its products for sale in Poland, Hungary, and Ukraine. Krchnavy is optimistic about sales of the company's products within the region.

Biotika was privatized in the first wave of voucher privatization. At the end of 1994, the National Property Fund (NPF) owned 15% of shares; the remaining shares were held by funds and individual shareholders. Krchnavy complains that the Board of Directors and the Supervisory Board are "bureaucratic"; fund representatives "are not so ready to take on new ideas," he says.

Raw materials make up about 50% of Biotika's costs, leaving it susceptible to price swings, good and bad. In 1994 and the first half of 1995, the

firm came out on the short end: raw-materials prices were up between 25 and 30% on average. Dry weather in Europe contributed to a poor beet harvest, and sugar prices (a principal penicillin ingredient) shot up 40 to 50%. Wages and salaries constitute 12 to 13% of costs and are growing about 12% annually.

Biotika has managed to slowly get a handle on a receivables problem that threatened the company in the early 1990s. The average receivable is now 50–60 days, down from 82 days in 1992.

Earnings were down dramatically in 1994 to Sk30 million from Sk118 million in 1993. But Sk79 million in 1993 earnings came from extraordinary (nonoperating) items. The firm's operating profit actually rose 9.6%. Return on equity has increased from 2.4% in 1992 to 9.9% in 1994.

Biotika has two production joint ventures. The first, with Germany's Hoechst, produces glass ampoules, tablets, ointments, and creams. Hoechst, another large European producer of penicillin, brought expertise in tablets production to the joint venture, while Biotika supplied experience with solution preparations. Management announced its intention to invest up to Sk100 million in 1995 to modernize glass-ampoule production. Hoechst-Biotika was founded in 1992 and showed an immediate profit. The firm paid dividends in 1994, and forecasts earnings of around Sk45 million in 1995, on turnover of Sk500 million.

The second joint venture will take longer to show similar results. Fermas, a venture with the German firm Degussa for the production of amino acids, was hurt by low sales prices of Threonine, its principal product, and high raw-materials prices (again, sugar). Too, Fermas has been dogged by inadequate capital. Krchnavy says the firm is getting ready to borrow to shore up its working capital. "We knew from the beginning [Fermas's] capital wouldn't be enough," he says. The company will likely not break even until 1996.

Biotika itself suffers from the same low-capital problem, according to Krchnavy. The firm issued Sk250 million in convertible bonds in 1994, which were held by the National Property Fund. Along with the Fund's 15% shareholding of common stock, the tender winner was to have received a 48% share of Biotika, worth Sk415 million. After postponing a decision from April to July, the Fund declared the tender unsuccessful and, as of 1995, said that the holding will be sold via direct sale. Three parties bid for the stake; one included a group of managers and a foreign partner. In explaining its decision, the NPF said that all the bids were unsuitable and that no consensus on the winner could be found among Fund representatives.

Short of working capital, the firm has reluctantly turned to the banks. Krchnavy says that the problem is not in obtaining loans – a traditional lament for Slovak companies – but "in using the loans more efficiently." Biotika's investment priorities are in energy efficiency (switching from coal

to natural gas); the introduction of new custom-premix technologies (completed in 1994); and environmental protection (investment on anaerobic processing of organic waste could top Sk200 million in 1995 and make Biotika a “wasteless” producer). Most of these investments have been financed by cash flow and the convertible-bond issue. Bank debt decreased in 1994 by 15%.

Biotika Exhibit 1. Income statements (in thousand Slovak korunas).

	1994	1993
Net sales of products	1,230,997	1,141,204
Sales of secondary products	31,398	21,433
Total net sales	1,262,395	1,162,637
Change inventory	(1,660)	(6,243)
Materials consumed	632,194	517,839
Wages and salaries	185,117	164,512
Utilities	93,879	99,317
Depreciation and amortization	85,792	67,610
Other miscellaneous expenses	114,587	180,503
	1,109,907	1,023,538
Net income from operations	152,488	139,099
Other income deductions		
Gain from disposal of equipment	4,188	8,506
Financial income	70,257	68,334
Financial expenses	(150,916)	(109,197)
	(76,471)	(32,357)
Income before income taxes and extraordinary items	76,017	106,742
Income taxes	(41,567)	(67,574)
Income before extraordinary items	34,450	39,168
Extraordinary items	(4,200)	79,542
Net income	30,250	118,710

Biotika Exhibit 2. Balance sheets (in thousand Slovak korunas).

	1994	1993
Assets		
<i>Current assets</i>		
Cash	39,371	59,270
Trade accounts receivable	201,640	238,998
Inventories, net	208,634	166,488
Due from associated companies	63,000	
Other current assets	1,429	208
Due from the state	61,796	8,097
Total current assets	575,870	437,061
<i>Fixed assets</i>		
Tangible fixed assets	916,290	737,760
Intangible fixed assets	13,781	18,604
<i>Investments</i>	554,295	586,963
Total noncurrent assets	1,484,366	1,343,327
Total assets	2,060,236	1,816,388
Liabilities		
<i>Current liabilities</i>		
Accounts payable and accruals	159,808	123,715
Bank debt, including short-term portion of long-term debt	153,304	6,251
Current portion of long-term research	6,224	6,674
Current portion of capital lease obligation	4,873	10,631
Payable to associated companies	7	494
Accrued wages and other amounts due to employees	22,145	11,281
Unrealized foreign exchange gains	1,921	7,285
Due to the state	5,928	49,895
Total current liabilities	354,211	386,226
<i>Long-term liabilities</i>		
Bonds	250,181	235
Deferred taxes	127,744	127,554
Long-term debt, excluding current installments	76,631	74,757
Long-term R&D, excluding current portion	9,413	13,347
Obligations under capital leases, excluding current portion	909	3,468
Total long-term liabilities	464,878	219,361
Total liabilities	819,089	605,587
<i>Capital</i>		
Capital	770,950	770,950
Statutory reserve fund	104,088	97,156
Revaluation reserve	191,614	191,330
Other reserves	54,915	37,344
Retained earnings	119,580	114,021
Total capital	1,241,147	1,210,801
Total liabilities	2,060,236	1,816,388

Botana, A.S., Czech Republic

Nineteen eighty-nine was a good year for Botana, Czechoslovakia's best-known manufacturer of sports shoes. Production and sales were up, and the company exported 600,000 pairs of shoes – one-third of production – to the Soviet Union. In a now-familiar story, Botana watched its biggest account dry up the next year: in 1990, the company did not sell a single pair of shoes to the USSR. In the same year, international shoe baron Tomas Bata began his quest to recover his family's Czech shoe empire. And Western shoemakers began shipping their higher-priced, higher-quality shoes to Czechoslovakia *en masse*.

Reaction at the company's Skuteč, East Bohemia, headquarters was swift. Management immediately considered two possibilities: licensed production or a joint venture, with either option to be undertaken with a famous Western name. Botana opted for the licensed production. Puma and Salomon, two of Europe's top brands in sports shoes and sports equipment, were chosen, and Botana began production of Puma tennis and basketball shoes for the local market. In 1991, Botana production made its way into Puma's sales network. In 1992, the firm expanded its Puma production to include football (soccer) shoes; these shoes were also sold internationally through Puma's existing distribution system. Impressed with Botana's quality (and its low wages) Puma eventually closed its Herzogenaurach, Germany, factory and moved the factory's entire sports shoe production to Botana. In 1993 Botana produced 350,000 pairs of top-of-the-line football shoes; most were exported.

Canstar, a Canadian manufacturer of sports equipment and shoes, was interested in establishing a joint venture, but the deal fell apart. Botana's director, Miroslav Pospíšil, jumped ship in 1993 and arranged for Canstar to invest in a new green field site in Ždár nad Sázavou, not far from Botana's home in Skuteč. Like Botana, the new factory produces the upper part of ice hockey skates. There is one rub: Botana also operates an ice hockey manufacturing line in Ždár nad Sázavou: the two factories sit a mere 50 meters from one another.

Proving that Botana could manufacture to Puma's quality standards was an important step, according to Jaromir Pecina, the company's Trade Director: "The first six months were difficult, but after confirming that Botana was able to produce good quality shoes, Puma trusted us more." Gaining access to the Puma network was also critical. Like other Czech and Slovak shoemakers, Botana's reliance on only two wholesalers (Velkoobchod Obyvy

This case was written from public sources with some cooperation with Botana executives who wish to remain anonymous. It does not have the official approval of the company.

Zlín in the Czech Republic and Partizanské Obuvy in Slovakia) proved disastrous. “Our wholesale network was completely bankrupted,” said Pecina. “We had to build our own warehouse in Heřmanův Městec [about 25 kilometers from Skuteč]. On the export side, two foreign trade organizations, Exico and Prago export, just left us.”

But while Botana was producing and exporting ever greater numbers of increasingly high-quality shoes, it was also importing shoes from Puma, Salomon, and Kneissl-Dachstein. “We were a sales agent for our own country,” said Pecina. Imports soared. “The situation got worse and worse. [Management] wasn’t watching what they bought; they weren’t paying attention. It was a time when everyone wanted to be an ‘entrepreneur,’ everyone wanted to be ‘in business.’ ” The firm ran into severe cash-flow problems, and insolvency loomed. The domestic market shrank in 1992 (sales fell about 15%), and secondary insolvency, the never-ending bane of the Czech economy, began to bite.

Botana’s line of products was extensive – too extensive, according to executives. The firm’s showroom was regularly packed with every conceivable variety of football shoe, cross-country ski boot, and hockey skate. Even so, Pecina feels in the “winter shoe” market, Botana has no rivals. “Summer shoes” are a different story. Competition from cheaper East Asian producers became fierce in 1993. Pecina acknowledges this fact: “There is big competition now from the Far East. Their quality is low, but so is their price.” Pecina estimates that Botana has perhaps a 10% share of the “summer” sports shoe market, good enough for first place among name brands. Adidas, which moved into Czechoslovakia early, occupies second place. Pecina states, “We are the most well-known brand; Adidas is second.” Heavy hitters like Nike and Reebok have increasing market shares, but their prices are still high for the average Czech.

The company’s turnaround year was 1994. The firm’s privatization was finally completed, and with a new director in place, shareholders approved a three-year development plan. After evaluating competitors’ production costs, Botana took a look at its own. The firm then worked on rationalizing production in the specific product groups where it felt it had a competitive advantage. Cost of goods sold and production expenses fell 30% from 1993. According to executives, this helped Botana concentrate resources in product development and further innovation. Production cooperation with private workshops in Slovakia – uppers are sown in Slovakia with elastic sown on in the Czech Republic – has proved profitable. Following its gains in productivity and implementation of higher quality standards, Botana garnered an ISO-9000 certificate.

Turnover fell 18% in 1994, but costs dropped further, by 22%. Value added increased substantially, up 23%. By the end of the year, Botana had

reduced its copious inventories and short-term receivables by more than a factor of two, from Kč104 million, to Kč48 million. Cash and other marketable securities increased as well, from Kč4.7 million to Kč52.5 million (see financial statements in *Botana Exhibit 1* and *Exhibit 2*). Although bank debt increased 15% from 1993 to 1994, Botana managed a restructuring at lower interest rates. Short-term payables were cut in half.

Has Botana turned things around? Pecina thinks so, but with one or two reservations. The firm has capacity problems now, and must choose carefully in which product groups it will concentrate. Executives say innovation and subsequent investment will be limited to areas where Botana can be price competitive. This rules out the cutthroat summer sports shoe market; new designs can be expected in skates and field athletic shoes, where the firm already has high quality standards.

Botana has concentrated on recovering lost markets to the East, partly in response to seasonal sales fluctuations in Western markets, but also because of its still-intact reputation and contacts. This is not without dangers, however. The firm still has trouble with payment from Central and East European markets, but hopes to get a handle on these foreign receivables problems with its new financial plan. Investment privatization funds own 75.8% of Botana equity. Individual voucher holders own 9.8% and employees another 1.0%. Another 13.6% has been distributed to restitutees (individuals whose property was taken from them following the takeover by the Communists in February 1948).

Botana Exhibit 1. Balance sheets (in thousand Czech korunas).

	1994	1993
Assets	538,292	598,507
Fixed assets	185,974	188,952
Intangible fixed assets	631	731
Tangible assets	184,143	186,621
Financial investments	1,200	1,600
Current assets	352,318	384,374
Inventories	130,947	172,588
Short-term receivables	145,830	207,024
Cash and marketable securities	52,554	4,762
Other assets	22,987	25,181
Liabilities	538,292	598,507
Basic capital	205,387	205,387
Capital funds	7,747	10,313
Funds from profit	12,773	9,738
Profit/loss of previous period	(40,914)	0
Profit/loss of current period	1,616	(37,879)
Reserves	3,325	3,132
Short-term payables	106,815	214,908
Bank loans and grant-in-aid	228,894	184,471
Other liabilities	12,649	8,437

Botana Exhibit 2. Income statements (in thousand Czech korunas).

	1994	1993
Sales	720,421	874,380
Total costs and expenses	718,805	912,259
Cost of goods sold	479,087	622,850
Personal expenses	146,315	143,176
Depreciation, taxes, and fees	13,924	13,680
Interest and other financial costs	44,968	82,384
Value added	191,142	148,503
Profit (loss)	1,616	(37,879)

Elektromontažní Závody, A.S., Czech Republic

During the recent bear run on the Prague Stock Exchange, Elektromontažní závody's shares defied the market's collective gravity. On December 16, the year's last day of trading, the firm's share price stood at Kč4,290, only 3.1% off its 52-week high, and fully eight times above its year low of Kč500. During the final quarter, the broad market lost 24% of its value. In fact, only one listed share – Sklářny Kavalier – managed to increase in price during the last quarter. Elektromontažní závody (EZ), a soup-to-nuts purveyor of electrical installation services, came in second. Why?

EZ is a contractor for projects of process-related electrical installations that include delivery, erection, assembly on site, trial runs, and commissioning. The firm was formed in 1951 from divisions of several local and foreign firms operating in Czechoslovakia, including Asea Brown Boveri, Siemens, Skoda Plzeň, and ČKD Praha (all heavy industrial enterprises engaged in electrical assembly parts and equipment). After years as part of the ELEKTROMONT Praha concern, EZ became independent as part of the Federal Ministry of Industry's transformation process. Reorganized as an independent joint-stock company in 1992, EZ quickly took the initiative and built on contracts already under way.

The size of EZ contracts ran the gamut from large heavy current electrical systems for nuclear power and hydropower stations to small low-voltage systems for neighborhood stores. The firm's fortunes were quite obviously tied to construction investment, particularly in infrastructure-related sectors such as civil engineering (transport, water treatment plants) and power and heat generation. Other industries, such as chemicals, foodstuffs, paper and wood processing, metallurgy, building materials, and office developments, were major contract sources as well.

At the end of 1994, the firm was the market leader in the Czech Republic, with excellent domestic prospects. At that time, EZ was delivering heavy current electric systems to Temelín Power Station, a nuclear plant in South Bohemia slated to go on line in 1997, and was simultaneously completing the reconstruction of safety systems at the Dukovany nuclear power station. The company was delivering desulfurization devices to coal power stations throughout the country, but especially to hard-pressed, coal-choked North Bohemia. Cable systems, low- and high-voltage distribution halls, and transformer stations have been delivered to such well-known firms as Avia, Skoda Plzeň, Tesla Lankroun, and ČKD Praha. The firm's long-held contacts and loyal customer base also contributed to its strong market presence.

Management identified several basic strategic principles with which to guide EZ, including the following: a stabilization of the work force; establishment of a quality-control system; intense utilization of internal resources

for improving efficiency of managerial and professional teams; expansion into new market sectors, utilizing active market operations (in terms of prospect-hunting, canvassing, and bidding); full employment of marketing tools for the benefit of the overall business policy; fostering of goodwill, especially in business and public relations; careful selection of suppliers of equipment and electro-installation components.

At the end of 1994, EZ showed a net profit of Kč68 million on turnover of Kč1.19 billion. Total assets stood at Kč2.23 billion. For a firm of its size, EZ's equity base – Kč143 million – was small. As of summer 1995 the company planned an equity increase, probably through a rights issue, although a firm date had not been set. Unlike most large firms in the Czech Republic, EZ had few problems with secondary insolvency, and bank debt was low. Long-term bank loans were Kč171 million, down substantially from previous years. Milan Hlinovsky, the General Director and Chairman, described the firm's debt position as "manageable," and noted that EZ intended to pay off its loans and be "completely self-sufficient." Short-term loans and debt totaled only Kč3.5 million. EZ expected to finance growth from cash flow. Net cash increased by Kč82 million in 1994.

In 1994 the firm employed 1,400 people, down from a high of 2,500, with an 8:5 worker-administrator ratio. The paring of employees was not difficult. EZ easily saw that the "self-privatization" of nonessential activities like reprographics and transportation was to its advantage.

Between 1991 and 1992, the company instituted rules "which allowed staff to act as 'entrepreneurs' within the company. We gave them the freedom they needed. These were not artificial rules: each unit, however small, had to answer for itself. In this way, we learned to economize." Productivity increased by 50% in 1993 and 25% in 1994.

If management expertise translates directly into an improved bottom line and confidence among shareholders, then much of the credit for EZ's success can be attributed to the team that Hlinovsky assembled. Executive management averaged 45 years of age, and two board members were only 30. (These two were representatives of privatization funds.) Hlinovsky, 54, started his career with EZ in electrical engineering and worked up the management ladder.

At a time when it was fashionable for Czech executives to chant the latest mantras from Western management gurus, Hlinovsky's group was a breath of fresh air. Training weekends at the company's recreational facilities were common and included frank discussions about how to motivate staff and increase productivity. Language lessons at these weekend sessions were *de rigueur* – the better to conquer foreign markets and deal with hard-bargaining Western customers. Total Quality Management, in many Czech firms little more than a cliché, was integrated as part of the firm's overall

strategy. Hlinovsky described it simply: “We wanted to have *real* quality in all our work.” The firm has won its quality wings with an ISO-9002 certificate.

EZ’s strategic objectives went through three iterations, as Hlinovsky recognized that the “power of some individuals was getting out of control.” An important innovation required that all major projects entered into first be in line with an overall trade strategy, and only then devolved down to various divisions. “We have a certain set volume of risk that any particular division can take on itself,” said Hlinovsky. “Anything above that must be sent up the chain for a review and a decision.”

EZ also began to evaluate suppliers on price and market availability. In line with the overall devolution of responsibility, divisional management received considerable authority in making supplier decisions – the days of contracting for services from within the organization at higher prices were over. The majority of suppliers, however, remained domestic.

The company currently faces changing local and international markets. As domestic privatization winds down and investment revives, construction-related spending will increase. The investment market will become more polarized: small and medium-size projects (which constitute the bulk of current revenues) will give way (again) to large projects. Although EZ enjoys an excellent position for these projects, more competitors can be expected to arise.

Internationally, EZ faces the drying-up of its traditional Eastern markets, which were a major source of income for large-scale projects. In its former incarnation as Elektromont Praha, EZ participated in dozens of major export projects – hydroelectric plants to Albania, oxygen plants in Yugoslavia, refineries in Syria, power stations in Ethiopia. But moving away from such Soviet-aligned contracts is a challenge. In 1989 the firm completed installations at power stations in West Germany and Denmark. But according to Hlinovsky, “Western markets are too closed.” One of EZ’s domestic competitors is ABB-EGF, a subsidiary of internationally connected Asea Brown Boveri. Although smaller, ABB-EGF has obvious advantages on foreign markets: by working with its parent company, it can exploit new opportunities quickly and cheaply.

Most of EZ’s contracts for the next five or six years are local, and although order books are full from 1995 to the end of the century, EZ would clearly like more work in the advanced markets of the West.

In 1994, exports accounted for only 5% of turnover, and the majority of that was to neighboring Slovakia. (By comparison, in the late 1980s about 25% of turnover was in exports.) To help, Hlinovsky would like to see some state support for major industries in the Czech Republic, especially those

that are big exporters and hard currency earners. “There is a big difference between exporting power stations and yogurt,” he notes.

Like many companies, EZ looks longingly to lost markets to the East. But these once-faithful clients can no longer pay outright, and EZ is not in a position to extend favorable credit terms on its own account. External financing mechanisms are not in place to assist EZ either. The Czech Export Bank is only now getting on its feet, and political risk coverage, through the Export Guarantee Bank, is expensive. By the same token, countries like Bulgaria, Russia, and Ukraine have their own domestic electrical engineering firms to maintain. International growth prospects, then, are limited. “That doesn’t mean we aren’t trying,” says Hlinovsky. Bids are out for water-related projects in several Arab and Central Asian states.

Elektromontážní Závody Exhibit 1. Balance sheets (in thousand Czech korunas).

	1993	1994
<i>Assets</i>		
Subscriptions receivable	0	0
Called-up share capital not paid	0	0
Total fixed assets	184,697	194,247
Intangibles	4,206	2,230
Tangible fixed assets	176,911	190,213
Long-term fin. investments, of which:	3,580	1,804
Shares in group and related companies	2,100	324
Other long-term investments	1,480	1,480
Total current assets	1,970,114	2,035,876
Inventories	1,195,741	1,116,314
Long-term account receivable	347,283	1,714
Short-term account receivable	284,468	608,652
Cash and cash equivalents	142,622	309,196
Payments and accruals	16,041	6,401
Total assets	2,170,852	2,236,524
<i>Liabilities and owners' equity</i>		
Capital stock	143,569	143,569
Equity funds – additional paid-in capital	0	4
Obligatory reserve fund and statutory reserve funds	22,031	25,789
Past retained earnings	0	1,698
Current retained earnings	21,793	68,746
Obligatory allowances for estimated liabilities	5,136	7,404
Other allowances for estimated liabilities	11	0
Long-term accounts payable	877,157	0
Short-term account payable	794,528	1,464,169
Short-term bank loans	3,539	
Long-term bank loans	294,835	171,971
Accruals and deferred income	11,762	349,635
Total liabilities and stockholders' equity	2,170,852	2,236,524

Elektromontážní Závody Exhibit 2. Income statements (in thousand Czech korunas).

	1993	1994
Revenues from goods for resale	596,205	1,071,907
Cost of goods for resale	534,489	1,040,743
Gross margin on goods for resale	61,716	31,164
Goods manufactured	986,829	1,191,157
Revenues from goods manufactured	1,044,146	1,282,274
Increase in inventories and work-in process	(66,767)	(100,840)
Manufactured goods capitalized	9,450	9,723
Cost of goods manufactured	609,446	761,215
Gross margin on goods manufactured	377,383	461,107
Value added (gross margin on goods for resale and goods manufactured)	439,099	
Payroll expense	243,811	249,388
Taxes and duties other than income taxes	2,001	1,625
Depreciation and amortization expenses	24,091	36,308
Other operating revenues	19,770	19,367
Other operating expenses	24,276	39,041
Decrease in allowances, unearned revenues and accrued payables	32,356	10,526
Change in allowances, prepaid expenses and accrued payables	47,884	22,889
Operating income	149,162	141,749
Revenues from financial activities	2,784	41,568
Expenses on financial activities	103,054	63,445
Increase in allowances for estimated financial expenses	11	10
Net gain from financial activities	(100,281)	(21,867)
Extraordinary revenues	17,381	1,294
Extraordinary expenses	44,469	4,614
Tax on extraordinary activities	(1,395)	
Net gain from extraordinary activities	(27,088)	(1,925)
Net income	21,793	68,746

Metrostav, A.S., Czech Republic

For Metrostav, the Czech Republic's leading tunnel construction company, an end to Prague's metro system might at first glance seem to be the end of the line. Once part of Vodni stavby, now another large independent construction firm, Metrostav is actively seeking new construction work that has little to do with tunnels – and in some cases, nothing to do with transportation. Even so, it will still likely garner most of its revenues from transportation-based construction projects. If the country's transportation networks develop in the way Metrostav hopes they will, the firm should be busy indeed.

Metrostav is best known as the general contractor for Prague's metro system. Between 1989 and 1992, Metro and other underground construction (Prague's massive Strahov Tunnel) accounted for between 90 and 95% of the firm's revenues. Beginning in 1993, however, that share fell to 40%, as the firm branched out into other phases of construction: reconstruction of historical monuments; a residential building complex in suburban Prague; a series of gasoline stations; the Zelivka waterworks; and a wastewater treatment plant in Český Brod, among others. In 1994, Metrostav completed the Western end of Prague's metro line B on schedule. Five new stations were added to the existing 41. The Eastern end of the same line will be completed in 1997. "This line was very difficult to finance," according to a company official. "During the Communist years, our government allocated Kč1.5–2.0 billion for metro construction. In 1991, the government said it will only pay Kč1.1 billion." An international \$250 million bond issue by the city of Prague helped Metrostav make up the shortfall: the city allocated about Kč1 billion to metro construction. Other projects included the reconstruction of a printing works, refurbishment of a large soccer stadium, a solid waste landfill, and a water supply system for a small South Moravian city. At year's end, revenues from Prague-related construction had increased by 35% versus 1993.

"Branching out" is a Metrostav watchword. Since 1992 a principal goal in Metrostav's basic business strategy has been to cast its geographical net wider: in 1994 offices were opened in Plzeň (West Bohemia), Brno (South Moravia), and Liberec (North Bohemia). Activities outside the capital city are forecast to grow by 30% annually, but that figure will not be reached easily. Metrostav faces stiff competition in South Bohemia and North Moravia, and it is not very active in those regions. This is a disadvantage, since North Moravia offers huge potential in heavy industrial and environmental construction, the very sectors which Metrostav is trying to branch into.

The next priority for the metro system will be the extension of line C (IVC) north from Holešovice. Construction plans to serve Prague's 150,000-strong North Town community await final approval by city hall. (North

Town is currently linked to the metro system only through buses and “one very bad tram.”) A Metrostav official appears sanguine about completing the line by 2000, even though financing has not been lined up: “Financing is a question for the government, not for us.” Perhaps.

In anticipation of winning any prospective tender from the Ministry of Transportation, Metrostav founded a 10-firm consortium for the reconstruction of the Czech portion of the Berlin-Prague-Vienna railway corridor in 1993. (The consortium, called Koridor, includes Sudop Praha, Sudop Brno, ŽPSV Uherskv Ostroh, Třineské železářny, ŽS Brno, Železniční stavitelství Praha, Elektrizace železnic Praha, AŽD Praha, and Posemstav Brno – an illustrious collection.) The cost for reconstructing the line will top Kč25 billion, making it one of the largest construction projects in the country.

Metrostav’s prescience was rewarded. In 1994, talks on refurbishing the line began in earnest, and financing from the EBRD and Japan’s ExImbank was secured. On behalf of state-owned Czech Rail, government guarantees were obtained as well. Although no tender has been announced yet, terms should soon be made public.

Metrostav got a boost from the government in late 1994 when parliament passed a new law giving domestic companies an edge in bidding for government-financed projects. The law says, *ceteris paribus*, a domestic firm can bid up to 10% more for, say, a construction project than a foreign company and still win the tender. (This is, however, sauce for the goose: other domestic construction firms will have the same advantage.)

Like haircuts (the classic example of a non-tradable good), construction services often do not travel well across borders. In the case of construction, however, the reason is due mostly to politics, not the sedentary nature of the company. Metrostav is very price competitive, and has bid aggressively on projects in Germany and Austria. But the firm simply cannot obtain approval from government authorities to participate in their countries. Unable to obtain work permits in Germany, the firm watched the koruna volume of foreign work in 1993 drop by 50%, to only Kč42 million. Prospects for 1994 looked better: Metrostav bid on 29 new foreign projects, 18 in Germany alone. But only a small delivery of steel halls were made to Vietnam; the remaining bids were lost.

Rejection, particularly in EU countries, can take the form of refusing to grant a permit for construction work, keeping out construction workers based on artificially low labor quotas, or not allowing the firm to bid at all. The result is the same: at a time when they have a distinct competitive advantage on price due to low labor costs, Metrostav (and most other Czech and Slovak construction companies) must bide their time, waiting until the Czech Republic joins the EU or their bids become less aggressive.

Metrostav is one of the five largest construction companies in the Czech Republic, and third in terms of turnover. In 1994, the firm had sales of Kč4.213 billion. Metrostav forecasts sales of construction work of Kč5 billion in 1995; Kč1 billion from Metro construction, Kč500 million from the Strahov Tunnel, and the remainder from other construction work. Analysts are more circumspect, forecasting sales of Kč4.668 billion. But despite an increase in materials costs of 35% and contracted services of 30%, the firm will squeeze more profits out of every koruna of construction work: earnings should grow 37% from 1995 to 1997. Increases in materials costs are forecast to fall to 15% between 1995 and 1997; subcontracting costs should increase 30% in 1995, before falling to 5% per year in 1996 and 1997. Metrostav wants to use subcontractors as sparingly as possible. Once these high increases in variable costs are pared, operating profits should improve.

The construction market in the Czech Republic is growing by 7% per year, about twice as fast as GDP growth. Several market trends are identifiable: increasing competition among large construction firms will squeeze margins; low margin work will be subcontracted out to smaller firms; financing terms are becoming an increasingly important part of project work; and the industry will experience some consolidation through mergers and acquisitions. Metrostav is well placed to successfully navigate these changes. The firm's low level of debt (debt/equity ratio of 25% in 1994) allows it flexibility to increase debt when needed, either to finance new acquisitions (for a push into new regional markets) or to fund other current activities. Metrostav has proved that it can bid aggressively, particularly in non-transportation-related projects.

The firm employs 3,500 people, down from 5,300 in 1989. About 70% are employed in the field. Metrostav has 10 divisions, all of which operate around a central headquarters based in Prague. Personnel expenses and related costs are growing about 5% per year. Privatization funds own almost 60% of Metrostav shares. Individual and corporate shareholders (domestic and foreign) hold about 32%. Other shareholders include the city of Prague, the National Property Fund, and employee shareholders. The firm was one of the most sought-after shares in the second wave of voucher privatization, and given its performance and future prospects, all brokerages and analysts rate the share a "buy."

Metrostav Exhibit 1. Balance sheets (in thousand Czech korunas).

	1994	1993
Total Assets	1,876,296	1,566,989
Fixed assets	555,335	513,900
Intangible fixed assets	5,581	11,084
Tangible fixed assets	461,769	429,121
Financial investments	87,985	73,695
Intercompany shares and group ownership interests	32,860	18,570
Other financial investments	55,125	55,125
Current assets	1,312,585	1,050,213
Inventory	79,417	112,866
Past due receivables	27,319	19,900
Receivables	705,640	741,078
Financial assets	500,209	176,369
Other assets	8,376	2,876
Total liabilities	1,876,296	1,566,989
Equity	635,973	604,898
Registered capital	475,589	475,589
Own shares	(7,171)	
Capital funds		
Funds created from net profit	53,902	50,559
Profit (loss) from previous years	61,160	11,905
Profit (loss) from current period	52,493	66,845
Liabilities	1,220,826	934,010
Legal reserves	40,625	13,826
Other reserves	20,810	1,100
Overdue payables		
Current payables	1,001,406	636,661
Bank loans and other debt	157,985	282,423
Long-term loans	157,985	107,423
Short-term loans	175,000	
Other liabilities	19,497	28,081

Metrostav Exhibit 2. Income sheets (in thousand Czech korunas).

	1994	1993
Revenues from merchandise	2,183	1,907
Cost of goods sold	2,102	327
Margin	81	1,580
Production	4,102,421	3,227,353
Revenues from products and services	3,972,448	2,532,673
Change in inventory	96,552	643,233
Capitalization	33,421	51,447
Production consumption	3,271,621	2,487,412
Added value	830,881	741,521
Personnel expenses	558,075	530,285
Taxes and fees	13,028	8,770
Other operating revenues	53,193	88,961
Other operating expense	49,200	104,163
Depreciation of fixed assets	89,453	69,961
Reserves, adjustments, and accruals	9,481	25,884
Additions to reserves, adjustments, and accruals	56,216	1,100
Transfer of operating revenues		
Transfer of operating expenses		
Operating profit (loss)	127,583	142,087
Financial revenues	43,642	100,340
Financial expenses	62,404	120,734
Adjustments to financial revenues		
Adjustments to financial expenses		
Transfer of financial expenses	3,270	
Profit (loss) from financial operations	(22,032)	(20,392)
Income tax on ordinary income	45,604	50,622
Deferred income tax on ordinary income	6,836	5,122
Ordinary income	53,111	65,951
Extraordinary revenues	943	2,692
Extraordinary expenses	2,012	1,067
Income tax on extraordinary income	(451)	731
Deferred income tax on extraordinary income		
Extraordinary income	(618)	894
Net income	52,493	66,845

Mlekarna Klatovy, A.S., Czech Republic

On October 31, 1994, Jaroslav Lizner, the head of the Czech Republic's Coupon Privatization Center, was arrested after accepting a briefcase containing Kč8.33 million in cash. The money, 166,000 50-koruna notes, was allegedly a bribe for making sure that shares of Mlekarna Klatovy, a West Bohemian dairy, went to TWI, a local privatization fund interested in purchasing the stake from another fund. TWI had won the right in a tender to purchase 34% of Klatovy for Kč220 million. Several competing investors wondered why TWI was willing to pay so much.

In the summer of 1994, Klatovy's management had filed a complaint with its owner – the National Property Fund – saying that the terms of the tender were not being met. In the dairy's estimation, TWI's liquidity was questionable, and its commitment to helping the dairy tackle its own liquidity problems was suspect as well. TWI, it seemed, had proved unable to come up with the Kč65 million required as a down payment, causing speculation that the buyer was less than whole. After looking into the complaint, the Fund judged the claim unfounded. Later, a rehearing reversed the decision after the Fund Supervisory Board focused “on whether or not the company really needed the money to be gained through the sale of shares. We found that they didn't,” said Fund Director Roman Ceska, “and that's why we allowed the tender to be dissolved.”

The dairy desperately needed the money. In 1990, Klatovy had purchased modern milk-processing equipment worth Kč500 million. By the summer of 1994, Kč100 million on the loan remained to be paid. In addition, the firm's equity, at Kč263 million, was and is inadequate. More new equipment – particularly for saving energy – is needed. Now that the dairy has offered 96% of its shares – the maximum amount permissible – through coupon privatization, its more than 8,000 shareholders will decide what happens next. General Manager Sekyrka says the firm hopes to increase equity next spring, probably through a rights issue of Kč150 to 200 million.

When Klatovy was still available during the tender, however, the dairy did not lack suitors, either domestic or foreign. Karel Pech, a local investor heavily involved in the food-processing industry, showed interest in the firm last August, but when the Fund announced a competitive tender for the 34%, Pech backed off. He did not even participate in the tender held later. France's Lescure Bougon was to purchase that same 34%; the firm withdrew its interest in October, before the Lizner affair began.

What was it about Klatovy – the fifth largest producer in an overcrowded, contracting market – that was so appealing? Some thought the

answer lay in the products which the dairy manufactures, its relatively modern assets, and the structure of the firm's – and the country's – milk-product exports.

Dairy processing, like several sectors in the food-processing industry, involves slim margins and stiff competition. There are more than 100 dairies operating in the Czech Republic. According to executives at Klatovy an "economically reasonable" number of dairies is nearer 25 than 100. "There is too much capacity," says the General Director, "and [the dairies] are themselves too small." Overcapacity is reckoned by the local dairy association to be as much as 40% countrywide. A typical West European dairy can process 500,000 liters of raw milk daily. Klatovy has the same capacity, thanks to modern equipment. But the typical Czech dairy is far smaller, able to process only 50,000 liters daily. In late 1994, Klatovy was profitable – just – at a throughput of 100,000 liters per day. The firm was trying to process about 130,000 liters a day.

Klatovy employs 450 people at its complex, more than other dairies, according to the General Director. The firm's main products are processed cheese and milk powder. The soft, spreadable white cheese which crowds local grocery shelves (and comes in a bewildering variety of fat contents and flavors) is big business both at home and abroad. Czechs consume more of the stuff per capita than any other country in the world. And a special type of processed cheese called *Akavy* is a major export to countries of the Middle East. Czech dairies have been producing and exporting *Akavy* cheese for 30 years, and according to the director, the Czech Republic produces more *Akavy* cheese than any other country (smaller amounts are produced in Bulgaria, Lebanon, and Syria). Customers in the Levant and Middle East consume from 6,000 to 8,000 tons every year. There, the cheese figures prominently as an ingredient in sweet delicacies. Customs figures show that Czech dairies export more cheese to Lebanon (40% of their total) than any other country.

Skimmed milk powder is an even bigger export product. In late 1994, world market prices were around \$1,600 per ton, and the firm produced roughly 3,000 tons of skimmed milk powder annually. Klatovy's 1993 revenues totaled Kč600 million, meaning that exports of skimmed milk powder accounted for nearly one-quarter of all revenues. The dairy's 1993 profit was Kč5.6 million. According to officials, Klatovy earns a 5–7% margin on exports of skimmed milk powder or about Kč7.2 million.

There are more advantages to dried milk production. Skimmed milk powder can earn generous subsidies from the Ministry of Agriculture's market regulation fund (the agricultural fund established to prop up farm prices). In the second quarter of this year, only 200 tons of processed cheese exports were subsidized by the fund. In comparison, 5,400 tons of dried milk were

subsidized – and those subsidies are increasing by about 25% per quarter. *Akavy* cheese is not subsidized.

Following the shares-for-favors scandal, one respected local paper fixed on processed cheese as the real impetus for interest in the dairy, weaving a plausible but ill-substantiated tale hinting at shadowy Middle East connections. But the numbers don't add up. Klatovy wants to produce five times more skimmed milk powder over the next three years – a sensible policy, given current world market prices for dried milk. Although Klatovy officials say “too much” milk powder is being exported, this is a reflection on the firm's market share, not the profits to be had in the market. On a unit basis, producers can expect a margin of from 5 to 7%. The General Director says he would like to increase production of milk powder by as much as five times.

Selling skimmed milk powder may not be as easy as it at first appears. When asked exactly who his customers for skimmed milk powders are, the General Director laughs. “We don't know,” he says, describing an intricate sales system which begins in Klatovy and flows from Prague to Hamburg to Senegal and then – maybe – to other markets. “Once something gets to Hamburg, you can never tell where it's going,” he says. The Director also notes that German exporters receive generous government assistance for exporting such products to less developed countries. (So do Czechs.) Klatovy exports 15% of its production to two markets: the Middle East and North Africa.

Processed cheese poses an even riskier bet. Imported cheeses will soon make up about 30% of the domestic market, and a typical Western dairy can produce up to 150,000 tons per year. Even if Klatovy can increase target production to 25 tons a day (about 7,500 tons per year), it will remain well behind the potential of foreign producers, not to mention rival local dairies such as Jihoceske Mlekárny and Plzenske Mlekárny. Moreover, the General Director expects domestic consumption of processed cheese to decrease. “Consumption is relatively high right now,” he says. “I suppose it can't get any higher and will slowly decline.”

Other Klatovy products, such as white (hard) cheese, are being rethought. The firm commands a market share of 10%, but according to the General Director, it produces white cheese at a loss. Klatovy's hard cheese line operates at only 45% of capacity. A surplus of white cheese on international markets means prices are low. Too, foreign governments are protecting their own producers. (Asked about trade relations between the United States and the Czech Republic, officials at the Ministry of Industry and Trade immediately complained of high tariffs on Czech white cheese.)

Executives worry about a lack of working capital. They would like to increase equity by between Kč150 and 200 million but the shares would be a

tough sell to a public skeptical of the food-processing industry. Management may decide on a rights issue. Nor is debt an answer: the Director says his firm cannot qualify for favorable interest rates, and without a restructuring of existing debt, new payments could break the company's financial back. Klatovy's early 1990s purchase of new equipment through high-interest bank loans now seems suspect: the equipment is idle far too often, and the firm is having trouble carrying the interest expense.

Klatovy suffers from a severe receivables problem. Two-thirds of all receivables, about Kč125 million, are past due. To combat the problem, Klatovy has restructured its sales force and has focused on working only with reliable (i.e., paying) suppliers.

Several large dairies are now splashing out expensive marketing and promotion campaigns. Klatovy has not yet, and at the end of 1994, marketing accounted for between only 1 and 2% of total costs. This matters in a market crowded with local and foreign products, many of which possess better packaging and smarter positioning than Klatovy's offerings. Klatovy brought bar coding to some of its products in 1994 and introduced technologies to improve shelf life. On the whole, however, the products do not have a progressive, modern image.

Wholesale milk prices increased slowly during the first half of 1994, before a rapid rise in fall 1995. Countrywide, prices are up about 5%. But the firm has little room to increase prices to consumers, which are being pressured from decreasing demand and cheap imports. Domestic consumption of milk and milk products fell from 256 kg per capita in 1990 to 190 kg in 1993. Cheap milk products from heavily subsidized EU countries are staples on Czech grocery shelves, and competition from the West will not abate. As the firm decides on its production strategy for the near future, it will have to face the unpleasant fact that consumption of its products will in all likelihood decrease over the next several years.

Mlekarna Klatovy Exhibit 1. Balance sheet in 1994 (in thousand Czech korunas).

Total assets	676,542
Fixed assets	390,010
Intangible fixed assets	122
Tangible fixed assets	389,868
Areas	6,916
Buildings, halls, houses	207,395
Machinery	157,492
Unfinished tangible investments	18,005
Deposits on tangible fixed assets	60
Financial investments	20
Current assets	287,582
Inventory	80,612
Material	38,271
Unfinished products	35,591
Production	19,513
Other goods	2,570
Deposits on inventory	(15,333)
Receivables	199,831
Trade-contact receivables	199,812
Other receivables	19
Financial Assets	7,139
Cash	724
Other bank accounts	6,108
Short-term financial assets	307
Other assets, prepayments, and deferred income	(1,050)
Total liabilities	676,542
Equity	282,240
Registered capital	263,251
Funds created from profit	17,721
Statutory reserve funds	16,996
Other funds	725
Profit of previous years	1,169
Profit of current period	99
Current liabilities	392,405
Reserves	3,675
Short-term payables	177,183
Taxes payable	(4,216)
Other payables	792
Bank loans	211,547
Long-term bank loans	91,547
Short-term bank loans	120,000
Other liabilities	1,897

Mlekarna Klatovy Exhibit 2. Income statement in 1994 (in thousand Czech korunas).

Sales of purchased goods	56,831
Cost of goods sold	52,980
Gross margin from trade	3,851
Sales of own products and services	564,560
Revenues from own products and services	493,022
Changes in inventory and work in progress	14,180
Own work capitalized	57,358
Production costs total	476,901
Raw materials and energy costs	439,084
Services	37,817
Value added	91,510
Personnel expenses	31,457
Wage expenses	23,193
Social security expenses	7,918
Other social expenses	346
Taxes and fees	1,103
Depreciations of intangible and tangible fixed assets	26,021
Revenues from the sale of fixed assets	1,463
Remaining revenue from previously sold fixed assets	863
Addition to reserves	1,575
Corrections to operating expenses	10,500
Other operating revenues	50
Other operating expenses	614
Operating profit	20,890
Revenues from the sale of securities and deposits	38
Revenues from interest	103
Interest expense	20,538
Other financial revenues	318
Other financial costs	1,451
Profit from financial operations	(21,530)
Income tax from the ordinary income – due	(270)
Profit of the ordinary income – due	(370)
Extraordinary revenues	989
Extraordinary costs	180
Income tax from the extraordinary income – due	340
Extraordinary profit	469
Profit of current period	99

Považské Strojárne, A.S., Slovakia

It is often tempting to judge a Czech or Slovak company by its annual report. Some are splashy, with little information; others are five or six pages long, and simple photocopies. Považské strojárne's (PS's) annual report is aggressively detailed: this is a company that *wants* you to know it is serious about turning itself around. Bar charts for implementation of total quality management are included, with target dates for ISO-9000 certification for each product group. The report explains *why* several managers were turned out, and how the firm settled on its strategic direction. Where most companies would publish an annual report in one or two languages, PS manages four. English is one of those languages (no surprise) and so is German. Importantly, the other is Russian.

True to Slovakia's vision as a bridge between East and West, Považské strojárne has not stopped looking East for sales. Bearings are sold to Bulgaria and India and copper tubes and castings to Ukraine and Slovenia. After winning a tender issued by the Russian government, PS signed an agreement in February 1995 to provide aircraft engines to the Russian Air Force. Terms of financing are still being negotiated, and although first deliveries are expected in early 1997, PS may need government export guarantees to carry off the deal.

PS is a truly comprehensive engineering firm. The company also produces small tractors for farming, machine tools and die casts, plastic injection molds, surface grinding machinery, gearboxes, and more. Its research institute is active in the development of food- and wood-processing technologies and machine-testing devices.

Aircraft engine production has been a mixed blessing for PS. Its DV-2 engines are produced primarily for Aero Vodochody. But the Czech aircraft manufacturers' troubles have hit PS hard: Aero will purchase only five engines this year, compared with the 20 originally expected in the contract. (Aero purchased 18 engines in 1994: 6 were for Egyptian aircraft, 10 for Tunisia, and 2 for parts.) PS is unhappy about the cutback, but is bound to honor the parts and service requirements in the contract until 2020.

After a 10-year layoff, PS is returning to small motorcycle production. In the 1950s PS began producing several types of motorbikes. Babetta mopeds, now firmly entrenched in the Slovak market, were once part of PS's product line. Central planners decided to remove Babetta from PS in 1984, and the firm watched helplessly as its "child" was transferred to another company. After intense negotiations with Italy's Piaggio, Považské strojárne Manet was formed last year for the production of Korado mopeds. PS produces Piaggio's Puch engines under license. PS produced 2,000 mopeds in 1994 and sold 6,900 engines to Piaggio. The firm estimates 1995 sales at 12,000

mopeds; capacity is between 40,000 and 50,000. PS is capable of manufacturing 50,000 to 80,000 Puch engines as well. The firm is targeting the Czech Republic as a key market; it plans to sell 54% of Korados to its northern neighbor. Other foreign markets include the USA, Brazil, Finland, and perhaps some Asian states.

In former times, PS was also a well-known manufacturer of weapons. (The firm was founded in 1929 as weapons maker.) Its FARMET division, which produces brass and copper tubes, wires, and specialist castings like thermo-regulators, made high-caliber shells for the armed forces. It has managed to find a new use for its artillery shell casings: fire extinguishers. The firm remains a manufacturer of small-arms ammunition.

Sales fell 12% in 1994 from Sk2.67 billion to Sk2.35 billion, although the firm managed a profit of Sk47.6 million. The profit came not from operations, however, but from extraordinary gains in the form of sales of outside shareholdings. After three consecutive loss-making years, the firm wanted for investment, and shareholders have opted to reinvest all profits. The most important investments in 1994 were for the start-up of Korado production, reconstruction of a production hall for the Sauer (of Germany) JV gearboxes, and new machinery for a pressing shop.

PS has a long-term liability in the form of the Piaggio license (Sk17.3 million) and bank credits totaling Sk117.3 million. Short-term liabilities include payables totaling Sk716 million and bank loans of Sk657 million. Total bank debt (including unpaid interest) is Sk862 million.

The company improved its cash position dramatically in 1994, up Sk126 million to Sk164 million. But PS is circumspect about overall liquidity: a more aggressive collection policy helped reduce receivables 5.6%, but past due receivables still represent fully 75% of the Sk935 million total. Clearly, the firm needs to prod its customers. Inventories were reduced 10%, to Sk782 million. Fixed assets fell marginally, from Sk4.27 billion to Sk4.14 billion. Assets in the form of controlling shareholdings in other firms (including its German JVs) roughly doubled, to Sk201 million.

The numbers perhaps belie the real state of affairs at Považské strojárne. Taking advantage of the EU's PHARE program (an aid fund for former socialist countries), PS hired a British consultant, March, to help sort out its various divisions and product groups. Management was shaken up in 1995, and the Head of the Supervisory Board, Alfréd Richter, took over as the General Director. The company got a new Director of Strategy as well. In fact, the top three positions in the company are held by long-time PS employees with recent experience in trade, strategy, or finance. Each has a technical education with expertise in engineering.

The firm's strategic plan calls for continuing consolidation within the parent company. PS will focus on sales of its copper and brass fittings and

tubes, bearings, and (after a pause) aircraft engines. The firm recognizes in its strategy statement that inexpensive labor is an asset it must use to the fullest. Contracting out spare capacity is not a foreign concept here.

Where possible, PS wants to spin off divisions into independent firms, and have these companies form joint ventures with Western firms. This helps guarantee continuing production while providing ready sales outlets. Independent subsidiaries also have cleaner balance sheets than the still top-heavy parent company. Clean balance sheets can help them get better access to financing. Already individual divisions and sections have been rationalized with an eye to best use of employees, capital assets, and the financial structure. The VALOŽ division, a producer of heavy-duty bearings, has been spun off into a separate joint-stock company called PS Ložiská. Považské strojárne MANET, the daughter company producing mopeds, was formed by detaching 48 employees from the Strategy Section. The POLNOTECH division, which produces farm machinery, will also make spare parts for a new joint venture with Germany's Sauer (see below). In 1995 the firm was expected to continue to lay off employees (901 left in 1994).

At the end of 1994, exports accounted for 54.8% of sales (up from 53.4% in 1993 and 46.9% in 1992), and the figure should increase as moped and bearings sales rise. Looking at the firm's range of exports, it is clear that PS is banking on foreign sales to help it recover. At present PS exports to all major West European markets; the majority of its bearings go to France and Germany. In March 1995, a joint venture was formed with Germany's Sauer to produce large gearboxes for concrete mixers. PS holds a minority 35% stake. Its presence in central European markets is also strong: Poland, Hungary, and the Czech Republic are customers for most of the company's products. It is tempting to say there is an overreliance on the Czech market: fully 60% of all exports in 1994 went to the Czech Republic, but aircraft engines accounted for the bulk of sales.

PS forecasts a slight fall in sales for 1995, to Sk2.3 billion, but this does not include sales of its subsidiaries (wholly and partially owned). These companies, which include the profitable bearings and gearbox ventures, should contribute another Sk470 million in sales. One year of profit does not mean the corner has been turned. But if mid-year 1995 show better-than-expected sales in its target products – the ones which contribute the highest percentage of profit, copper tubes, and specialty tools – and if the firm can manage to successfully wind up its aircraft engine deal with Russia, PS may well have good short- to medium-term potential.

Považské Strojárne Exhibit 1. Balance sheets (in thousand Slovak korunas).

	1993	1994
Assets	6,779,291	6,726,720
Fixed assets	4,426,646	4,372,883
Intangible fixed assets	16,426	4,286
Depreciable tangible fixed assets	4,271,579	4,141,935
Financial investments	138,641	226,662
Shares and ownership interests with		
controlling influence in enterprise	110,324	201,662
Other securities and ownership interests	28,317	18,500
Other financial investments	0	6,500
Current assets	2,332,590	2,277,441
Inventory	871,213	782,672
Paid-in-advance inventory	74,572	60,608
Long-term debts	38,828	25,798
Short-term debts	1,309,350	1,243,970
Cash and bond	38,627	164,393
Other assets	20,055	76,396
Liabilities	6,779,291	6,726,720
Registered capital and capital funds	4,542,167	4,587,660
Registered capital	3,994,018	3,994,018
Capital funds	253,986	152,538
Profit funds	454,501	399,402
Previous year's financial results	-5,888	-5,888
Net profit	-154,450	47,590
External sources	2,116,292	2,016,366
Legal reserves	32,201	32,610
Long-term credits	22,308	17,628
Short-term credits	1,307,373	1,181,001
Bank loans	754,410	785,127
Long-term loans	754,410	774,507
Short-term loans	0	10,620
Other liabilities	120,832	122,694

Považské Strojárne Exhibit 2. Profit and loss statements (in thousand Slovak korunas).

	1993	1994
Sales and factored goods	110,749	66,941
Costs of factored goods	81,709	55,978
Production	3,941,476	3,499,517
Production costs	3,088,186	2,763,623
Value added	882,330	746,857
Personnel costs	517,673	499,434
Taxes and duties	13,755	12,263
Depreciations of tangible and intangible assets	224,302	216,176
Other operating revenues	434,314	454,548
Other operating costs	474,233	422,720
Operating financial result (1)	86,681	50,812
Financial revenue	45,890	91,443
Financial costs	223,718	189,152
Result of financial operations (2)	-177,828	-97,709
Gross profit before taxes (1+2)	-91,147	-46,897
Income tax	30,005	24,439
Payable	0	0
Deferred	30,005	24,439
Net profit (3)	-12,152	-71,336
Extraordinary revenues	14,727	141,587
Extraordinary costs	48,025	22,661
Net extraordinary profit (4)	-33,298	118,926
Total net profit (3+4)	-45,450	47,590
<i>Ratio indexes</i>		
Net profit per share (Sk)	-38.67	11.92
Return on sales (%)	-3.40	1.12
Return on capital employed (%)	-3.87	1.19
Credit indebtedness (%)	16.61	17.11
Overall indebtedness (%)	33.00	31.80
Overall liquidity (%)	121.8	119.39

Solo, A.S., Czech Republic

Reach for a match in the Czech Republic, and chances are you will be lighting a match with a 159-year-old tradition. Solo, a match manufacturer located in Sušice, South Bohemia, has been exporting its matches for more than a century. The match company was established in 1836 by a Sušice (then Fürth) carpenter. The business grew and eventually boomed when it received financing from a rich local investor. By the end of the century, Solo matches were sold throughout the world, thanks in part to a strong presence in Great Britain. The match museum in Sušice sports wooden matchboxes with trade names in English, Hindi, Chinese, German, French, Italian and Spanish. Some of its best-known trademarks from a century ago – The Key and Scissors – are still produced.

By the end of the 1980s, management had recognized that survival depended on expanding the product line. Demand for matches – even quality wooden matches like Solo’s – had dropped steadily with the advent and popularity of disposable lighters. (According to Pavel Probst, Solo’s Sales Director, about 70 to 80% of all smokers use lighters.) The firm had, however, begun to make hardboard panels in the 1950s. Faced with a changing market, in the early 1990s executives decided to concentrate their efforts on manufacturing hardboard and to pare production of the firm’s hallmark wooden matches. A product-profitability study was conducted in early 1994, and by the June annual meeting top management and divisional Directors had formulated a four-year production and financial strategy.

Production restructuring followed swiftly. As late as 1990, 75% of Solo’s match production was exported to Great Britain. (Since 1969, the firm has sold its products through a trade partner in Britain.) Domestically, it exported matches through Lignaexport (now simply Ligna). In 1991, matches accounted for 60% of sales. But by 1994, as a share of total sales, the firm’s hardboard products occupied first place, with a share of 59%. Production of matches dropped by half in the four years to 1994, and matches now represent 25% of all sales. Pruning match production has resulted in spare capacity: the company sells about 20 million matches a month, but could produce three times more.

Solo maintains a domestic market share (in matches) of about 60%, although competition from cheap foreign producers continues to eat away at that figure. “Even with transportation costs,” says Probst, “matches from Poland and Russia are 20% cheaper.” (In fairness, however, Solo’s matches are of a much higher quality. The Polish matches which Probst eagerly showed broke easily. The match heads also tended to fall off, flaming as they landed inevitably on one’s trousers.)

There are no match manufacturers in Germany or Austria, and Britain's last match manufacturer folded in 1994. Even so, overcapacity haunts the European match market. SwedishMatch and ItalMatch are two large West European producers and have a substantial market share throughout Europe. The influx of matches from the East has meant that Solo must constantly seek out developing country markets (where matches are still used more than lighters).

Fixed assets increased in 1994, as Solo purchased new equipment to expand hardboard and I-joist production. The firm reduced inventories slightly in 1994. Long-term suppliers' credit more than doubled; short-term receivables, however, were reduced by almost 45%, reflecting a general concern with shortening collection periods. Bank debt increased by 33%.

With assets still working toward match production, Solo lost Kč1.17 million in 1994, on top of a Kč7.93 million loss in 1993. Even so, the firm showed a slim operating profit in both years. Cost of goods sold was reduced by 23% in 1994, and the firm trimmed its personnel costs slightly. Solo uses the same type of material – pulpwood – that is used in the production of paper. Like the paper industry, Solo faced rising raw-materials costs throughout 1994. In early 1995, pulpwood prices increased another 20%. Combined with a seasonal dip in supply, which often occurs in winter, the firm had to stop production because it simply could not get raw materials. Still, total costs and expenses have fallen from Kč550 million in 1992 to Kč400 million in 1994. The firm employs 800 people, down from a high of 1,500. Each division (organized by product) has its own sales force. About 25% of all staff are employed in sales and administration.

Probst is firm about Solo's strategic direction: "Our future is in hardwood-based panels and I-joists," he says. Sales of I-joists took off in 1994, increasing 10-fold from 1993, to Kč70 million. At present, the firm's I-joists are sold to Elk-Haus, an Austrian construction company specializing in residential building. The I-joists are basically a hardboard panel wedged into two softwood beams marked with flanges (hence the name). They are extremely sturdy and can be manufactured in lengths up to 12 meters. The joists are used in ceilings and floors in wood-construction houses and allow space for insulation. Wood housing is still rare in the Czech Republic and is catching on only slowly. The rest of Europe is perhaps 5 to 10 years ahead of the Czechs in acceptance of wood frame housing.

The firm has several ideas about how to expand its market for I-joists. Solo wants to build single-floor additions on top of *panelaks*, the country's ubiquitous, but ugly, panel apartment blocks. The firm has prepared blueprints for the additions and proposals have been made to the city of Liberec, where it has an eye on two or three buildings as prototypes. Several buildings in Sušice are suitable candidates as well. The idea has won kudos

for helping to solve a housing shortage in provincial towns, but wood-based housing is uncommon in the Czech Republic, and financing will be a problem. *Panelaks* are often owned by municipalities themselves, which cannot afford the upgrade. Moreover, buildings are changing owners constantly: Solo does not always know who it should be negotiating with.

Solo hardboards are priced lower than those made in Western Europe, but their quality is lower, too. The firm's hardboards are suitable for industrial uses, such as construction; furniture requires a higher-quality product. Although Solo wants to compete principally on price, it obviously cannot continue to absorb constant price increases in its inputs. The firm raised its prices on exports of hardboards – sold to Germany and the Benelux countries – 10%.

Hardboard panels are produced by soaking wood chips with steam and heat. The result is a fibrous mass which is similar to a clump of very rough paper. The mass is then pressed into panels, which may be smooth on both sides, webbed on one side (for better adherence), or formed into a single board made of two, three, or four panels. Panels may be laminated to use in making cabinets or doors. Solo has recently purchased a cut-to-size saw and sanding machine, which will help with custom orders. A new painting line, supplied by a German customer, will enable Solo to produce painted hardboard panels.

Other wood products account for 5% of sales. Included in this share are sales of punched hardboard for the automobile industry. Backed with PVC (from Fatra), these hardboard panels make their way into the back seats of every Skoda Felicia, Favorit, and Forman sold by Mladá Boleslav. Solo has the contract to supply the panels for the new Combi as well. Obviously, Solo is eager to see Skoda increase production.

Solo's machine division, in former times occupied solely with repairs and production of the firm's own equipment, now contracts to supply domestic and foreign toolmakers and engineering firms. The majority of contracts are with Germany. This engineering production accounts for just under 5% of sales.

The process is efficient: three cubic meters of hardwood (poplar) yields one ton of hardboard. About 20% of the hardboard that is not immediately pressed may be recycled. Only 2% of wood is eventually unused and burned as waste.

Surprisingly, Solo has few environmental problems. It has switched from coal- to oil-burning boilers, and it complies with new clean-air regulations. The chemicals used in its match heads are benign, and unless a customer wants extraordinary strength in hardboard panels, the pressure and steam process by which Solo forms its boards uses no chemicals. The firm's wastewater treatment plant is modern, and its once-spare capacity is now used to

treat other industrial wastewater along with portions of the city's sewage. Water treatment and sales of energy to the town of Sušice account for 5% of sales. Solo's sales mix is the following:

Matches	25.6%
Laminated hardboards	58.8%
Hardboards	4.9%
Energy production	2.9%
Machinery/engineering production	4.8%
Other	3.0%

Solo Exhibit 1. Balance sheets (in thousand Czech korunas).

	1993	1994
<i>Assets</i>		
Fixed Assets	354,751	381,168
Intangible assets	0	69
Tangible assets	354,015	380,162
Financial assets	736	937
Current assets	270,063	240,659
Inventory	110,237	101,818
Long-term receivables	24,361	52,146
Short-term receivables	131,452	72,454
Marketable securities	0	0
Cash and cash equivalents	3,022	13,168
Prepayments and accrued income	991	1,073
<i>Liabilities</i>		
Capital and reserves	436,045	436,481
Common stock	363,214	363,214
Surplus funds	70,823	73,173
Cumulative profits	2,008	94
Payables	188,769	185,346
Provisions	25	10,615
Bank credits	48,044	63,834
Other liabilities	133,867	108,291
Accruals and deferred income	6,833	2,606

Solo Exhibit 2. Income statements (in thousand Czech korunas).

	1993	1994
Sales	433,076	398,034
Other operating income	80,666	17,049
Material charges	357,591	278,436
Wages and salary expense	75,804	74,144
Depreciation of fixed assets	30,434	27,629
Other expenses	44,847	27,365
Operating profit/loss	5,066	7,509
Financial income	302	1,770
Other financial expenses	2,498	2,427
Interest payable	6,446	7,619
Financial profit/loss	(8,642)	(8,726)
Profit/loss on ordinary activities	(3,756)	(767)
Extraordinary income	5,357	(39)
Extraordinary expenses	9,716	367
Extraordinary profit/loss	(4,359)	(406)
Total profit/loss before tax	(7,935)	(1,173)
Income tax	0	0
Profit/loss	(7,935)	(1,173)
Other use of profit	0	0
Net profit/loss	(7,935)	(1,173)

BHG Híradástechnikai Vállalat, Hungary

Eva Kiss was appointed Marketing Manager of BHG in the summer of 1995. She is a graduate of the University of Economics in Budapest, and had been working for BHG as a Product Manager for five years. The company has been struggling over the past five years to stay in business. After several restructurings, 1994 finally proved to be a successful year: the company had revenues of Ft5.2 billion, which led to a Ft45 million profit. BHG executives believed that the solution to keeping the company on a profitable path was to strengthen the marketing and sales activities. In 1995 Kiss was among the officers who believed that marketing could solve the company's problems, so she was anxious to put her ideas into action.

Until 1990 BHG was one of the biggest telecommunications equipment producers, employing 7,700 persons in its main plant in Budapest and several smaller plants in the countryside. All the telephone exchanges in the Hungarian telecommunications network were produced by BHG, and it had 80% of the market share of smaller telephone switches (PABX). The company also produced auxiliary telecommunications equipment and tools and parts for the maintenance of its products.

During the centrally planned economic regime, BHG was a major vendor of the Hungarian Telecommunications Company (MATÁV). MATÁV was the state-owned telephone monopoly that provided telephone service for the whole country and also developed and owned the network. BHG's capacity was able to serve more than the Hungarian market, so the company exported about two-thirds of its products. Its major customers were the Soviet Union, the countries in the Council for Mutual Economic Assistance (CMEA), and some developing countries friendly with the Soviet Union (Algeria, Syria, and Iraq). Of these trading partners the Soviet Union was the biggest: 2.5 million Soviet telephone lines were connected to BHG switches annually, compared with 180,000 lines in Hungary.

By the late 1980s it was clear that the Hungarian government intended to change the central-planning economy to a market system. It was expected that other CMEA countries would soon change as well. In 1989 the Hungarian market began opening to outside competition: import restrictions were lifted, and new companies mushroomed. The government started to channel the exports of Hungarian companies toward the Western markets by imposing a 26% tax on exports going to the socialist countries. These two steps and the economic collapse of the former Soviet bloc markets had several major effects on BHG.

BHG's management had anticipated these changes and started to take steps to compete in the new situation. Some of the company's exports to the socialist countries were still profitable despite export taxes. However,

the company started to look to the West and decided to invest in new digital technology developed by Northern Telecom of Canada. BHG signed a licensing agreement with Northern Telecom for the production of digital exchanges. The investment in new production and technology left BHG with a Ft900 million debt. However, management was encouraged by MATÁV's development plans, which included the development of a digital backbone network connected through state-of-the-art digital switches. A contract for these switches would have more than paid off the investment.

The 1990–1991 period turned out to be the start of a new era for the company. During this period CMEA markets collapsed, leaving BHG with 40% excess capacity. The worst situation developed on the Soviet market: the company already had contracts signed for exchanges, production had started, but the Soviet partners declared that they were unable to pay, so the products stayed in BHG's warehouses.

BHG tried to sell these products in other markets. However, it faced difficulties, as all the other former socialist countries started focusing on imports from the West, discriminating against products from their former economic allies and favoring Western-made products. This resulted in a further general decrease of possible exports to former CMEA countries.

BHG's expectations regarding the Hungarian market failed to materialize, as Western products were increasingly preferred over Hungarian-made products. The new companies entering Hungary, most of which were dealers for Western equipment, aggressively marketed their products. BHG was not used to competing on these terms; therefore, it started to lose its market share. Moreover, when MATÁV put out the tender for the new digital exchanges of the national grid in 1991, BHG lost against Siemens and Ericsson. With this loss, the company's market share of exchanges shrank overnight from 100 to 20%.

The company took another hit from the financial field. BHG took out a loan to finance the investment in the Northern Telecom digital technology in the late 1980s at a 6% annual interest rate. After 1990 this interest rate increased to 30%, placing a tremendous strain on the company. Under these circumstances management had to face two questions: Will BHG be able to stay in existence? What steps could be taken to save the company?

With its 7,700 employees, BHG was one of the biggest employers in Hungary. Management hoped it might be able to find some sympathetic politicians and receive some help from the state, which was the owner of the company. The pleas were answered; BHG was included in the group of companies that were considered important and allowed to participate in the crisis management program of the government providing assistance during restructuring.

The company's debt was eliminated in two steps. BHG sold its subsidiaries (three plants in the countryside). These sales totaled Ft450 million, which was used to pay off half of BHG's debt. The other half was covered by a Ft450 million capital increase, which was provided by the state owner.

In the course of the crisis management program the company applied for technical assistance grants from the World Bank and PHARE. (PHARE is the European Union's aid fund for former socialist countries. The fund can be used for reconstruction and investments in new technology.) As part of these grants consultants visited BHG and prepared an asset evaluation and a restructuring plan. The consultants' report and the restructuring plan were accepted by the state owner in 1994.

The restructuring plan called for the closing of all plants in the countryside, limiting the company to its main plant in Budapest. BHG converted its rural plants into subsidiaries and sold most of them. The remaining few plants were maintained at a minimum level until buyers could be found for them.

The Budapest operation was also restructured. Before the changes BHG was a product-based company. The new structure focused on four new divisions: main exchanges, PABXes, parts and tools, and maintenance. The restructuring plan required that each division remains largely independent, so that each could be privatized separately if necessary. Management expected that this new structure would improve the company's flexibility. However, this structure also required that each division have its own administrative staff, leaving the company with relatively high administrative costs.

The elimination of the rural operations and the restructuring of the Budapest operations decreased the work force from 7,700 to 1,200. Laying off employees was a difficult action to take, but management had no choice. Management retrained a number of workers, but the remaining employees were laid off and received six-month severance pay, on average.

BHG also sought new areas to enter into. The company developed new products to bridge the gap between telecommunications technology that was in operation and the new digital technology that was to be installed gradually. These products had good market potential not only in Hungary, but also in the neighboring countries. The company also started developing its connection to Western markets more aggressively than before. BHG digital products had initial success in Germany. This was an encouraging sign, and it was thought that with further marketing efforts sales could be increased in that country. BHG also formed a joint venture with Antenna Hungaria, the Hungarian Broadcasting Company, for transmission-related production and services.

As a result of these efforts the company realized a small profit in 1994. However, management knew that the company was still a long way from

being a market-oriented company. The strengthening of the marketing area was a top priority. The sales staff needed to be trained to be more aggressive, and new markets and products had to be developed both in Hungary and abroad. Management was especially worried about the local market. Management decided to start negotiations with the state owner to try to obtain a government decision that would oblige MATÁV to buy 5% of its annual purchases from BHG. Management believed that this would be a solid basis to help the company stay profitable.

When Kiss took on the position of Marketing Manager, she knew that she had to show positive results immediately in order to strengthen the company's market position. This strategy was important not only for the survival of the company, but also to support management's long-term plans. Management and the state owners were planning to privatize the company through a sale to a strategic investor within three years. The company needed to build up its income statement and balance sheet to attract serious potential investors.

Budapest Stock Exchange, Hungary

Krisztina Reichart, Head of External and Public Relations at the Budapest Stock Exchange (BSE), sat in her office and gazed out the window at the shops on Budapest's famous Vaci Street, where capitalism had comfortably settled in. As she watched the people below carrying their purchases of compact discs, tennis racquets, and McDonald's hamburgers, she wondered how to draw more investors to the BSE. After five years it seemed that capitalism was establishing itself in Hungary among both domestic and international investors. But while the BSE had taken a number of significant steps toward integrating into the world economy, it was still not a major area of finance in Hungary.

An emerging market is commonly defined as a securities market belonging to a developing country. (A developing country, as defined by the World Bank, is one whose per capita gross national product in 1990 was less than \$7,620.) Generally, certain characteristics can be found in emerging markets. Often liquidity is poor, and there are gaping discrepancies between the demand for and supply of a particular stock. Trading in these markets is often heavily concentrated in a few stocks, research into companies is generally inadequate, and supervision is lax. Consequently, emerging markets tend to be volatile, often with drastic price fluctuations.

Equity markets are evolving in developing countries as well as in more developed countries whose economies are in transition from central planning to a market orientation. As the governments of these countries institute macroeconomic and institutional reforms, international investors are slowly gaining confidence and directing capital flows toward the new markets. These equity markets, most of which evolved in the late 1970s and early 1980s, have emerged as part of the development process of many countries and have only just begun to be accepted in the global financial marketplace. Markets provide alternative sources of capital for entrepreneurs and for government-owned companies attempting to privatize. The greatest demand for capital has been generated by fast-growing, export-oriented companies operating with low-cost resources and technology transfers.

Equity markets in emerging countries generally go through four stages of development and tend to develop only after a country has achieved a certain degree of economic and political stability and after its government has begun to implement growth-oriented policies. Periods of global economic expansion tend to accelerate the development of equity markets by shortening the duration of each phase.

In the first stage, equity prices tend to rise. As they do, the market gains the confidence of domestic investors and becomes widely accepted as an investment alternative to traditional bank deposits and short-term government bonds.

In the second phase, because the equity market has attained some degree of credibility, foreign pressure for increased accessibility and local pressure for cheap capital funding leads to a loosening of regulations. As market liquidity increases, risk-adjusted returns rise, and international investors begin to realize the diversification benefits of investing in such markets.

In the third, or expansion phase, the market offers the prospect of higher and less volatile returns than before. The volume of issues increases rapidly as firms strive to reduce debt, and private or newly privatized companies make their initial public offerings; investors easily absorb these new issues of stocks and bonds. Trading activity increases, producing effective intermediation, while the growing need for risk-transfer mechanisms spurs the development of equity-and-currency-hedging instruments such as derivatives and index products.

In the final, or mature phase, equity-risk premiums fall to internationally competitive levels and the equity markets begin to achieve stable growth.

In the summer of 1995, Hungary's economy was experiencing moderate growth (2% in 1994). This level of growth was expected to continue throughout 1995 (1% forecast) and 1996 (2%). Much of the macroeconomic stabilization was contingent on the success of the Hungarian parliament's austerity program, which was passed in March, 1995. The goals of the program were to reduce Hungary's budget deficit and to end the country's persistent balance of current account deficit. Some aspects of the plan included devaluation of the forint, liberalization of currency-conversion regulation for corporations, and an 8% import surcharge. In 1995, the impacts of the plan were not yet clear. Although inflationary expectations had begun to decrease by midsummer, the trade deficit endured, possibly due to the dependency of Hungarian exports on raw-material imports.

By 1995 Hungary's current account deficit was chronic and high, and was perhaps the largest macroeconomic problem the nation faced. During 1994 Hungary's current account deficit totaled \$3.9 billion. The net external position of all sectors of the economy worsened, particularly the banking sector. Despite continued devaluations, imports did not slow, although in 1995 exports showed considerable growth.

By 1995 Hungary had a relatively large amount of foreign investment – about \$7.8 billion, compared with Hungary's GDP of about \$40 billion. In contrast to other East European countries, the Hungarian government had positioned the country well prior to the 1990s by opening up many markets to foreign investors and private enterprises. Companies were allowed

to establish joint ventures and subsidiaries in Hungary in the 1980s, and many controls and guarantees were in place to assure companies that their investments would not be expropriated.

The structure of this foreign investment developed largely independent of the BSE. Most foreign investment was direct – i.e., it was by strategic investors, not via the BSE with multiple shareholders. Of the almost \$8 billion invested in Hungary by foreigners, only about \$1.5 billion was in the BSE, i.e., less than 20%.

This structure had both positive and negative effects on the country's development. Strategic investors generally exert considerable influence over their investment interests, compared with ordinary shareholders, who give management independence. Since the majority of the foreign investment in Hungary was via strategic investors, the parent companies tended to influence much of the management of the companies, and tended to favor productivity and trade promotion investments.

Hungarian companies benefited from this type of arrangement in that their managers were directly exposed to Western business practices and standards and were able to establish contacts in Western countries. Furthermore, strategic investors tended to look out for the company's long-term well-being. This meant that they generally assured that the company had sufficient resources, good management, and reasonable technology.

The principal drawback for Hungarian firms in a joint venture was that ultimately the primary interest of the parent company was for the affiliate or subsidiary to prosper within the overall prosperity of the parent. Since the affiliate was motivated to satisfy the investors of the parent company, the latter could be inclined to transfer profits from the subsidiary in the developing country to the parent, in the form of transfer pricing. The challenge in 1995 was to find the equilibrium point, at which there were enough investment opportunities in the country such that the foreign parent was motivated to make long-term investments in Hungary.

Another important macroeconomic issue was the privatization of utilities and other formerly state-owned enterprises (SOEs). The public sale of companies in Hungary was less than smooth during the early 1990s. Investors' attention was drawn toward the privatization of a few large companies, as compared with a potentially wider and more diverse offering of investment opportunities available in other developing markets. Furthermore the Hungarian government put considerable emphasis on stabilization of the economy between 1990 and 1995, particularly in 1995, which drew attention away from privatization. Therefore, privatization lagged behind. In 1994, the only, albeit quite significant, privatization occurred in the Richter Gedeon Company, a large pharmaceutical firm. In 1995 privatization was

brought to the forefront again as part of the macroeconomic stabilization package.

The BSE was founded in 1867, but was closed when the Communists took over in 1948. In 1987, 41 banks and financial institutions signed an agreement on trading securities; this agreement was the initial legal step toward reestablishing the BSE. The BSE officially reopened on June 21, 1990, as a self-governing, autonomous, nonprofit organization, owned by 44 broker and dealer firms (“members”) and supervised by the State Securities and Exchange Supervision Board or Commission.

The members of the stock exchange were licensed broker or broker-dealer companies. Banks and financial institutions were not permitted to trade in securities so they conducted business on the market through subsidiaries. Broker and dealer firms fell into two categories. One comprised companies with share capitalization of Ft5 million or more. These firms could carry out clients’ orders, but were not allowed to trade their own accounts. The second category encompassed firms with Ft50 million or more that were permitted to make transactions for their own accounts.

Three different groups supervised operations of the exchange:

- *The General Meeting of Members* was the supreme governing body and dealt exclusively with major issues.
- *The Council* managed the exchange.
- *The Secretariat* carried out decisions made by the General Meeting and the Council.

Three committees were also established: the Trading, Listing, and Settlement Committee acted as an advisory committee to Stock Exchange Council; the Ethics Committee; and the Arbitration Court settled disputes.

Trading on the exchange was computerized, occurred on the floor, and was supervised by the Speaker. Its free-auction market system meant that prices could change with every trade. The BSE securities were divided into two markets: listed and traded securities. Those that met the more stringent requirements were traded as “listed” securities, while those which met the basic requirements were designated as “traded.” The rules for trading and settlement were the same for both categories, but the requirements differed for minimum capital, public ownership, and investor and information requirements.

Transactions by foreign investors were limited to registered Hungarian securities. Joint approval by the Securities Supervision Board and the National Bank of Hungary was required for foreign securities to be listed on the BSE. Foreigners could own 100% of the issued shares of a company but required joint regulatory approval for ownership of over 50%. Foreign participants in a Hungarian company enjoyed tax concessions. Listing a

Hungarian security on a foreign stock exchange was allowed only if it was already listed on the BSE.

Since reopening in 1990, the BSE has focused on developing the exchange. The first two years were spent developing basic systems, regulations, and procedures to ensure that the BSE could provide the services and functions expected from a stock exchange. This was a formidable challenge because foreign investors were accustomed to certain services in the developed markets and demanded similar amenities in Hungary. Meanwhile, the BSE had to work to accommodate the needs of less financially sophisticated domestic investors.

To satisfy these varying needs and to bring the BSE in line with the global equity markets, the management at BSE identified three major areas on which to focus:

- Computerized trading system.
- Settlement and depository system.
- Derivatives market.

When the exchange reopened in 1990, the trading floor operated entirely in an open-outcry system. However, this system severely limited the number of foreign investors that could invest in the exchange since brokers had to be present to participate. Therefore, the BSE has slowly been shifting to an entirely computerized trading method. Two milestones in this effort were the implementation of the Central Market Support System (CMSS) in 1993, and the Fully Automated Execution System (FAES) in 1994. By 1995, most active securities were traded on the FAES. The trading floor, which was open daily from 10:30 a.m. to 2:00 p.m., operated on the open-outcry system from 10:30 to 11:40, at which time it shifted to fully automated trading. The BSE would like a gradual transition from open-outcry system to automated trading; it plans to be completely automated by 1997.

This trading infrastructure not only provided a flexible trading environment where the BSE could accommodate the needs of the market participants relatively easily, but also served as a system where no technical breakdown could prevent continuous trading. The computer system was also used as the basis of disseminating real-time market information through Reuters monitors all over the world.

One of the most important areas of change for attracting new investors to the exchange was the implementation of an effective settlement and depository system. As of 1995, the exchange still operated with a T(rade)+5 (days) rolling settlement system. Securities were printed out and only some of them were kept in the central depository. Until 1993, clearing and settlement systems were operated by the BSE, at which time they were transferred to the newly created Central Clearinghouse and Depository (KELER).

KELER served as a central depository and a clearinghouse for cash- and exchange-traded derivatives, and administered cash accounts for the intermediaries. Risks related to the complexity of KELER were expected to be balanced for reducing settlement risks, costs, and time and achieving true delivery versus payment. As of 1995 the BSE had not made improvements in reducing settlement times, but it expects to reduce the settlement time to T+4 or T+3 days in the near future.

Another major development was the organization and establishment of derivatives markets, which occurred in early 1995. Hedging instruments to protect against fluctuations in the equity market, interest rates, and currency exchanges were considered an important risk-management tool among foreign investors. The value of these tools rapidly became clear to domestic investors as well, given the huge, unhedged interest rate and currency risks to which domestic institutions and investors were exposed. The derivatives markets initiated in 1995 included standardized futures trading for several contracts:

- Share index (BUX) of the Budapest Stock Exchange to manage market risk on the equity market.
- Yield of three-month discount T-bill contract to mitigate interest rate risk on money market funds.
- Deutsche mark and US dollar contracts to eliminate foreign exchange risk.

The BSE made other significant improvements to the exchange in the first five years of its existence.

- An equity index was unofficially calculated starting in 1991, and became official in 1995. This stock index is calculated on a daily basis, and represents the weighted average of the 17 most active shares on the exchange; the content of this basket is reviewed semi-annually by the BSE Council. The objective of the index is to reflect the current state of the market. The BUX depicts changes in the value of the securities package compared with the base date (January 1991=1,000). The BSE plans to institute an index that is calculated on a continuous basis to satisfy increased demands from investors for information.
- To address issues of disclosure by brokerage firms the BSE set up a new department – the Membership and Control Department – in January 1995. The objective of this department is to follow the activities of brokerage firms operating on the BSE. In the past brokerage firms were required to report all of their activities to the BSE, but this function was not regulated carefully. With the establishment of the new department, brokerage firms are required to show figures on all trades, and are

also required to keep their accounts separate from client accounts. This new department is also allowed to go to brokerage houses to research transactions.

- An information center was established in 1994. The center allows visitors and investors access to all annual reports.
- In 1995 the BSE began requiring that all brokerage houses provide weekly reports on all over-the-counter transactions. The BSE tracks these data and publishes a weekly official securities and exchange publication, which is edited by both the BSE and the Securities and Exchange Commission, the regulatory agency of public equity markets.
- In late 1994 real-time data dissemination (teletex) and a Reuters connection became available on the trading floor, allowing domestic investors to view real-time trading on Hungarian television.

By the summer of 1995, the exchange had 54 members. Thirty-six companies were listed on the exchange, with total market capitalization at about Ft950 billion (about \$7.8 billion). Over-the-counter transactions accounted for between 50 and 60% of all securities traded on the exchange.

In 1995 the BSE was considered one of the most sophisticated exchange trading systems in Eastern Europe. At that time it was the only exchange in the region that had continuous trading sessions every day since its foundation.

Despite these major achievements, the BSE has continued to slip behind its counterparts in Prague and Warsaw in attracting investors. Several key areas of development were targeted for improvement, and will be critical to improving the BSE's efficiency in terms of liquidity, transparency, and cost.

- Systems, regulations, and procedures in the clearing at settlement of securities must be improved; KELER should be enhanced to make it an internationally recognized and central depository for Hungarian securities.
- The next step in building up a full-fledged derivatives market is to implement trading and settlement systems for option trading. Continuous product development on the basis of the existing futures market will help the BSE to accommodate the needs of market participants.
- The third development area involves the trading system, where the physical decentralization of computerized trading is on the agenda. Decisions on issues such as the form of decentralization, the combination of floor trading, and decentralized computer trading will be taken at a later stage. This will remove the physical constraints on the current trading environment.
- Finally, and most critical, are marketing issues. The BSE must promote its services to the international financial community so that investors decide to trade on the BSE rather than on nearby markets such as those in

Frankfurt or London. Furthermore, as domestic investors become more affluent, they must be educated on ways to invest in capital markets and the benefits of doing so. Most importantly, more Hungarian companies must be persuaded to list themselves on the BSE. The advantages of a BSE listing include an enlarged investor base, lower capital costs, membership in an “exclusive” club, and the free publicity that accrues to companies whose equities are traded.

Chinoin Rt., Hungary

Chinoin, the first Hungarian pharmaceutical company to be privatized and the only one in which a foreign corporation has majority ownership, has successfully integrated itself into a market economy. Having Sanofi of France as strategic investor was key to Chinoin's integration, because the joint venture gave Chinoin, among many things, much needed support in both research and development and marketing, the two most expensive and most important investments for a pharmaceutical company. Sanofi's investment brought about a restructuring of the company's system to reflect modern practices. Nevertheless, it is interesting to note that despite all the efforts to "Westernize" its internal system, Chinoin maintains its Hungarian identity.

The Hungarian pharmaceutical industry traces its roots back to 1867, when it was one of the first countries to start mass production of pharmaceutical goods. After World War II, all pharmaceutical companies in Hungary were nationalized, giving the state the authority to dictate all aspects of business. Although sales were limited to the CMEA market, the industry continued to excel, because Hungary's emphasis on scientific education produced many good chemists. In the CMEA market, the Soviet bloc trading group, Hungary, and Poland were the major pharmaceutical suppliers to the former Soviet Union and the bloc countries. In fact, the majority of the Hungarian pharmaceutical companies' sales were to the Soviet Union. However, as drastic political and economic changes took place in Eastern Europe in the early 1990s, many Hungarian pharmaceutical companies realized that they were no longer protected, and had to quickly learn a new concept – market competition – in order to survive.

Hungary's pharmaceutical market today exceeds Ft63 billion (\$500 million). The six largest Hungarian pharmaceutical companies are EGIS, Richter Gedeon, Alkaloida, Biogal, Chinoin, and Human, and their sales, in volume, are responsible for over 90% of the country's pharmaceutical production. Chinoin is the second biggest in terms of revenue after Richter Gedeon, yet it is the most profitable among the Hungarian pharmaceutical companies. All of these companies hold license agreements with international companies such as Syntex, Sandoz, Bayer, and Eli Lilly to produce various products, and all are on their way to being privatized.

Chinoin was founded by Emil Wolf in 1910. In the 1950s, Chinoin was the first company to produce penicillin in Central Europe. In 1995, Chinoin produced over 148 products in human pharmaceuticals and agrochemicals. Animal treatment activity, which used to be part of Chinoin's activities, was spun off as a separate joint venture with Sanofi in 1994. Some of Chinoin's human pharmaceutical products include Selegiline, an effective drug to treat Parkinson's disease, and Jumex, which was introduced in 1980 against

Parkinson's and Alzheimer's diseases. Products designed for nonhuman use include pesticides used on fruits and vegetables and insecticides for cockroaches, flies, mosquitos, and other public-health pests. Chinoin has been granted 567 patents, the most of any Hungarian pharmaceutical company.

In 1994, the total sales revenue and net profit for Chinoin were Ft18.1 billion and Ft4.0 billion, respectively. Sales revenue increased 15% from 1993 in nominal terms. Human drugs accounted for 85% of Chinoin's sales revenues. Exports dominated Chinoin's sales, and exports to the CIS were becoming increasingly important. *Chinoin Exhibit 1* and *Exhibit 2* present regional and product breakdowns of Chinoin's sales.

Chinoin's market share in the domestic market fell considerably from 10.9% in 1993 to 8.9% in 1994, mostly due to the growth of pharmaceutical imports in Hungary. However, Miklós György, Managing Director at Chinoin, explains that "this is not Chinoin's problem alone; it's [the] same for all domestic companies." Since the early 1990s, when Hungary liberalized imports, foreign competitors have entered the Hungarian pharmaceutical markets. Between 1989 and 1990, 800 new pharmaceutical products were introduced in Hungary, 88% of them by foreign firms (Girocredit Analyst Report, 1994). *Chinoin Exhibit 3* indicates that domestic companies have been losing their market shares to foreign competition. However, the market share indicator is based on the *value* of products sold, not on *volume*. It does not give a complete picture of market penetration, because foreign products are about four times as expensive as domestic products. Although imported pharmaceutical goods are more expensive than domestic products, they are also partially reimbursed by the Social Security program, described in *Chinoin Exhibit 4*.

In 1990, Sanofi, a French pharmaceutical company, purchased 42% of Chinoin after one and a half years of negotiations. The rest of Chinoin remained under state ownership. Sanofi's acquisition marked the first time a Hungarian pharmaceutical company gained a strategic foreign partner. When Chinoin approached Sanofi in 1989, it was looking into expanding its activities in Eastern Europe. Sanofi wanted to gain access to the former Soviet Union market through Hungary, since it could not sell directly in Russia at the time. The Hungarian government was interested in finding a Western company that could provide Chinoin with capital, Western management knowledge, and access to Western markets. The high costs of research and development, Chinoin hoped, could be split between the partners.

The two companies saw a perfect strategic fit, but this would not have been enough to make Sanofi purchase Chinoin. "Psychological fit was very important for our consideration," said Sanofi's Vergnaud. György stated that one reason Chinoin is successful is that it remained a Hungarian

company. It was important to Sanofi that Chinoin be run by local managers and employees. Out of 2,842 employees at Chinoin only six are foreigners.

The Chinoin-Sanofi joint venture received a five-year tax holiday and 60% tax holiday for the following five years. In 1994, the ownership structure was as follows: 51.0%, Sanofi-Winthrop; 32.5%, AV Rt., the state holding company; 5.4%, employees; 2.1%, Chinoin; 9.0%, free floating. Sanofi has reportedly been considering increasing its share to 60%.

As the Hungarian market opened up and competition increased, all pharmaceutical companies, including Chinoin, had to find their places in the market. Having a strategic investor was the key to Chinoin's successful integration into the market economy. Sanofi brought in the assistance, knowledge, and expertise to set up a new system and train people in a manner that is suitable to the new market environment. Chinoin streamlined production to increase efficiency, implemented marketing and sales activities – a new concept to former state-owned companies – and took cost-cutting measures. It also started to rejuvenate its product line with the introduction of Sanofi products.

Even when Sanofi was not a majority shareholder, it was able to have a great deal of influence on management decisions at Chinoin, because AV Rt., the state holding company, "left [them] alone as long as the company was profitable," Vergnaud stated.

Some of the steps Chinoin took to increase efficiency included reducing consumption of energy and water, using rolling sales forecasts, enhancing process control and inventory management with forecasts based on material and time-demands analysis, and introducing a computer-aided material flow and material requirements planning (MRP) system. Such steps paid off, as Chinoin was the first Central European pharmaceutical company to receive the ISO-9001 quality certificate in 1994.

Contrary to its old marketing approach – if you produce they will come" – Chinoin quickly adapted more modern marketing methods. Realizing the importance of information flow, Chinoin set up a big sales force to visit physicians and pharmacies to inform them about Chinoin products. Of course other companies tried to do the same, but one advantage that Chinoin had over others was that it was the first one to implement an aggressive marketing effort, since it was the first one to be privatized.

Chinoin has taken a long-term approach to training people in marketing. Rather than spoon-feeding the marketing concepts that work in France to the Hungarian trainees, foreign trainers learn about the local environment to help Chinoin employees respond to the specific needs of Hungarian consumers. "You can't just send people for a few weeks to train others. It is important that people build up local knowledge by working and living in

foreign countries. Many people make the mistake of thinking that the methods that you use in France or England are transferable, but they are not,” stated György.

By adopting a Western approach to accounting, Chinoin has achieved tight financial control. It has implemented a financial system to closely monitor budgets. Investment return analysis ensures proper expenditures. Under the old system there was no control on how much and for what purpose money was spent. “In the old supply-short days, people just purchased whatever was available, not because it was needed, but because whatever was out there today may not be there tomorrow. You would not believe how many machines which were purchased then are still sitting in our warehouse unused,” states Vergnaud. Today every major investment has to be approved by Sanofi.

Research and development (R&D) is perhaps the most expensive, yet the most important, investment for pharmaceutical companies. Traditionally, Hungarian companies only spent about 5-8% of sales on R&D, too low to be able to compete against large international firms that spent an average of 12–15%. While Chinoin spends the highest percentage of sales on R&D among the Hungarian pharmaceutical companies, it needs Sanofi’s expertise and financial support. *Chinoin Exhibit 5* shows R&D expenditure by selected Hungarian companies in 1993. In 1994, Chinoin spent Ft1.2 billion on R&D. Chinoin carries out research in conjunction with Sanofi to avoid duplicate efforts. Three main areas of expertise are pharmaceuticals for the central nervous system, respiratory diseases and disorders, and osteoporosis. “There are two ways of discovering a new drug: the random and the scientific. One cannot depend on random discoveries; it’s too expensive to count on luck,” Vergnaud stated.

Chinoin has taken steps to “Westernize” its personnel management, focusing on the well-being of its employees and making them more productive. When Chinoin was first privatized, it went through a painful process of laying off employees to slim down the company. In 1991, there were 4,500 employees at Chinoin, compared with 2,842 in 1994. As one way of reducing the work force, Chinoin established an early retirement program for older workers.

The company has initiated programs to enhance its employees’ attitudes toward work. Workers monthly base wages increased by 32% in 1994 (unadjusted for inflation) and performance-related bonuses totaled Ft466 million in 1994. In addition, 5.4% of Chinoin’s stock is owned by employees. Chinoin introduced this concept in 1991 to give employees a sense of ownership of the company. Vergnaud indicated, however, that he personally does not see any difference in people’s attitude toward work.

As the only foreign manager at Chinoin, Vergnaud feels that it is natural to face problems resulting from cultural differences: “Things do not go as fast as I am used to. You must know how people work here and you have to realize that sometimes you cannot impose on everyone else your way of doing something.” Certain cultural differences have to be addressed, however, such as the ways employees deal with problems. “People here tend to hide problems, hoping or thinking they will go away.” Vergnaud has tried to teach people that problems do not just go away and that it is better to confront a problem in the beginning rather than later.

Chinoin’s integration into world economy shows the necessity of upgrading production and financial systems and of investing in R&D and aggressive marketing approaches. Perhaps more important, it shows the necessity of having good managers who can implement these decisions. The managers at Chinoin, especially Managing Director Miklós György, help to explain Chinoin’s success.

György, 51 years of age, was born in Hungary and studied in Switzerland. He joined Sandoz, a Swiss pharmaceutical company, 27 years ago. He worked in Europe, then Korea for eight years, setting up and operating Sandoz subsidiaries, and Japan for two years in different positions. He then joined Sanofi and returned to Hungary five years ago when Chinoin was privatized.

He sees himself as a product of both West and East European cultures. His expertise has helped in intercultural exchanges, and his role now is that of liaison between Sanofi and Chinoin. As György stated, “If Sanofi people tell me that I am like a Chinoin guy, I am doing my job well and if Chinoin people tell me I am too Sanofi, I have done my job very well. It’s very difficult to have two heads but very important. You have to be sensitive to differences in cultures. Even within a country, when two French companies are merged they can have the same problems. I do not consider myself a foreign or a local manager, I am in between.” György further believes that success requires a match between a manager’s and the company’s philosophies. “Since Sanofi’s philosophy was to keep Chinoin local and that is my belief, it is easy for me to work for them.”

As *Chinoin Exhibit 6* indicates, most Chinoin managers are Hungarians. It is important to both Chinoin and Sanofi to keep the management and employees as local as possible, because no one else understands the Hungarian market better than Hungarians. Most of the managers have been working with Chinoin for a long time. In fact, for some, Chinoin has been their only employer. György said he believes that Hungarians in general are bright, motivated, and loyal to the companies for which they work; they just need the right environment.

Chinoin Exhibit 1. Sales breakdown (in million Hungarian forints).

	1993	% of total	1994	% of total
<i>Sales type</i>				
Domestic	6,106	38.7	6,432	35.4
Export	7,839	49.7	9,713	53.5
Royalty income	1,636	10.4	1,766	9.7
Human pharmaceutical products	13,387	84.9	15,302	84.3
Agrochemical products	2,012	12.8	2,311	12.7
Veterinary products and other	373	2.4	534	2.9
Other	191	1.2	236	1.3
Total net sales	15,772	100.0	18,147	100.0

Source: Chinoin Annual General Meeting, 1994.

Chinoin Exhibit 2. Exports by country in 1993 (in percent).

CIS	32.93
Finland	5.53
Italy	2.11
Japan	4.29
Turkey	4.62
USA	6.79
Austria	3.19
Czech Republic	2.05
Poland	2.29
Other	36.20

Source: Girocredit Investment Bank.

Chinoin Exhibit 3. Market share of Hungarian pharmaceutical producers at factory prices.

	1990	1991	1992	1993
Chinoin	16.1	14.6	13.2	10.4
EGIS	17.7	18.5	15.2	13.1
Biogal	18.0	17.4	14.1	11.2
Alkaloida	18.0	17.4	14.1	11.2
Richter	14.5	13.1	11.0	9.1
Pharmavit	2.1	2.0	2.8	1.8
Foreign producers	26.3	29.3	38.0	46.6

Source: CS First Boston.

Chinoïn Exhibit 4. Drug consumption and the Hungarian social security system.

Hungarians are the number two consumers of medicines in Europe (Girocredit Analyst Report, 1994). Until 1989 consumption in Hungary had been heavily subsidized by the state social security system, and medicines were provided free of charge. More than 400,000 so-called exemption certificates were given out to pensioners or very poor people to enable them to get free medicine. About 48% of prescriptions were for pensioners in Hungary in 1994. Since 1989 Hungarians have had to pay 100% of the price for nonessential drugs and between 5 and 40% of the costs for other selected drugs, but they still enjoy generous reimbursements from the health insurance system.

Consumers are reimbursed for prescription pharmaceuticals on a percentage basis. In 1993 the Hungarian government incurred a reimbursement bill of Ft51 billion, a threefold increase from Ft17 billion just four years earlier. Most of the increase is due to more expensive imported products. Beginning in January 1995 most imported drugs were assessed a value-added tax of 12%. Prices for pharmaceuticals did not increase with inflation over the past five years. The low prices were maintained by low, regulated domestic producer costs, which forced the domestic companies to keep R&D, marketing, and promotional costs low.

There are great efforts to change the drug reimbursement programs to include lowering subsidy levels for consumers and encouraging doctors to prescribe cheaper drugs. The government hopes to shift demand toward Hungarian generics which are cheaper than imports.

Chinoïn Exhibit 5. Comparison of main Hungarian pharmaceutical manufacturers in 1993.

	Sales revenue (mill.Ft)	Profit gross (mill.Ft)	Market share	Export sales (mill.\$)	R&D cost (%)	Employees
Chinoïn	15,772	3,169	10.4	108	8.0	3,066
Richter	18,264	2,322	9.1	136	6.8	4,639
EGIS	12,872	1,657	13.1	62	7.2	3,605
Biogal	9,877	860	11.2	33	5.5	2,168
Alkaloida	8,197	95	3.8	46	5.0	2,000
Pharmavit	2,388	533	1.9	2	0.9	104
Rank of Chinoïn	2	1	3	2	1	3

Chinoïn Exhibit 6. Management profile.

Miklós György, Managing Director, 51.

Education: University of Economics, Basel.

Péter Arányi, Director of Research and Development, 47.

Education: University of Chemicals, Budapest.

Éva Csákvári, Director of Human Resources, 48.

Education: High School.

Peter Hajnal, Commercial Director, 48.

István Jelinek, Production & Development Director, 52.

György Mihály, Administrative Director, age unavailable.

István Székely, Director of Production of Plant Protection, age unavailable.

Gyula Szük, Technical Director, 63.

Zoltán Vargay, Director of Quality Assurance, 54.

Philippe Vergnaud, Financial Director, 49.

Duna Elektronika, Hungary

Peter Freed, a Hungarian-American entrepreneur, came to Hungary in 1990, bringing a new business concept with him. As a franchisee of three major computer retailers in the United States, he was as well-suited to do the same business in Hungary as anyone was, if not better. Market opportunity was new and big, he had much industry knowledge, and he was fluent in Hungarian. However, Freed found international business much more difficult than he anticipated. It brought him a whole new basket of challenges – devaluations, local taste, import duties, to name a few, which he later learned at the expense of his business. By 1995 Duna Elektronika was in a recovering phase after a financial restructuring.

Duna Elektronika was founded in 1991 as an importer of personal computers from the United States. The company was set up to franchise the computers in Hungary and, then, in Central Europe. “Franchise was not a known concept here when I was thinking about coming to Hungary, except for maybe McDonald’s or the big hotel chains.” Freed was a franchisee for ComputerLand, Entre, and Microage in the United States, and therefore had considerable knowledge of the franchise business and the computer market. His hope was to bring his experience and skills to Hungary where there was a significant need for infrastructure building.

The HAEF was established during the Bush administration as an investment fund to help build enterprises in Hungary. Duna Elektronika was the first HAEF project, “but it took a long time to put it together.” HAEF’s initial commitment was to provide 50% of the cash needed to finance the set up. Freed brought the other 50% from personal sources and outside investors. Duna Elektronika’s initial capitalization was Ft185 million in 1991, equivalent to approximately \$2.7 million. Of the Ft185 million only Ft60 million (equivalent to \$1 million) was cash which, in retrospect, Freed did not think was enough to start a very capital-intensive business.

In 1991 Duna Elektronika was founded with the following ownership structure: 15%, Hungarian American Enterprise Fund (HAEF); 51%, Donasphere Limited in USA (Freed’s company set up in USA); 7.5%, Microage; 6.5%, Kia Intertrade (a South Korean conglomerate); 7%, Szki (Hungarian); 13%, Szu (Hungarian).

Since its beginning Duna Elektronika sales revenues have grown rapidly: 1991, Ft150 million; 1992, Ft500 million; 1993, Ft700 million; 1994, Ft900 million; 1995, Ft500 million.

When Duna Elektronika started its business the initial focus was on the retail market. Its main business was to import brand-name personal computers, such as IBM, Compaq, and Digital, and to distribute them in the wholesale market. It had 55 employees, 3 offices in Hungary and 1 in

Warsaw, and a distribution center in Hungary at the time of the restructure. Duna Elektronika had a network of 22 stores through which computers were distributed. As part of its sales effort Duna Elektronika trained over 200 sales people in 4 months. Soon into its operation Freed realized that he had made a wrong assumption about the Hungarian personal computer market. His past experience in the computer business taught him that American consumers linked brand names to quality and were willing to pay a premium for quality products. Therefore, brand name was important in the computer business. He thought that Hungarian consumers would be as brand loyal as American consumers. "This is where I missed the boat," Freed stated. He did not realize that in Hungary people were looking at the clones because they were cheap, even though they are of lower quality.

The problem was two-tiered. On the one hand, consumers did not know better and tended to buy whichever product was cheaper. On the other hand, and more importantly, the sales people whom Freed spent time and effort to train, did not push the products. As a result, inventory piled up. Noticing that the the sluggish sales were due to a lack of effort by the sales people, Freed started a direct-sale division. He even hired an American expatriate to train sales people. Suddenly, the business became successful. As Freed put it, "It has to do with how for the last 40 years people were not taught to sell, sell, and sell, and unfortunately you cannot change the world overnight."

Although Freed found direct-sales profitable, he eventually decided to shift away from retail business in general and go into corporate accounts for two main reasons. In retail business all inventory must be purchased first and resold, requiring very difficult inventory management. Also, business becomes very vulnerable to currency devaluations when buying with one currency (dollars) and selling in another (forints). Duna Elektronika faced a huge problem regarding forint devaluation, and this is one reason why the company faced bankruptcy in March 1995. The other problem with the retail business, Freed found, was that his company could not offer some products that were popular to its customers, because someone else had an exclusive license agreement with the manufacturers. Freed learned as he went along, and after restructuring, discontinued all distribution activities and wholesale business, and focused more on the large corporate accounts.

In 1995 Duna Elektronika began providing corporations with computer installation services. Its main customers include big American corporations that have offices in Hungary, Poland, Russia, and other East European countries. Among them are Philip Morris, Readers Digest, and Young & Rubicam. Other customers include the Hungarian and Slovakian parliaments. In 1994 its sales were about Ft900 million, and in 1995 sales were about Ft500 million. (In March 1995, Duna Elektronika went out of business and it had

to be restructured. The decrease in sales represents discontinuation of some of its activities.) Corporate account business was the only remaining activity at Duna Elektronika as of March 1995, with 17 employees.

In March 1995, Duna Elektronika was cash strapped, even though it achieved its highest sales in 1994. It had \$2 million in bank debt, of which half was from Inter Europa Bank, backed by HAEF. The loan expired, and it needed to be extended. HAEF, the guarantor of the loan, decided not to extend its guarantee. Freed and HAEF tried to turn the short-term debt into long-term equity-type convertible bonds transaction, but by the time it was negotiated another round of devaluation hit. At this point, HAEF decided to pull out its investment from Duna, forcing Duna into liquidation. The liquidation process called for automatic application of 50% of Duna's receipts against the debt and sale of Duna Elektronika's assets. With \$200,000 from personal sources, Freed set up another limited company by buying the operating assets of Duna Elektronika and the rights to the Duna Elektronika name and logo. He also took leases and financial responsibilities such as warranty and services, so the customers were not affected by the liquidation. The new limited liability company operated out of a portion of the previous office space, servicing corporate accounts.

"Hungary became a tough market," Freed stated. International business brings a bowl of new challenges, some of which can be managed yet most are unpredictable. Many problems were ignited externally, and it is important for a company to be flexible enough to adjust quickly. Among the problems were a 23% devaluation of the forint in less than a year and an 8% import duty imposed in the government's austerity package in March 1995.

1. Forint Devaluation. The average forint-to-dollar exchange rate was 60 to 1 in 1991. By June 1995 it was at 125. Given that most of the forint devaluations were not too severe until 1994, Duna Elektronika ignored them until it woke up with approximately \$400,000 foreign exchange losses. As an importer Duna buys inventory from the United States and sells domestically. This means that Duna receives forints from its sales and it pays in dollars. In addition, customers were late in paying their bills, and the uncollected receivables piled up.

If this weren't enough, forint devaluations hurt Duna Elektronika in yet another way – in its foreign currency loan. Duna had \$2 million in foreign currency debt by March 1995. "When the company was small and operated out of its own money, it was manageable, but once it had foreign currency debt, it started having problems."

2. The March Austerity Package. On 15 March 1995, in an effort to control high inflation and to discourage imports, the Hungarian finance minister, Lajos Bokros, imposed an austerity package, and imposed an 8% duty

on all imported goods. This action hurt many importers who were faced with an overnight cost hike. Importers could raise prices on their goods, but at the risk of turning away customers. This hurt Duna Elektronika even further which was already struggling with forint devaluations.

3. Foreign Suppliers. Duna Elektronika also faced a problem with its suppliers. Freed had to deal not only with logistical problems but also with the competition from his own suppliers. Duna Elektronika had direct contracts with four or five manufacturers in the United States including IBM, Compaq, and Digital. A problem arose when Freed needed a product which the manufacturer has already given an exclusive license to another company; therefore, he could not sell that product. When asked whether this type of issues could have been researched, Freed said, "Yes, but I just didn't, because I got caught up in putting the company together and thought I'd work out the details later."

Supplier problems did not end here for Freed, or actually for the whole PC industry in Hungary. When Freed first started business in the PC market, competition was low. Some manufacturers, such as IBM, had presence in Hungary but their concentration was in bigger main-frame computers, not in the PC market. In 1991 IBM sold only about 700 PCs, where Duna sold 1,500 at twice the price with a smaller staff than IBM. Freed even has a trophy to prove that it was the largest seller of IBM machines. However, Duna Elektronika could not enjoy its market position for long before IBM started to eat away Duna's market share by giving more licenses to other companies and starting up its own direct-sales team. Unfortunately because IBM does not license exclusively, there was nothing that Freed could do to keep the competitors away. This hurt Freed. "It was a crazy market. Everyone was running scared. Price wars were dramatic."

4. Human Side of Business. Often it is too easy to ignore the cultural side of doing business, and Freed found that one should never make an assumption without testing it. Freed found it more difficult to train people in Hungary than in the USA, because of the difference in culture. He faced high turnover in his trainees who would come to take the training course and then go somewhere else. Although Duna Elektronika had an incentive system tied to sales, it was not well received by the employees. "Hungarians aren't used to incentive programs. They like structure, and not taking risk. Incentive system is a risk-taking program. Nevertheless it is getting better."

Having learned a painful lesson, Duna Elektronika is taking a different approach. Duna Elektronika is focusing on selling computers directly to commercial accounts. However, switching to bigger volume has not relieved

Duna Elektronika from all problems, but some can now be managed better. Bigger sales are actually more price sensitive, because business is based on competitive bidding. It is just as competitive, if not more, as the retail business. One big difference is that there are not many inventory problems because Freed deals with the customers on an as-you-go basis. He gets sales first and then orders the inventory. Regarding the devaluation problems, Duna Elektronika has watched its customers significantly closer than before by making them sign a contract stating that, if they don't pay within a certain period, they are responsible for possible devaluations. Normal terms range from 8 normal bank-transaction days to a maximum of 30 days.

Freed plans to remain fairly small and to undertake only profitable projects. "We grew too big, too fast, too diverse. The lesson learned was that a company needs to live within the limit of its capital. It outgrew the limit of its capital and later had to get outside sources. It just was a disaster."

Duna Elektronika Exhibit 1. Management profile.

Peter Freed, President, American of Hungarian descent, 45. Freed is a CPA and has worked for an accounting firm. In 1977 he entered the computer industry and was appointed CFO in a computer company. In 1979 he started his own computer distribution company. As President of Duna Elektronika he is in charge of business development and vendor negotiations. He is married to Joyce Freed.

Joyce Freed, Vice-President, American. She has worked with Freed since 1981 and is responsible for internal administration. B.S. from Auburn University and an EED from George Mason University. She taught high school for 10 years, and has worked in the computer industry since 1984.

Bela Huebert, General Manager, Hungarian, 55. Huebert has an engineering background, and has been with Duna Elektronika since 1991. Prior to joining Duna, he was Chief Engineer and Head of the Department of the Computer Research Institute in Budapest for 15 years. He is in charge of administration, legal and tax matters, finance, and human resources.

Mark Vadi, Sales Manager, English, 31. After high school he studied banking for three years. Four years ago he moved to Budapest, and worked for Walton Network, a Novell distributor in client relations. He joined Duna Elektronika three years ago as Sales Manager. His main responsibilities are creating sales and managing sales teams. He speaks Hungarian and English.

Ganz-Ansaldo, Hungary

Ganz Electric Works was founded in 1844 by Abraham Ganz, a Swiss. The main factory, built in 1897, is located in central Budapest. It was a private company until the Communist takeover after World War II, at which time it became a state-owned enterprise. In 1991, Ganz and Ansaldo (of Italy) formed a joint venture; Ansaldo, at the time, held 51% of the company. By 1995, Ansaldo controlled 82% of the company. Ansaldo belongs to the Italian state-owned Finmeccanica conglomerate, which, in turn, is owned by Istituto per la Ricostruzione Industriale (IRI), Italy's biggest state-holding company.

For Ganz, the 1991 joint venture was essential. Ganz's plant, equipment, and technology were obsolete, and the government owner had no capital to invest. Ganz was also operating at a loss and the government, burdened as it was with a sizable budget deficit, was eager to be rid of this loss-making enterprises.

Ganz-Ansaldo is a major manufacturer of power station equipment used by electric utilities and transport industries. Among other products, it produces power generators, transformers, electric motors, and switch gears. About 30% of sales in 1994 were from generators, about 25% from transformers, with the rest divided between switch gears and electric motors.

Ansaldo is the head of 20 companies of the IRI-Finmeccanica Group. Ansaldo designs and supplies systems, plants, machines, and electrical and electronic equipment to the energy, transport, and manufacturing industries. It is headquartered in Genoa, Italy, with 1994 annual sales of \$1.4 billion and 20,000 employees. Ansaldo – at times in collaboration with Ganz and at times on its own – has sizable contracts in Taiwan, Indonesia, Malaysia, Egypt, Korea, Costa Rica, China, Belgium, Hungary and Italy. No profit data are available for Ansaldo; however, its parent company, Finmeccanica, was profitable in 1991 and 1992, the last years for which these data were available. Ansaldo “was expected to pass ‘positive results’ at the parent level for the year to 31-12-95 that will be better than 1994's” (*Financial Times*, 1995).

According to a Ganz manager, “There was no company strategy in the old days” (Personal interview, 1995, Budapest). It was a state-owned company, and it depended on orders from domestic sources, the Soviet Union, and other East European company sources.

The joint-venture company decided to move from its central Budapest location to Tapioszel, some 90 kilometers (55 miles) from the present site.

This case was written from public sources with some cooperation with Ganz-Ansaldo executives who wish to remain anonymous. It does not have the official approval of the company.

(Because of the poor road conditions the distance of 90 kilometers takes much longer to travel in Hungary than it does in Western Europe or the United States.) This move would, ostensibly, cut costs as the pre-1995 facilities were antiquated. A more serious issue in 1995 was to generate orders for Ganz-Ansaldo. Between 1991 and 1995, output dropped by about 50%, the number of employees decreased from 2,600 to 1,600, and, in 1995, capacity utilization stood at about 50%. The large decline in output is attributed to both the collapse of the ex-Soviet bloc market, including the domestic market in Hungary, and the lack of commercial orientation and lack of familiarity with the East European markets by the Italian-Ansaldo management.

Before 1989, Ganz had a monopoly position in Hungary and a favored position in the ex-Soviet bloc. After 1989, these advantages disappeared as markets became increasingly more open. Noting the plight of many of its state-owned companies, in 1994 the Hungarian parliament passed a law requiring state companies to purchase at least 30% of their large investments from domestic sources – provided that quality requirements were met and that the price did not exceed more than 15% of the price quoted by a comparable bid. Since December 1994, Ganz-Ansaldo has adhered to ISO-9001, the West European quality standard. The difficulty is that given the very poor budgetary situation of the Hungarian government virtually no investments have been made to improve utilities, railroads, and street cars, which are all state owned. These conditions are expected to improve and it is hoped that orders will begin to come in, though it is not certain that Ganz-Ansaldo will receive these orders. Exports as a percentage of total sales increased between 1989 and 1995 (from 40% to 67%) not because exports increased significantly but because the domestic demand collapsed.

Exports were (and are) done indirectly through Ansaldo, and it is unclear whether the joint venture is benefiting from this arrangement. As Ansaldo owns 82% of the joint venture – the management is almost completely in Italian hands – a reasonable assumption is that management will keep Ansaldo's interests in mind. Ansaldo did pass some low value-added subcontracting work to its joint-venture partner. The fact is that Ganz's higher value-added product lines were de-emphasized. Moreover, Ansaldo's management's lack of interest in the Hungarian and ex-Soviet bloc markets exacerbated this joint-venture situation over and above what might have been expected in these countries due to the poor macroeconomic situations (Csermely, 1996). *Ganz-Ansaldo Exhibit 1* provides highlights of the company in 1989, 1994, and 1995.

The joint venture has posted losses every year since its formation in 1991. The losses were made up by Ansaldo by acquiring more equity in the company thus raising Ansaldo's stake from the original 51% to 82% by mid-1995. A profit was predicted for 1997 in a strategic plan formulated in 1992,

Ganz-Ansaldo Exhibit 1. Financial highlights (in billion Hungarian forints).

	1989	1994	1995
Sales/Turnover	3.0	4.7	10.0
Loss	0.6	0.7 (1.6 in 1993)	minimal profit (the first since 1991)

but this is unlikely to occur (Personal interview, 1995, Budapest). Running a deficit is in Ansaldo's interest as it is a smooth way to acquire full ownership and eliminate the minority Hungarian partner. Furthermore, Ansaldo itself is state owned and, therefore, its profit motive is not as strong as it would be for a private company. Finally, the joint venture's true profitability is difficult to establish because of transfer pricing between Ansaldo and the joint venture. At the parent level Ansaldo was, as indicated earlier, profitable. The joint venture's total assets were about Ft2 billion. Outstanding debt was between Ft2 and Ft3 billion. About 50% of the debt was made up of loans from Hungarian banks and the other 50% was from Italian banks with Ansaldo's guarantees.

By mid-1995, all the top executives were from Ansaldo: the General Manager, the commercial, financial, and production managers. This would facilitate a transfer-pricing system that would indeed benefit Ansaldo. The president was Hungarian but the position was a part-time and representational one. In an interview he said: "While president sounds very nice, this is not my main job. I kept my own enterprises – trade in Russia, Ukraine, Moldova, and the Baltic States. At Ganz-Ansaldo the management is Italian, I am 'the Hungarian' " (*Heti Vilaggazdasag*, 1995).

On the one hand, the joint venture had some positive results:

The joint venture saved jobs All these [Ganz-Ansaldo] people would be out of a job if it were not for the joint venture Some foreign investors [Siemens] shut down their Hungarian manufacturing operations after they acquired a domestic company [and Ansaldo did not] Workers are being paid higher than average salaries." In the last four years managers salaries doubled in real terms. [Personal Interview, 1995]

On the other hand, a 150-year-old Hungarian flagship company was, by 1995, virtually an Italian-owned company.

In forming the joint venture, Ganz expected to increase sales and to return to profitability. At the time of the joint-venture agreement, Ganz had no other alternative than to find a joint-venture partner but, obviously, its expectations were not met. Ganz, or rather the government owner, did not shop around for the most suitable partner. The joint-venture agreement was part of a government-to-government deal concluded during the Hungarian

prime minister's visit to Italy in 1990. For Ansaldo, Ganz was a strategic partner, a reputable (and broke) firm in the same industry. While wage rates were lower in Hungary than in Italy, this was not a major consideration as the company is very capital intensive. Ansaldo received in the joint venture Ganz's underutilized plant and equipment, i.e., inexpensive spare capacity. Ansaldo's share of the joint venture was capital infusion, though it is not clear how much investment was committed by Ansaldo over and above making up losses in exchange for increasing its share of ownership. The main attraction of Ganz to Ansaldo was the former's contacts in Hungary, other East European countries, and the ex-Soviet Union states. While these economies have, to varying extents, been recovering since 1993–1994, this joint venture has not benefited from greater volume of orders. Yet it is the continued low level of orders, together with the corresponding low capacity utilization, which is at the crux of Ganz-Ansaldo's financial problems.

Graboplast Rt., Hungary

In February 1990 a group of foreign financial investors represented by Creditanstalt-Bankverein, Vienna, purchased 30% of Graboplast Textile and Artificial Leather Manufacturing Co., a company formerly owned by Hungary. Since then, Graboplast Rt., the newly formed company, has successfully integrated itself into the world economy without a joint-venture partner or foreign strategic owner. The transformation took place because of increased efficiency throughout the company and its strategic response to changing market demand – something unheard of during the Communist rule. As easy as it may have appeared, Graboplast would not have succeeded without a strong management team that supported this painful and long process. The most crucial factor in its success was the attitude of CEO Péter Jancsó, who “admit[ted] that he had a problem, and that he did not know everything about running a company.”

Győr, 120 kilometers west of Budapest, is the fifth largest city in Hungary, with a population of 131,000 in 1994. Graboplast was founded in Győr over 70 years ago. Graboplast is Hungary’s largest manufacturer of home-improvement and artificial leather products, but it was founded as a textile company. The company later went into coated textiles used in artificial leather, which the company still makes, and into polyvinyl chloride (PVC) floor coverings. It was nationalized after World War II, and for the next 45 years it was a “typical Hungarian company.” As Steve Kopits, consultant to the company from one of the Big Six American accounting firms, notes:

A typical Hungarian company under Communism tended to be very heterogeneous in terms of products and activities. For example, in addition to artificial leather, Graboplast had an incinerator with the third largest capacity in Hungary, a service company, a canvas-making company, and a maintenance company. This is different from the West where companies are specialized. Companies were given incentives simply to make something – just make anything. Many of the subsidiaries did not perform well given the lack of professional management and undercapitalization.

In 1989, the Hungarian State Property Agency (SPA), looking to privatize Graboplast, contacted a local trade representative in Vienna who introduced them to Creditanstalt-Bankverein, Vienna, an Austrian investment banking group. In 1990, Creditanstalt purchased 30% of Graboplast at 125% of nominal value (the actual purchase price has not been disclosed). The state still owned the remaining 70%. “It was an act of good faith,” stated Klaus Requat of Creditanstalt, referring to the purchase price in excess of nominal value. Creditanstalt resold 25% of its shares to other financial investors in pieces. “We valued the company with a projection under COMECON market assumptions, which was a big gamble, and did a

prospectus and printing over a weekend and took it to London,” said Requat. Creditanstalt was to act as representative for the shareholders. With the purchase, Graboplast received a 100% tax holiday for five years and a 60% tax holiday for an additional five years. (At the time of purchase the Hungarian tax rate was 44%, and was reduced to 36% in 1993. The tax rate was further reduced to 18% in 1995, but a dividend tax of 23% was introduced.) By 1994, the privatization of the company was complete, with all shares in private ownership. On July 27, 1994, Ft2,282.5 million of Graboplast’s stock began trading on the Budapest Stock Exchange. *Graboplast Exhibit 1* shows the ownership structure in 1994.

In 1994, Graboplast manufactured over ten different products through two divisions – artificial leather and home improvement. Total sales for Graboplast in that year totaled over Ft4.8 billion, a 20% increase from 1992. Some of its main products are PVC floor covering, wallpaper, artificial leather tablecloths, and bookbinding. Since 1990, Graboplast has been shifting its business away from its traditional product lines such as artificial leather toward more profitable lines, such as home-improvement products, because the market demands shifted and foreign competition in the domestic market increased when Hungary liberalized imports. *Graboplast Exhibit 2* shows the product lines and sales breakdown. The divisional sales breakdown in *Graboplast Exhibit 3* shows that the percentage of total sales attributed to the artificial leather division decreased, while home-improvement product sales grew.

In domestic markets, Graboplast has been a market leader with a 70% share of the artificial leather market and a 45% of the floor-coverings and wallpaper market. Its main domestic competitor in the PVC market is Pannon Flax Rt. While over 50% of its total sales consisted of domestic sales, Graboplast recognized that growth is in the East European market.

One of the problems of typically East European heterogeneous manufacturers surfaced in the privatization. Strategic investors are usually interested in specialized businesses. For example, a Western PVC manufacturer would only be interested in PVC, and not artificial leather. Yet the Graboplast factory had its PVC manufacturing line literally next to its artificial leather line, so that it was very hard to separate them. Shutting down a line would mean losing a large portion of business. Furthermore, a company’s assets may be so mixed together that they are virtually impossible to separate. For these reasons, Graboplast had difficulty getting a strategic investor. However, for a financial investor such as Creditanstalt, Graboplast was good candidate for stock market flotation. In addition, even though the SPA owned 70% of the company, it was an “absentee owner.” This situation enabled Creditanstalt to take a more active role in the company’s management than did

the majority owners. As Requat stated, “You can be weak on paper but tough in reality.”

The condition of the company at the time of the purchase was about the same as most other Hungarian companies. The company had been making artificial leather for a “supply-short” Hungarian economy and for the ruble-based CMEA market. Manufacturers sold everything that they produced, and they rationed what they sold, so not all the customers got what they wanted. Creditanstalt immediately brought in Czipin, an Austrian productivity consulting firm, to find ways to make the company more efficient – a new concept to the former Soviet bloc companies.

One of the keys to Graboplast’s future success would be lowering costs and improving product quality. The company introduced an inventory management system and reduced the number of employees from 2,284 to 1,383. A new cost-accounting system studied various costs such as material usage, energy usage, and allocation of indirect costs. New and young management teams have entered the company lowering the average age of the managers to around 40. Key in East European countries is getting an organization to react. “There is always strategy, and strategy is great; but if your organization can’t implement your strategy it’s useless. So the first thing is to get cost down and efficiency straight, and your system to react to changing market,” said Kopits. The increase in sales revenue per employee per year, which was Ft2.69 million in 1990 and Ft4 million in 1993, demonstrates Graboplast’s increase in productivity.

Bringing in consultants was an expensive new undertaking, yet CEO Jancsó fully supported the program. While the consultants cost Graboplast \$1.6 million, the billing period was six months, and the project built the solid base of a modern company. Consultants could not have implemented any changes in Graboplast without the support from its management, as Kopits explains:

The most important element which made this company turn around is the attitude of the CEO. It was the fact that he admitted that he had a problem, and that he did not know everything about running a company and looked for outside help. This is contrary to other companies where they “don’t have any problems.” Without the manager’s support to bring in outside consultants to cut the fat around the company, Graboplast would not be where it is today. This is unlike managers at other companies, who do not ask for help and who are not willing to change since they believe they know everything and that they can solve any problems on their own.

Besides the CEO, Miklós Patkós, SPA’s representative to the company and Deputy President of Graboplast, supported the changes. With the management’s full support, Graboplast made its first steps toward the world market. *Graboplast Exhibit 5* presents the company’s management profile.

Graboplast's efforts to integrate into the world market were still not problem-free, despite its newly implemented systems. The rapidly declining economic conditions in Hungary between 1991 and 1993, the maturing artificial leather and PVC industries, and entry of foreign competitors were some hurdles which Graboplast continued to encounter.

Two major economic developments in Hungary took place around 1991. First, liberalization opened up the entire market to Western imports, and the world collapsed for domestic companies that had been coddled and protected from free-market competition for more than four decades. Second, the Hungarian economy contracted by 4% in 1991, 12% in 1992, and 4% in 1993, for a total 20% contraction in four years. (For comparative purposes, during the Great Depression the US economy contracted 30%, and George Bush lost the 1992 election after a 2% contraction of the economy.) The free-falling economic conditions undoubtedly hurt Graboplast. Its output fell by about one-third during this period, which was typical of many Hungarian companies. Businesses saw rapidly falling sales, and their attempts to hold on to their customers by providing them with attractive payment terms resulted in a pileup of accounts receivables. Graboplast, however, instituted a tight credit policy by 1993. With many customers, it went to a cash-only basis.

Graboplast faced further challenges in both the domestic and foreign markets. *Graboplast Exhibit 6* lists the major competitors. Foreign companies tended to be bigger, more sophisticated, cleaner, and have a better product selection. With centralized purchasing and more volume, larger foreign manufacturers could price products lower than Hungarian companies. Graboplast also found its products tough to sell abroad, because environmental concerns about PVC are widespread in Western Europe. The company, however, no longer believed that foreign importers were a big threat in its domestic market:

Imports arriving mainly from Italy and Germany account for 5–10% of the market, and these imports primarily fill unsatisfied niches in the market with high-fashion goods. The business policy of Graboplast is to insure its role as a cost leader and maintain its competitive advantage in price and service. [Graboplast *Annual Report*, 1994]

The Company made a fundamental marketing decision to stay in Eastern Europe's markets. The PVC industry in the Western market is very mature and concentrated. There are five big companies that produce PVC in Western Europe, two in Hungary, four in Poland, and two in the Czech Republic. Graboplast opened offices in East European cities such as Prague, Bratislava, Moscow, and Warsaw to push its products.

They were aggressive in efficiency yet cautious in strategy because they did not know how things were going to turn out in 1992–1993. Things were in

a death spiral during this time in Hungary. The economy was free-falling, and Graboplast decided that in this environment they would just wait, and not commit too early.

The artificial leather sales by Graboplast accounted for between 70 and 75% of the domestic market in 1994, but Graboplast was still losing market shares to importers. *Graboplast Exhibit 7* gives a breakdown of market shares by product and region. Sales of artificial leather were low except for plastic tablecloths, so the company decided to shift its line of business toward more profitable home-improvement lines, such as wallpaper and carpeting. Between 1992 and 1993 Graboplast bought a wallpaper machine for \$1.5 million. The planned strategy was to migrate out of artificial leather into household do-it-yourself products. Since Graboplast had a PVC line, management thought that wallpaper would be complementary.

Graboplast followed conservative measures to finance itself in an environment with high inflation and interest rates. The base rate of the National Bank of Hungary was 25% at the end of 1994, whereas commercial bank interest rates reached 30.5%, compared with year-end rates of 25% in 1993. The company financed working capital with short-term loans.

Looking to the future, Graboplast's strategic goals include:

- To focus on activities in its home-improvement division.
- To grow substantially in Eastern Europe.
- To become increasingly cost-driven.

The company plans to stay predominately in the domestic market. To compete against imported goods in the domestic market, it plans to continue its cost-leading strategies, while increasing both production efficiency and the quality of products. The company plans to continue increasing its market shares in Eastern Europe. It is expected that sales will increase by 75% in Eastern Europe by the end of 1995.

To further shift its product lines toward home-improvement products, where it sees high potential for growth, the company has been negotiating for the acquisition of a majority ownership of a Hungarian carpet factory.

Graboplast Exhibit 1. Breakdown of shareholders (in percent).

Foreign investors	48.0
Management	30.5
Domestic investors	10.0
Bills, asset management, and trading	7.8
Local municipalities	3.4
Repurchased shares	0.3

Source: Graboplast *Prospectus*, 1994.

Graboplast Exhibit 2. Products groups and production status.

PVC floor covering	Actual production was 3.46 million m ² in 1993 and 5.94 million m ² in 1994. At the beginning of 1995, the annual capacity of 7.6 million m ² was increased to 9.5 million m ² . Additional investments of Ft200 million in machinery and Ft130 million in working capital implemented by fourth quarter of 1995 will expand capacity from 5.5 million m ² to 15 million m ² . All proposed expansions are for 2-meter-wide production lines. Investing in a 4-meter-wide production line for the type of product popular in Western Europe will be considered by management.
Wallpaper	The two production lines have a nominal capacity of 3 million rolls per year on a seven-day week format. The production of wallpaper increased by 18.2% from an average of 10.4 million m ² in 1993 to 12.3 million m ² in 1994.
Artificial leather	The division produces materials for both further processing (artificial leather for bags, belts, cases, writing pads, clothing and shoes, auto-upholstery, etc.) and direct use by households (tablecloths). Production shrank by 13.7% in 1994 from 10.1 million m ² to 8.75 million m ² . Raw materials for production of artificial leather are partly provided by Grabotext.
Fleece	This product represents the primary external output of Grabotext and is mainly sold to West European companies.
Other	Products of lesser significance – bookbinding materials used for lexicons, national passports, etc., and roofing insulation.

Graboplast Exhibit 3. Breakdown of sales.

Division/product line	1993		1994	
	(in mill.Ft)	% of total	(in mill.Ft)	% of total
<i>Artificial leather division</i>				
Fancy leather	651	15	595	11
Products for clothing industry	237	5	226	4
Shoes	226	5	244	5
Auto upholstery	454	10	391	7
Tablecloths	144	3	247	5
<i>Home-improvement division</i>				
Floor covering	1,220	28	1,913	36
Wallpaper	448	10	619	12
Insulating materials	32	1	37	1
Bookbinding	110	3	159	3
Fleeces	850	19	854	16
Total	4,372	100	5,285	100

Source: *Creditanstalt Analyst Report*.**Graboplast Exhibit 4.** Net sales from basic activities in 1994.

<i>Breakdown by division</i> (in mill.Ft)	Domestic	Export	Total
Artificial leather	929.4	772.8	1,702.2
Home improvement	1,150.2	1,249.2	2,399.4
Book binding	119.1	39.7	158.8
Total	2,198.7	2,061.7	4,260.4
<i>Breakdown of net sales (%)</i>	1992	1993	1994
Domestic sales	58	52	
Eastern Europe	9	16	26
Traditional Western sales	29	26	22
Total	100	100	100

Source: Graboplast *Annual Report*, 1994.**Graboplast Exhibit 5.** Management profile.*Péter Jancsó*, President, 44.

Education: Technical University of Budapest, Textile Mechanical Engineering, 1975; Industrial Economics, 1983.

1975: Employed by Rábatext Textile Company, Győr.

1979: Plant director at Graboplast Cotton Weaving and Artificial Leather Factory of Győr.

1988: Chief Executive Officer.

1990: President-Chief Executive Officer of Graboplast Rt.

1991: Chairman of the Board of Trustees of the "Nándor Jankovich" Fund.

- 1992: Chairman of the Supervisory Board of the “Josef Varga” Foundation, Chairman of the Board of Directors of Masterfil Cotton Weaving Co. Ltd., member of the Board of Directors of Gracia Co. Ltd. and North Transdanubian Chamber of Commerce and Industry.

Foreign language: German.

Miklós Patkós, Deputy President, 42.

Technical University of Budapest Faculty of Chemical Engineering, Organizer, 1976; Industrial Economics, 1985.

- 1976: Employed by Graboplast Cotton Weaving and Artificial Leather Factory of Győr.
 1980: Assistant Plant Manager.
 1984: Plant Manager.
 1988: Head of Administration Department.
 1990: Director of Grabocenter and member of the Board of Directors.

Foreign language: German.

Tibor Bori, Financial Director, 37.

University of Economics Wroclav, Faculty of Chemical Industry Organization and Economics, 1983; University of Economics in Budapest, Faculty of Complex Company Planning and Analysis, 1989.

- 1983: Employed by Pét Nitrogen works, Head of Department, 1984.
 1987: Chief Accountant of Graboplast Cotton Weaving and Artificial Leather Factory of Győr.
 1990: Member of the Board of Directors of Graboplast.

Foreign language: English, Polish.

Sándor Nagy, Sales Director, 41.

University of Pecs, Faculty of Economics, Market Organization Economist, 1975; University of Economics in Budapest, Market Organization Economist, 1981.

- 1975: Employed by Graboplast Cotton Weaving and Artificial Leather Factory of Győr.
 1982: Head of Sales Department.
 1988: Sales Director.
 1990: Member of the Board of Directors of Graboplast.

Foreign language: English.

Imre Fekete, Production Director, 49.

Bánki Donát Technical College of Mechanical Engineering, Machine Production Technology Production Engineer, 1974.

- 1964: Employed by Graboplast Cotton Weaving and Artificial Leather Factory of Győr.
 1971: Plant Manager.
 1975: Head of Inspection Department.
 1982: Head of Production Unit.
 1991: Member of the Board of Directors of Graboplast.

Graboplast Exhibit 6. Major competitors.

<i>Artificial leather</i>		
Fancy leather goods, tablecloths	Stab. Brandizzo	Italy
	Freundenberg, Hornschuh	Germany
Clothing	Vinylplex P.P.H. TEXSPUR	
	Zaklad Skor Synt. ERG ZTS.	Poland
	Zaklad Tworzyn Sztucznych	
	Akzo	Netherlands
Shoes	Plocquet	Germany
	Porvair	Great Britain
	Goretex	USA
	B Crespi, Synt. 3SPA, Duplotex	Italy
Upholstery, auto industry	SRI	
	Benecke	Germany
	SANWIL Zaklady Wyrobow	Poland
	Powlekanych, DAMATEX	
	Benecke-Kalido, Hornschuh,	Germany
	ERA	
	Wardle Storeys	Great Britain
	Wulcaflex	Italy
<i>Home-improvement materials</i>		
Floor coverings	Kazimierz Parol z.P.U.,	Poland
	Vinylplex P.P.H	
	Pannon-Lucky	Hungary
	Fatra, Technoplast, Chernické	Czech Republic and Slovakia
	Zabody, Nováaky	Czech Republic and Slovakia
	ERG Olawa, Lentex, Gamrat	Poland
	Takett Pefulan, Deutsche	Germany
	Linoleum Werke	
	Forbo	Switzerland
	Sommer Allibert, Gerland	France
Wallpaper	BNI	The Netherlands
	Keszta-Dunawall	Hungary
	Brecke Papirovy, Gnasyyn	Czech Republic and Slovakia
	Papierny, Prazke Papiernz	Czech Republic and Slovakia
	Tarcianske Papierny	
	ERG Olawa	Poland
	AS Creation, Marburg	Germany
	Forbo	Switzerland
	Decofrance	France
	Sanders, BNI	Netherlands

Source: Graboplast *Prospectus*, 1994.

Graboplast Exhibit 7. Market share (in percent).

	Domestic	Eastern Europe	Western Europe
Artificial leather	70–75	8–10	2–3
Floor coverings	60–65	5–6	2–3
Wallpaper	40–45	3–4	3–4
Bookbinding	30–35	0–1	0

Graboplast Exhibit 8. Main financial indicators in 1994.

	1993	1994
Equity/debt	3.85	3.57
Interest cover	5.0	10.0
Liquidity ratio (%)	204.8	218.9
Quick ratio (%)	139.8	136.3
Inventory turnover	7.8	7.2
Average collection period (days)	81	64
Return on assets (%)	4.2	9.6
Return on equity (%)	5.9	12.8

Source: Graboplast *Annual Report*, 1994.

Graboplast Exhibit 9. Profit and loss statements (in million Hungarian forints).

	1991	1992	1993	1994
Net sales	4,564	4,235	4,372	5,285
<i>Operating expenses</i>				
Goods sold	3,417	3,164	3,006	3,675
Sales and administration	816	949	1,075	1,131
Operating profit	331	122	291	479
<i>Other income and expenses</i>				
Interest income	79	77	10	
Interest expense	(283)	(213)	(74)	(50)
VAT penalties and related costs		(39)		
Restructuring costs	(25)	(45)		
Other	45	77	(13)	(31)
Income before unusual item	147	(21)	214	398
Discharge (repayment) of bill of exchange		34	(32)	
Gross profit	147	13	182	398
Tax				3
Net profit	147	13	182	395
<i>Assets</i>				
Cash at bank	102	151	75	133
Trade debtors	1,126	887	800	949
Prepayments and other assets	161	52	177	187
Inventory	795	700	682	981
Deferred income tax benefit				7
Total current assets	2,184	1,790	1,734	2,257
Fixed assets and other tangible fixed assets	1,321	1,267	1,740	1,892
Intangible assets	11	94	74	51
Investments	18	15	20	30
Total fixed assets and other	1,350	1,376	1,834	1,973
Total assets	3,534	3,166	3,568	4,230
<i>Liabilities and owners' equity</i>				
Current liabilities				
Trade creditors and accrued expenses	776	623	460	845
Short-term loans and other	496	445	413	302
Total current liabilities	1,272	1,068	873	1,147
Long-term loans	16	8		10
Owners' equity				
Share capital	2,000	1,997	2,328	2,324
Share premium	111	111	111	111
Retained earning	135	82	256	638
Total owners' equity	2,246	2,190	2,695	3,073
	3,518	3,258	3,568	4,220

Source: Graboplast *Annual Report* and *Prospectus*, 1994.

High-Tech Consulting, Ltd., Hungary

To be known and to know whom to know!
High-Tech Business Plan

In the summer of 1995, Miklos Illovszky was the managing partner of High-Tech Consulting, Ltd., a consulting firm based in Budapest. The firm had been formed in 1993, when three former executives of Müszertechnika formed a partnership to advise foreign companies seeking entrance into the Hungarian market. (Műszertechnika is a computer supplier. Established in 1981 it was the first, post-1950, private company in Hungary.) The advice was originally on how to set up successful affiliates and subsidiaries, but by mid-1994 High-Tech was supplying information on dealing with financial, managerial, and marketing crisis management. The early 1990s gold-rush mentality of foreigners in Hungary had changed; they were no longer satisfied with merely a presence in Hungary. The work of advising the established foreign companies on adapting to the Hungarian ways of doing business was the next booming market for locally based consultants.

Illovszky provided some information on the challenges that the changing business climate held for High-Tech, as well as some insights on the characteristics of Hungarian companies that have successfully integrated into the world economy. In his former position at Müszertechnika, Illovszky became knowledgeable about the efforts of Hungarian high-technology companies that were entering the world marketplace.

High-Tech originally had five main business goals: advise owners and operators of domestic firms on how to “Westernize” their organizations; assist potential foreign and domestic investors in their attempts to begin new ventures in Hungary; prepare long- and short-term strategic plans; perform system integration and technological system development; provide special services such as market studies and surveys. The partners tried to focus their efforts on the high-technology industry, particularly telecommunications, computers, and electronics. They saw this field as the most competitive and fastest changing industry and felt that their experience in the Hungarian high-technology arena would provide them with the best functional match. The pharmaceutical, insurance, and utilities industries were also seen as areas with strong business potential for High-Tech.

High-Tech regarded three factors as keys to success: competence, credibility, and active involvement.

Competence was defined as the ability to perform “locally,” meaning with a full understanding of the domestic culture and business practices, as well as the ability to perform “globally,” meaning use of internationally proven and accepted standards. With this knowledge, High-Tech would be

able to perform the cultural integration that was perceived as key to their activities.

Credibility and active involvement were seen as complementary success factors. Both were considered necessary to deliver the competence described above to the client and the market. High-Tech felt that the prime factor in building credibility was a willingness to focus on implementation rather than theory. This tied into High-Tech's belief that there was far too much emphasis placed upon theoretical "strategy" work; companies in the Hungarian market were demanding basic solutions to their operating problems. High-Tech wanted to take advantage of this market gap.

High-Tech evaluated competition in the Hungarian consulting industry on two main issues: "locality" and pricing. There were four categories of competitors that they evaluated on these criteria: multinationals with local subsidiaries; multinationals covering Hungary from a West European office; small foreign companies; and domestic companies.

High-Tech saw multinationals with local subsidiaries as being primarily affiliated with the consulting arms of the Big Six accounting firms. Having established a strong base from their accounting and auditing practices, these companies were the best-positioned international firms to transfer their efforts to management consulting. The Big Six firms addressed the "locality" issue by hiring Hungarian expatriates, although this strategy was initially limited by the relatively small pool of qualified individuals. The pricing level for this type of competitor's services was considered fairly high, and the segment of the market that they focused on was primarily made up of clients that were developed through the audit practice.

Multinationals operating in Hungary from their West European office were represented by the traditional Western management consulting firms (McKinsey, BCG, and Roland Berger). They primarily positioned themselves using consultants from convenient West European offices (primarily Germany). The projects that these companies worked on were primarily government activities or major joint ventures. For these projects, "locality" was not a necessity, and the payment ability of the clients was high enough that pricing was not an issue.

Small foreign companies were primarily based in neighboring West European countries (Austria was a prominent source). They generally had better "locality" than the main strategy consulting firms due to their willingness to hire Hungarians on a free-lance basis. They also had low pricing procedures because of their practice of using a tiered salary structure: salaries for West European employees were higher than salaries for Hungarian free-lance consultants. These firms typically concentrated on the "top 100" domestic companies in Hungary. High-Tech saw these competitors as having an optimum trade-off between lower prices and proven references.

Fully domestic companies were typically “one-man-show” operations – basing their competitive advantage upon individual talent and personal contacts. They were generally strong in the “locality” dimension, and were fairly price attractive. However, due to their limited track records, they were generally forced to concentrate on second-tier firms.

High-Tech saw itself positioned in the fully domestic category, but with several key differences. Due to the high level of credibility of each of the three founding partners, High-Tech was accepted early on by foreign companies and joint ventures. In fact, the initial operating results of High-Tech showed that its revenues were from foreign companies in the form of hard currency.

In addition, High-Tech had a strategy for entering the more profitable market areas that were dominated by the foreign firms. High-Tech established an early strategic goal of finding a well-known foreign strategic partner. With this partnership, High-Tech hoped to acquire the credibility necessary to compete for the largest and most lucrative engagements. High-Tech felt that it had a proven track record of profitability, along with local references and full “locality,” and none of the risks related to the fixed costs of setting up a local subsidiary.

Local companies were anxious to meet potential international business partners; Illovszky and High-Tech were often able to provide these introductions. For example, the relationship between a Viennese bank and trading company (VT Corp.) and the Hungarian market leader (more than 50% of the market) for point-of-sales terminals and cash registers (S Corp.) began through a personal relationship between a senior VT Corp. executive and the owner/managing director of S Corp. Even though S Corp.’s owner was a “one-man-show-type leader” and spoke only Hungarian, the early years of this relationship were characterized as successful. VT Corp. managed all of the foreign activities of S Corp., and also provided financing. S Corp. had access to all of these services through telephone or telefax contacts, and the language used for all business directives was Hungarian, a fairly substantial advantage for S Corp. The primary negative factor in this relationship from S Corp.’s perspective was that it had to pay significant charges and interest in return for this “easy business.”

The relationship was extremely profitable in 1992 and 1993. However, in 1994 VT Corp. began to notice a lack of consistency on the part of S Corp. for repayment of financing. Personal contacts between executives of both companies were ineffective due to a deterioration in the level of trust between the key individuals. At this point VT Corp. contacted High-Tech and asked it to contact S Corp. and offer the company its services. By the summer of 1994, S Corp. and High-Tech had a contract.

High-Tech found some serious problems in S Corp.’s situation. The primary problem was that there were no management control systems in place

to monitor either the day-to-day or long-term decisions of company employees. Since the owner/managing director had no technical background, many of his executive decisions were made on the basis of “feelings.” Furthermore, although the R&D division, customer support teams, and service groups were all seen as company strengths, they were not being effectively managed because of the owner/managing director’s lack of technical knowledge. This lack of management control systems was best evidenced by the fact that S Corp. did not create financial statements or projections of any kind.

High-Tech proceeded to identify all of the tasks that S Corp. had to accomplish over the following year: financial statements of the previous two years; creation of a mission statement; division of S Corp. into strategic business units (SBUs) with real decision-making power at the SBU level; down-sizing; short- and long-term R&D planning; liquidation of obsolete inventory; improvements in marketing; tapping alternative financing sources; renegotiation of existing liabilities between S Corp. and VT Corp., and a search for new foreign vendors and partners. High-Tech also focused its efforts on finding reasons for recent operating losses.

High-Tech was able to accomplish this list of tasks in a five-month time frame, and satisfactorily resolved the conflict between S Corp. and VT Corp. However, Illovszky saw the key point of this engagement as one of cultural facilitation, as opposed to pure technical engineering. Illovszky believed the core problem was a lack of international business knowledge on the part of S Corp., and a lack of knowledge of local circumstances on the part of VT Corp. With its knowledge in both areas (as well as its skills in technical business), High-Tech successfully resolved the conflict.

Illovszky was acquainted with three companies in the high-technology field that had gone abroad and achieved some measure of success. These companies were Graphisoft, a designer of CAD software used in building design and room layout; Recognita, a leader in the optical character recognition industry; and Procomp, a producer of computer hardware, specifically SCSI controller boards. Procomp had been part of Müszertechnika, and until 1993 Illovszky had been a Vice-President of Müszertechnika.

According to Illovszky, Procomp’s integration into the international marketplace was due to an unusual set of circumstances that will probably not be repeated in the near future. The basis for this unique opportunity was the 1981 introduction of private companies into the still centrally planned Hungarian economy. Müszertechnika was the first company to take advantage of this opportunity; it entered the computer business. Because of a huge demand for and limited supply of computers, Müszertechnika was able to sell computers at an enormous profit. In fact, Müszertechnika sold its computers with a lead time of three years.

Starting in 1981, and until 1988, Müszertechnika was able to stockpile a sizable war chest. Müszertechnika was able to invest this capital in several different R&D projects over the 1981–1988 period. By 1987, about 15 different products had been developed.

In 1987, Müszertechnika introduced these products at the Novell-sponsored NetWorld industry trade shows in Boston and Dallas. Only one of the products was up to international standards. That product was the SCSI controller that became the base product for Procomp.

Műszertechnika made an initial investment of approximately \$400,000 and introduced Procomp operations in the United States; these operations employed US citizens and appointed a second-generation American of Hungarian descent (previously employed by Ernst and Young) as Chief Executive.

Initially this turned out to be a very successful move, with Procomp (USA) Americanizing the product through packaging and advertising and ironing out the “wrinkles.” Procomp also benefited from a great deal of luck, because companies like Novell were just starting out and were developing both hardware and software. Novell decided to concentrate on software and to leave Procomp with the hardware SCSI niche.

This successful relationship between the American Manager and Müszertechnika management in Hungary had rapidly deteriorated by 1991, basically because of the huge differences in culture. The American Manager was seen as an individualist and a power grabber, and it was soon apparent that he would have to leave. His successor was not nearly as successful. The new Chief Executive had no industry knowledge and lacked international experience. The second Chief Executive was fired in 1993.

Meanwhile, there were problems for Müszertechnika in Hungary as well. The environment had changed dramatically. Between 1989 and 1990, the domestic computer market had opened up, and the pre-1989 computer prices, which had been artificially inflated by import controls, had declined to international levels and the company’s profits were squeezed. With the reduction in cash flow, the investment capability of Müszertechnika deteriorated. Eventually the R&D staff was slashed from 22 world-class engineers to 1. Procomp (USA), in the meantime, went from slow growth to no growth because of a lack of investment and the above-mentioned managerial problems. By 1994, Procomp (USA) had no market value.

Illovszky saw the greatest difference between the eventual failure of Procomp and the modest international success of a company like Recognita and Graphisoft (see below) as being primarily due to the fact that the successful companies allowed foreign capital investments.

Recognita, an optical character recognition company, sold a minority interest to an American management team. This was enough to keep the

local management interested, and as of 1995 Recognita was maintaining a presence in the United States.

Graphisoft, a CAD for building- and room-design use, initially followed the same path as Procomp. The directors of the company were leery of foreign investment, and avoided it as long as possible. When CAD users started shifting to Windows from Macintosh operating systems, Graphisoft was forced to develop new CAD software based upon the Windows operating system. To finance this shift, it had to sell part of the company (a distribution network) to a Munich-based German firm. Graphisoft had to give up some control to the German investors. By the summer of 1995, Graphisoft had a niche in CAD in Europe; in fact, the bulk of the software production was for markets outside Hungary. In March 1996, the Japanese computer toy company, Sega, invested \$7.5 million to purchase a minority share. Sega announced that it planned to use Graphisoft as a platform for further software activities in Hungary (*HVG*, 1996). In 1995 Graphisoft had a net profit of \$4.5 million on revenues of \$15 million and employed 40 programmers in Hungary and another 60 in the United States, Germany, Italy, and Japan (*Central European Business Review*, 1996).

Illovszky has found the structure of foreign companies in Hungary has gradually been changing. In the early 1990s, foreign companies at the top had been staffed entirely by expatriates. By 1995 there was an expatriate Managing Director, along with one or two Vice-Presidents who were Hungarians; it was expected that one of these Vice-Presidents would become the Managing Director. Foreign companies in Hungary are increasingly becoming local in nature, especially as the local talent pool raises its business standards to international levels. Another reason for this localization is that expatriate salaries are considerably higher than local salaries. In 1994, expatriates could expect to make between Ft2,000,000 and Ft10,000,000 annually; these salaries, at the time, were several times higher than local salary levels.

Hungarian Telecommunications Company

Janos Toth, 32, arrived in Hungary in the summer of 1995. He was to become a consultant to the Director of Strategy at the Hungarian Telecommunications Company (MATÁV). His boss at Deutsche Telecom recommended him for this position. Toth was of Hungarian ancestry and had finished his MBA in the United States. He was the perfect candidate for a job that would involve interaction with the German, American, and Hungarian owners of the company and the staff.

The position of the Director of Strategy was created in 1992, but was vacant for a long time because of political infighting within the company and between the company and the Hungarian state owner. This infighting resulted in the dismissal of the CEO in 1995. The new CEO, Elek Straub, the former General Manager of IBM's operations in Hungary, took office in July 1995. Straub realized the importance of creating a long-term strategy for the firm and revitalized the Strategy Department. The company's goal was to become the best communications provider in Central and Eastern Europe. Toth, and the department he was going to help, was to come up with the plan on how to achieve this goal.

MATÁV was established on 1 January 1990 when it was separated from the Hungarian PTT. Even after the separation the company was Hungary's third largest company employing 18,000 people. The company's sales revenues in 1994 were Ft91 billion (at the end of 1994 \$1 equaled Ft100). The company was the main telecommunications service provider and owned most of the telecommunications infrastructure. The company had five regional directorates (the actual service-providing units) and 14 general directorates for different centralized services. Until the end of 1991 the company was owned by the state.

The privatization of MATÁV was the first of the telecommunications privatization procedures carried out in Central and Eastern Europe. In 1991 the company was transformed into a shareholding company, with the State Asset Handling Company (AVRT) holding all the shares. Over the next two years the company prepared for privatization. In 1993 a tender was issued to search for a strategic investor for 30% of MATÁV's shares. (AVRT planned to keep 67% of the shares, and 3% were given to the European Bank for Reconstruction and Development and the International Financial Corporation.) AVRT and the management of MATÁV thought a big international operator would not only provide the necessary funds for future investments, but also have a long-term perspective regarding investments in the company and bring in technology, management, and strategy expertise to turn MATÁV into a first-class communications service provider. The winner of the contract received concession rights for long-distance and international

service throughout Hungary and for local telephone service for designated areas. After privatization the company enjoyed a five-year tax holiday, and 60% tax holiday during the second five years of operation.

The tender was won by MagyarCom, a 50–50 consortium of Ameritech International and Deutsche Telecom. Besides paying for the equity interest in the company, MagyarCom agreed to guarantee a 15.5% per year access line growth, to eliminate the waiting list for telephones by 1997, and to create an international hub switch. Management believed that the American-German consortium would be the optimal investor. The American side would represent the market focal point, and its experience in operating in a competitive market would help MATÁV to adapt to new market conditions. The German expertise would help the company to comply with European standards and become part of the European telecommunications system.

MATÁV was in many ways a typical East European state-owned, technology-oriented company. The state ownership and monopoly position on the Hungarian market resulted in a company culture where business was driven not by market forces, but rather by technology and politics. Although the company was investing heavily in high-quality technology, there was a complete lack of customer focus. Efficiency of investments and operations were low, and there was a general lack of understanding and use of ratios such as return on assets, return on investment, or return on operations to measure performance. The company did not concentrate on its core business. The company had more than 60 subsidiaries, most of which performed services for MATÁV at a high cost.

The staff was very well prepared technically, but there was no sense of financial management. The company was overstaffed, and the employees considered their positions safe until retirement. Company objectives and the concept of motivation was missing. Responsibilities were rarely defined, and if they were defined, they were not enforced. There was no appraisal system. There was a lack of communication between management and employees, and even between levels of management. Information was regarded as a power tool, and people were trying to retain for themselves every item of news that they thought might make them indispensable.

The company was heavily in debt. Most of the investments of the previous years were made from loans from international organizations: the World Bank, the International Finance Corporation, and the EBRD. The company's capital structure seemed to make MATÁV vulnerable to any major changes in the value of the local currency, the forint vis-à-vis the dollar or the Deutsche mark.

During 1994 MagyarCom assessed the state of the company and decided which areas should be restructured. The investors identified the following critical factors for the successful transformation of MATÁV:

- Development of an effective marketing unit.
- Development of an integrated planning system.
- Development of a management control system and an investment appraisal process.
- Installation of a management information system that improves management effectiveness of revenue production, expense control, and utilization of capital.
- Creation of a company culture directed toward customer satisfaction.

The foreign investors, jointly with management, set out to transform the company. During the fall of 1994, Ameritech and Deutsche Telecom brought in experts from their own companies to help in the transformation. Consultants were assigned to the most important areas to assist the Hungarian managers and staff in adopting new concepts and techniques. Some consultants were based at the regional directorates to help the staff adjust to the new requirements of headquarters. The company's training center had its own consultant so that it could prepare for the emerging training needs of restructuring. The consultants had to work closely with Hungarian managers, and were instructed to guide and educate them, and to develop solutions together with the Hungarian staff.

The restructuring of the company was started on several fronts. One was the financial area. As MATÁV became part of two big foreign companies, it had to transform many of its accounting and reporting practices to comply with international standards. A controlling and planning department was set up. A major task of the planning unit was to establish a new, integrated planning process. A difficult problem for the company was dealing with high costs relative to revenues. The new planning process was to become a tool that managers could use to better estimate and control their costs and revenues, comparing budget and actual data and examining the variances. Management could also use the planning system as a tool for a new incentive compensation system.

Other changes involved marketing. The company had no separate marketing department. Marketing functions were distributed between several offices, which assisted other company groups in providing statistical data regarding demand trends and providing customer service. A marketing department was needed to centralize these functions and to handle other marketing tasks (such as pricing, market research, generation of new projects, business cases for these projects, and revenue forecasting). A sales force had to be created, and marketing processes had to be established. Management hoped that the new marketing unit would help to introduce more services which would make the customer the focal point of the company.

On the technical side, changes were aimed mostly at the introduction of new concepts. The technical side did not pay much attention to how effectively resources were being used. Although the engineers had great expertise in network planning, they concentrated solely on getting state-of-the-art technology built into the network. For instance, during network development, relatively new and properly operating network parts were scrapped and redeveloped unnecessarily just because they included copper cables instead of fiber-optic cables. Spending on development projects was considerably higher than necessary. The consultants worked together with the Hungarian project- and contract-approving officers to enforce a more economical approach to network development.

A separate division was created for logistics. Before privatization each directorate had separate support units that were responsible for information technology services, warehousing, transportation, etc. The activities of these separate units were not co-ordinated, resulting in major problems especially in the warehouse. The company kept a high level of stocks; generally there was a 12-month supply of almost all parts and materials. The company was the largest buyer of telecommunications equipment in Hungary, and many vendors took advantage of the underdeveloped negotiating skills of MATÁV representatives. This was also the case for subcontractors, some of which became sole contractors with the company, reaping high profits by charging above market fees for their services. With worsening macroeconomic conditions, it was urgent to introduce methods that would make operations more economical. Business support areas, such as warehousing, billing, and real-estate management, were reorganized and centralized to reach economies of scale. Most of the main purchasing and leasing contracts were signed centrally so that more favorable terms could be reached.

The company also needed to revise and analyze the performance of subsidiaries. The number of subsidiaries was cut in half based on company synergies. Management decided that only subsidiaries that create value should remain with the company. The others should be either sold or consolidated into the corporation.

By mid-1995 some of the reorganization efforts started to show results. The best and most visible results came from the introduction of the central Operational Support System (OSS) which handled billing for the entire country. Changes in the financial field also started to show some results, especially regarding accounting and reporting procedures. In the capital expenditures (CAPEX) field, the centralized department seemed to have established control over planning, purchases, and contracting. The CAPEX people were already working on the second phase: to enforce the new methods and to establish a system of follow-ups. Special task forces worked on

the logistics of the structural changes. The first structural change was introduced in 1995 when the new marketing and logistics offices were set up.

Some officials within and outside the company were not satisfied with the pace of the transformation. The slow pace was due to several reasons. First, the company was under financial pressure. Owing to concessionary obligations considerable attention had to be devoted to basic infrastructure development. This kept the company from meeting customer needs in other areas and from instituting changes in operations. Besides, commitments in a number of old, long-term contracts had tied the managers' hands when they had to make business decisions.

The foreign investors faced several surprises between 1993 and 1995. A big shock was the behavior of the Hungarian government toward the company. The government still controlled more than 60% of the shares, and wanted to be actively involved in company matters. But the three government agencies (Ministry of Industry, Ministry of Telecommunications, and State Asset Handling Company) that oversaw the company's operations had different interests and conflicting views regarding the management of the company. These conflicts frequently delayed many decisions. The government agencies also had strong views and influence on personnel issues. For example, after the election of 1994, the government forced the company to look for a new General Manager as the existing one had ties to the former government. It took almost a year to find a candidate who satisfied the expectations of all the parties. During that year the company basically came to a standstill as both managers and employees waited for a new General Manager to set the direction for the company. Decisions were postponed, and all projects, including the ones on restructuring, slowed down.

Cultural differences were major obstacles to changes. It took a long time for the investors to understand the power structure within the company, which often differed from the hierarchical structure. There were large gaps between what was legally correct and what could be practically implemented, especially regarding personnel issues. The cultural differences also resulted in tensions within management, as the three sides (American, German, and Hungarian) did not always agree on issues. Management could not determine a unified strategy for the company. The German managers preferred making MATÁV a traditional telephone company, whereas the American managers insisted on diversifying the company into businesses that would bring in high revenues. Very often management could not take a unified stand on operations-related issues, making employees believe that only the foreign managers and advisers were pushing for changes. This resulted in hostilities and resistance to Western methods. As for the new methods, the Hungarians were disappointed because they felt that the foreign advisers were pushing

for the methods they were using in the United States or in Germany without considering adapting these methods to the Hungarian circumstances.

The Operating Committee (OC) was regarded as another major obstacle to quick changes. The OC was created after privatization at the request of the foreign investors. The OC consisted of one representative of both foreign investors and two representatives of the Hungarian owner. The idea was that through the OC the foreign owners would be able to exercise their power despite minority shares in the company. All major decisions were to be approved by the OC before implementation. Without a fully operating information system and without delegation of responsibilities the OC was forced to deal with everyday operational issues, and lost track of the main issues to be resolved. The company was operating the OC instead of the OC operating the company.

The macroeconomic environment did not help the transformation either. In March 1995 the government introduced a new austerity program to get the Hungarian budget deficit under control. The Hungarian currency was devalued by 20% in March. To make it easier to plan for further devaluations, the government introduced the crawling peg method for exchange rates of the forint, projecting an approximate 1% devaluation each month. The government also imposed an 8% import duty and increased the value-added tax. Due to these measures inflation increased; the inflation rate for 1995 increased to 28 from 20% in 1994. Interest rates increased from 25 to 33%.

These macroeconomic changes imposed a strain on the company. As most of the network developments of the past two years were financed with foreign debt, the March devaluation resulted in a huge loss in financial activities; this loss had to be made up by stricter cash control during the rest of the year. The company tried to reduce operating costs and accelerate the network expansion program to increase revenues as much as possible. Unfortunately the worsening of the macroeconomic situation put a cap on the amount of revenues the company could realize. Telephone usage is a price-sensitive service; the tariff increase to compensate the effects of the increased inflation rate somewhat reduced usage. The company managed to push through a Ministry of Transport decree on higher telephone installation fees, hoping that the accelerated network extension program would bring in enough revenues from the new connections to compensate for the losses the company suffered from lower usage and devaluation. Management held that with more discipline the company could remain in the black despite the devaluation's impact on the income statement.

Toth arrived a week before the meeting of the Operating Committee on the corporate budget for 1996. Management decided to execute top down planning for the upcoming year. The company needed to show a profit of about Ft7 billion under the International Accounting Standards in order to

meet debt obligations. Management expected to barely break-even in 1995, so it was important to determine on the company's strategies to achieve the profit target by the end of 1996.

The question to be answered was: Should the company continue to serve its core business based only on the concession agreement or should it try to diversify into fields that could prove to be profitable in a few years? The answer to this question was vital. The monopoly position of MATÁV will expire in 2002, and a number of companies are currently getting ready to break into the lucrative long-distance and international service markets. Among the possible competitors are Antenna Hungaria, the former Hungarian Broadcasting Company, and utility companies. These competitors are already active in nonconcessionary areas (leased lines, data transfer, VSAT communications) and are investing in upgrading and extending their networks.

Hungarian Telecommunications Company Exhibit 1. Balance sheets (in million Hungarian forints).

	1994	1993	1992
<i>Assets</i>			
Liquid assets ^a	23,128	49,992	3,255
Receivables	27,095	16,089	9,709
Inventories	3,291	4,259	5,059
Securities	11	1,327	171
Intangible assets	4,361	2,351	1,805
PP&E	227,475	185,014	153,881
Financial investments ^b	13,042	10,844	9,138
Accrued and deferred assets	5,532	1,069	801
Total assets	303,935	270,945	183,819
<i>Liabilities and owners equity</i>			
Short-term loans	8,770	2,066	2,157
Accounts payable	14,795	9,340	8,380
Other current liabilities ^c	30,890	37,395	12,371
Long-term liabilities	52,296	35,987	34,093
Provisions ^d	634	347	58
Deferred and accrued liabilities	12,072	4,590	4,100
Shareholders' equity	184,478	181,220	122,660
Total liabilities	303,935	270,945	183,819

^aLiquid assets include cash and cash equivalents and bank deposits.

^bFinancial investments include shares, securities, loans granted, and long-term bank deposits.

^cOther current liabilities include prepayments from customers, bill of exchange debts, short-term credits, and other current liabilities.

^dProvisions are set up for expected losses and expected liabilities.

Hungarian Telecommunications Company Exhibit 2. Income statements (in million Hungarian forints).

	1994	1993	1992
Sales revenues	89,935	67,559	53,008
Other income	2,170	901	990
Capitalized own performance	2,426	2,810	3,609
Total operating revenues	94,531	71,270	57,607
Expenses of material nature	13,310	10,624	8,453
Personnel costs	18,732	15,274	12,788
Depreciation	18,299	12,958	12,925
Fees and charges	31,756	19,462	13,970
Other expenses	8,207	4,345	2,289
Total operating expenses	90,304	62,663	50,425
Operating profit	4,227	8,607	7,182
Balance of financial transactions ^a	-4,016	-8,171	-5,658
Extraordinary profit ^b	-38	1,168	-290
Taxes	0	4	0
Net profit	173	1,600	1,234

^aBalance of income from financial transactions (interest receivables and interest income, dividends and income from investments, and other income from financial transactions) and expenses on financial transactions (interest payables and interest expense, depreciation on investments, and other expenses of financial transactions).

^bBalance of extraordinary income and expenditure.

Hungarian Telecommunications Company Exhibit 3. Chronology of events.

1990. The Hungarian PTT is divided into three individual companies: Hungarian Telecommunications Company, the Hungarian Postal Service, and the Hungarian Broadcasting Company. MATÁV remains the monopoly telecommunications service provider and the owner of the telecommunications network in Hungary.

November 1992. After two years of delay and debates the Law on Telecommunications is passed by parliament. The new law specifies that all public switched telecommunications activities are to be performed exclusively by concession companies. The law allows the development of local telephone companies (local concessions), but MATÁV retains the monopoly right to provide long-distance and international public-switched services (national concession). The law also creates areas of limited and full competition. In areas of limited competition, the number of players is determined (mobile communications, paging). In areas of full competition, services may be performed by any party, including concession companies (e.g., data transmission, leased lines, dedicated networks). The law creates competition for MATÁV in all fields except national concession services.

April 1993. The tender for the sale of 30% of MATÁV's shares is opened to strategic investors. The consortium of Ameritech and Deutsche Bundespost Telekom wins in the bidding process. The consortium pays \$875 million for the shares and for the national concession rights of MATÁV. As a result of the sale, the ownership of MATÁV changes to the following: State Assets Holding Company, 66.74%; MagyarCom Consortium, 30.29%; EBRD, 1.98%; and International Finance Corporation, 0.99%.

October 1993. A tender is called for regional concession rights in 25 rural districts. Companies that win regional concessions are granted the right to upgrade and operate local public telephone networks that were previously operated by MATÁV. MATÁV competes for some of these districts. In the process 7 companies gain rights to provide local telecom services in 15 primary areas of Hungary. MATÁV wins 8 local concessions. The company remains the local operator in 39 primary areas out of the 54 primary areas of Hungary. The concession contract stipulates that local concession companies must grant a 15.5% capacity growth annually and that the telephone waiting list must be eliminated by 1997.

End of 1994. The government determines that MATÁV should be introduced to the stock exchange in Hungary and abroad. A date for the introduction has not been picked at the time this case was written.

Hungarian Telecommunications Company Exhibit 4. Miscellaneous data.

	1994	1993	1992	1991	1990
<i>Investment data (in million Hungarian forints)</i>					
Telecommunications	33,099	36,700	31,145		
Plant development	1,716	1,674	1,867		
Training	203	138	358		
Reconstruction under Ft20,000	399	2,941	2,410		
Total	35,417	41,453	35,780		
<i>Penetration indicators</i>					
Main lines (in thousands)	1,732	1,498	1,291	1,128	996
Extension lines (in thousands)	n/a	619	757	826	876
Connected main lines ^a	17.40	14.57	12.52	10.92	9.62
Connected telephones ^a	23.10	20.59	19.86	18.92	18.08
Public telephone station ^a					
Budapest	n/a	0.47	0.53	0.53	0.49
Countryside	n/a	0.25	0.21	0.20	0.19
<i>Waiting list for telephones</i>	1994	1993	1992	1991	1990
Residential					
Budapest	190,372	224,621	221,815	208,947	226,147
Countryside	429,833	478,751	455,853	398,945	345,190
Business					
Budapest	59,645	54,663	64,166	42,359	26,340
Countryside	12,500	13,178	9,974	6,713	8,145
Public					
Budapest	450	489	705	449	413
Countryside	190	271	566	383	335
Total	692,990	771,973	753,079	657,796	606,570
<i>Quality indicators (%)</i>					
Telephone seizure efficiency rate	51.00	47.82	45.40	44.92	
Customer service operators					
answering rate	76.00	74.19	78.21	68.50	
Rate of faulty main lines per month	4.24	5.00	5.25	6.30	
Availability of public payphones	94.00	89.10	85.24	78.39	

^aPer 100 population.

Source: *Telecommunications Statistical Yearbook*, 1993; *Statistical Pocketbook*, 1994.

Hungarian Telecommunications Company Exhibit 5. Number of employees.

	1994	1993	1992	1991	1990
<i>Full-time employees</i>					
Blue collar	8,806	8,986	10,075	10,843	11,176
White collar	9,888	9,553	9,601	10,055	9,845
<i>Part-time employees</i>					
Blue collar	271	271	266	252	229
White collar	122	122	135	144	121
Total	19,087	18,932	20,077	21,294	21,371

Source: *Telecommunications Statistical Yearbook*, 1993; *Statistical Pocketbook*, 1994.

Hungarian Telecommunications Company Exhibit 6. Development (in million Hungarian forints).

	1995	1996	1997
<i>CAPEX program 1995–1997</i>			
National concession	43,785	51,218	29,176
Local concession	10,248	13,015	3,120
Nonbasic telephony service	1,197	1,669	1,674
Business service development	4,088	5,608	5,260
Transit network	6,466	5,796	6,049
Operation management development	4,600	5,500	5,000
Technical development	500	973	994
Corporate infrastructure	4,548	5,071	5,540
Other developments	950	1,300	1,300
Total	76,382	90,150	58,113
<i>Telephony development 1995–1997</i>			
National concession growth rate (%)	23	19	9
Total growth rate	25	20	10
New connected lines			
National concession	297,701	311,003	177,317
Local concession	84,227	76,147	40,612

Source: MATÁV's Business Plan, 1995.

International Management Center, Hungary

In a 1993 report the International Management Center (IMC) was described as “the lynchpin program and, in terms of orientation, curriculum, and pedagogy, probably the only ‘Western-type’ business school in Hungary” (Grayson, 1993). Founded in 1988, and heavily financed externally, IMC was affiliated with the University of Pittsburgh, Tulane University, Emory University, and Temple University, and offered MBA, executive MBA, and executive education courses. Between 1993 and 1996, IMC became even more integrated into the world economy *via* its students, faculty, graduates, the firms that used its executive programs, and so on. By 1996 Vanderbilt University, the University of South Carolina, and George Washington University in the USA, Manchester Business School in the UK and Nijenrade in the Netherlands had joined as cooperating institutions. Then in 1996, IMC and Case Western Reserve University in Cleveland, Ohio, implemented a joint MBA degree program – accredited by the American Association of Collegiate Schools of Business (AACSB).

The Dean and CEO of IMC, Peter Bartha, viewed graduate business education as a competitive industry; he is a Hungarian-born Canadian citizen (he has spent most of his adult life in Canada), a former oil company executive, and, upon taking early retirement, an academician. Management education started in Central East European countries after the collapse of the centrally planned regimes in 1989. IMC was the first institution in CEE countries to ally itself with a US MBA program, at the University of Pittsburgh. Pittsburgh provided curriculum, some faculty, and scholarships for IMC students to continue their studies in the United States. Funds came from Western sources including USAID, the UK’s Know-How Fund, and EU assistance programs.

IMC graduates were hired, first, by multinationals that were entering the CEE markets. In fact, demand exceeded MBA-type supply by a considerable margin. Seeing attractive business opportunities (and fear of being left behind) precipitated a score of new competitors to IMC. They included the established universities’ economics and industrial engineering departments, entrepreneurial national schools, and independent consultants. Regional competitors included the Czech Management Center, Warsaw University, and the International Executive Development Centre in Slovenia. INSEAD (France) began offering scholarships to students from CEE countries.

The new entrants may create an excess of MBA programs, but they must also face some serious constraints. The first constraint is that it is difficult to maintain a well-qualified CEE faculty. Everyone in the permanent IMC faculty has had experience working and teaching in the West. IMC faculty members are well paid by CEE standards, but they receive less than visiting

American faculty. Keeping faculty at IMC is a problem as compensation in the business sector is higher than what the Center is able to offer. The faculty includes professors from Russia, the United Kingdom, France, Canada, and the USA. Generally, there is a Fulbright scholar on the faculty every year.

Another constraint is the entrance examination. Applicants to IMC must pass the Graduate Management Admissions Test (GMAT) and the Test of English as a Foreign Language (TOEFL). Unfamiliarity with multiple-choice questions (GMAT), a sort of testing not used in CEE countries, and, of course, English-language barriers, severely limit the pool of qualified applicants. Those who successfully pass both tests form an elite group of students. The Soros Foundation annually awards 20 scholarships to students hailing from CEE countries. Additional scholarships are also available.

The ratio of applications to acceptance is 8:1. Particularly large numbers of applicants come from Romania, the Baltic states, and the CIS. More than 70% of the 1996–1997 class was non-Hungarian. In recent years, there has been steady growth in the number of students from the West. With the new joint international MBA program with Case Western Reserve, the number of American students is expected to continue to increase. The high entrance standards provide reasonable assurance that those who are ultimately accepted are also likely to succeed in the program. Indeed, admissions officers and deans of IMC's American partner universities report that transfer students from IMC invariably graduate in the top third of their class.

IMC is international not only in its name but also in the composition of its student body, faculty, and the companies that hire its graduates or have contracts with IMC for executive programs. As of early 1996, 40% of graduates were with international joint ventures and more than 20% had been hired by multinationals. According to a study by Hay Management Consultants (1995), IMC graduates with MBAs "typically triple or quadruple their salaries within two years" after joining a company.

In terms of IMC's financial situation, 1996 was a watershed year. IMC had no endowment and, hence, needed contributions and self-generated revenues to cover expenses. In 1996, three major contributors, who funded about 25% of the budget, did not renew their support: the Hungarian-American Enterprise Fund, the Rockefeller Brothers Fund, and the East-West Management Institute. To offset the loss of these contributors, IMC launched a fund-raising campaign and, more significantly, it began to offer additional executive programs. Clients for executive programs include, among others, General Electric, Coca-Cola, United Technologies, Hilton, Cyanamid, Ernst & Young, Ford, Johnson & Johnson, Daewoo, SKF, Novotel, Shell, Siemens, and Unilever.

IMC further strengthened its capacity to develop general management training programs by winning a \$1.8 million contract from PHARE to train

some 500 Hungarian middle manager. The project comprises five modules over three days of training, plus individual consultations for companies that employ participants. IMC faculty has participated in executive program activities in Prague, Moscow, and Bucharest.

IMC's budget had a slight surplus in 1995 and a surplus is also expected for 1996. As of 1996, IMC was able to cover about 75% of its expenses. IMC is faced with the challenge of offering more executive programs, taxing an already burdened teaching faculty.

International Management Center Exhibit 1. Financial statements between 1993 and 1995 and budget estimates for 1996. (For confidentiality, data are in percentages.)

	1993	1994	1995	1996
Ratio of earned revenues to expenditures	53	54	71	73
MBA programs	20	28	30	23
Executive programs	27	27	40	49
Contributions	47	44	30	28
Personnel expenditures	48	44	38	34

Műszertechnika, Hungary

I learned that growth can be dangerous if it is not managed properly.

Dániel Bárdossy

Vice-President, Investment, Strategic Planning

By 1995, after undergoing a painful restructuring, Műszertechnika had entered a growth phase. The company at this time was better positioned to adapt to the changing conditions than in 1992, when it suffered from trying to grow too big, too fast. Műszertechnika recognized that integration into the world's markets must start with its internal management.

Műszertechnika's main business lines consisted of computer hardware and telecommunication, but it also manufactured and distributed office automation products, electronic visual displays, and frequency converters. In 1994, its total sales revenues were Ft4.5 billion with approximately 45% of total revenues coming from computer-related sales. The breakdown of the total sales in 1994 was as follows: computers, Ft2.0 billion; telecom, Ft0.5 billion; electronics, Ft1.0–1.5 billion; and finance, Ft0.5–1.0 billion.

Telecommunications, a relatively new venture, was starting to give returns on Műszertechnika's investment. The company believed in the high growth potential of the telecommunications sector in Central and Eastern Europe.

In 1981, Hungarian law began to allow the formation of private companies. That same year, Gábor Széles, an electrical engineer, formed Műszertechnika in a Budapest apartment with \$500 of capital. The company, which started as a manufacturer and distributor of personal computers in Hungary, grew and became quite profitable throughout the 1980s. Soon, it had diversified its production by moving into other technology-related areas, such as telecommunications, office automation products, and electronic visual displays, and gained access to global markets by teaming up with foreign partners.

But the story would have been too simple had Műszertechnika continued growing into the 1990s. As the company entered a new decade, it faced many problems, including rising competition in both domestic and external markets, a rapidly changing computer industry, and financial mismanagement. These problems combined with highly vulnerable economic conditions in Hungary in 1991 and 1992 to significantly hurt the company's sales and profits. *Műszertechnika Exhibit 1* and *Exhibit 2* show Műszertechnika's consolidated sales and net profits.

Műszertechnika's attempt to overcome these difficulties was the true test for a company seeking to integrate into the world economy. The management's recognition of a problem before it surfaced and its commitment to change saved Műszertechnika from bankruptcy.

Műszertechnika grew steadily into the early 1990s as the demand for personal computers increased. Dániel Bárdossy, Vice-President of Investment and Strategic Planning, recalled that the company focused on sales growth, and only sales growth: "If you could sell twice as much, that was twice as good, and bank loans were easy to get, because banks saw this company as a rapidly growing, profitable company, and everyone wanted to finance this company. Banks were also very inexperienced." Emphasizing sales growth without looking at the other half of a formula – expenses – Műszertechnika did not see that the company was about to face serious problems.

At the root of the financial problems was Műszertechnika's organizational structure. Because the company started small and was essentially entrepreneurial, its internal system could not support a rapidly growing business. Műszertechnika became a huge company with many subsidiaries under one umbrella, yet with no separate profit centers. One of the problems was the poor cost-accounting system. "The rough, Communist-type accounting did not reflect the true picture of the company," Bárdossy stated. Rather than allocating sales and expenses to different subsidiaries for different activities, accounting allocated everything to the parent company. Cash flow generated by one subsidiary went to support another that needed it. This presented two problems. First, it was difficult to sort out which activities were truly profitable and which were losing money. Second, there was no sense of responsibility for profits and losses at the subsidiary level, since the end results showed up only at the parent level.

Management did not pay attention to such problems as long as sales were up. It did not realize that though the company was profitable, it was also very vulnerable to any changes. Before too long, unanticipated changes took place in Hungary. In 1990, trade was liberalized and more foreign competitors entered the computer market. As a result, the margins of 50% or higher, which Műszertechnika had enjoyed in the past, were squeezed down. In addition, Hungary faced high interest rates. By this time Műszertechnika was already approximately \$10 million in debt, and new financing would be very expensive.

These problems were not unique to Műszertechnika. Its other three major domestic competitors – Kontract, Mikrosystem, and Control – had virtually identical problems. "Everyone had big bank loans and was growing too rapidly," Bárdossy recalled. "By 1992, everyone had cash-flow problems. Everyone also had big projects in unrelated areas, such as real estate. By

the end of 1990, many companies realized that they were doing something wrong.”

To survive, companies looked for equity financing, such as public offerings or foreign investors. Mikrosystem and Control could not raise the necessary money and quickly went bankrupt. Kontract and Müszertechnika each managed to raise \$10 million from private investors. According to Bárdossy, Robert Maxwell had said, “At least one of the investments should survive.”

“Everyone learned a lesson from the past,” said Bárdossy, “but not too much, because the companies who were able to raise money once again decided to start big projects, sometimes returning to unrelated areas.” Finally Kontract joined Mikrosystem and Control in bankruptcy.

Műszertechnika’s salvation was that its management recognized problems a little bit earlier than the others and was committed to change. Bárdossy stated:

Gábor Széles was very committed to change the company and take any confrontation that went with it. We were ready to fire people, sell assets, and reorganize to a structure that is more suitable to economic change. We also needed some time to get our act together. Luckily or not, we bought some time due to Robert Maxwell’s death, because there was no longer immediate pressure from the “sleeping shareholder.”

In the short run, Müszertechnika generated needed cash flow by selling inventories at a loss. Much of its built-up inventory was quickly becoming obsolete, and it was better to sell and recognize the loss right away rather than hold on to outdated inventories. In the long run, it decided to focus its activities on selling off companies that did not fit its electronics profile or that were losing money. For example, the unprofitable Procomp subsidiary was sold. (*Műszertechnika Exhibit 3* provides a brief description of Procomp.) Unlike its competitors, Müszertechnika decided to diversify the company’s activities yet still stay in the electronics field.

Another important decision Müszertechnika made was to reorganize the company. The company was too big and too diversified to function as a single operation, and it needed a flexible organizational structure that could be adjusted as it went into different activities. The end result was a holding structure. *Műszertechnika Exhibit 4* shows the new organizational chart. The various activities of Müszertechnika were structured as independent profit centers under the coordination and control of MT Holding. At the end of 1994, MT Holding had an interest in over 30 enterprises worldwide, which include limited companies, stock companies, and wholly owned subsidiaries founded by Müszertechnika.

There were two main reasons why reorganization was necessary. First, it became essential to have a good accounting system that accurately reflected

the operations of the company. Second, by setting up a holding company and independent subsidiaries, each subsidiary was responsible for its own profits. The old organizational structure did not make sense for a company with so many different activities, and the in-house accounting was not strong enough, Bárdossy said: “There were arguments about expense allocations. Some activities were profit makers for the long term and others were loss makers, but we could not explain which were good and which were bad.”

Under the new organizational structure, the subsidiaries were responsible for making their own operational decisions, leaving the holding company to deal with the macro decisions, such as strategic and financing issues. For these reasons, MT Holding kept all bank loans and real estate, and real estate was leased to the subsidiaries. All other assets were distributed among the subsidiaries. The idea was that smaller groups would be more entrepreneurial, and each subsidiary could find its own place in the market. It also gave the subsidiaries tighter control in their operations. “In the new structure, it is clear to see which sub is doing well, and which is not,” Bárdossy claimed.

It took about one year to organize this structure. The holding company’s responsibilities included business development of new projects, control, and personnel management such as salary determination and contract negotiations. Müszertechnika paid more attention to the importance of financial management and began using new accounting methods, such as weekly financial reports for each subsidiary, comparing its projected performance with its actual performance.

In trimming the company, the holding company also cut down its employee size from 100 to 20. MT Holding sold assets such as real estate in the more pricy Buda part of Budapest and, to cut down operating costs dramatically, moved out of its expensive downtown office. Bárdossy recollected:

We [the management] could not afford this. We did not change our old cars. When traveling abroad, we did it by car, and if air, then coach. The smallest things were controlled. There was no salary increase, not even for the management and board members. Széles was very supportive of this downsizing.

This holding structure and control system was very new in Hungary and had been adapted from a Western concept. When asked how this type of organizational structure came about, Bárdossy explained, “Reading many books, like the *Harvard Business Journal*, about how other people are doing and being exposed to foreign investors with very good education, I learned a lot about how other people do business.” This specific idea came from talking with foreign investment bankers, who gave the company free advice on what they thought of the problems at Müszertechnika and recommended a holding structure. Bárdossy also noted that “attending Harvard in 1991 was

very important, because I understood that our problem was not unique to us, and that there was a solution. It also opened my eyes (and Széles's) that growth can be a very dangerous thing if you cannot manage it." Harvard further taught him the importance of financial management. One of the actions he took upon his return was replacing bank loans with commercial paper. Müszertechnika was the first company in Hungary to do such a thing, as commercial paper was a new concept in Hungary. At that time the gap between treasury rates and bank interest rates was very big, sometimes 6–7%, so they saved a good deal of money.

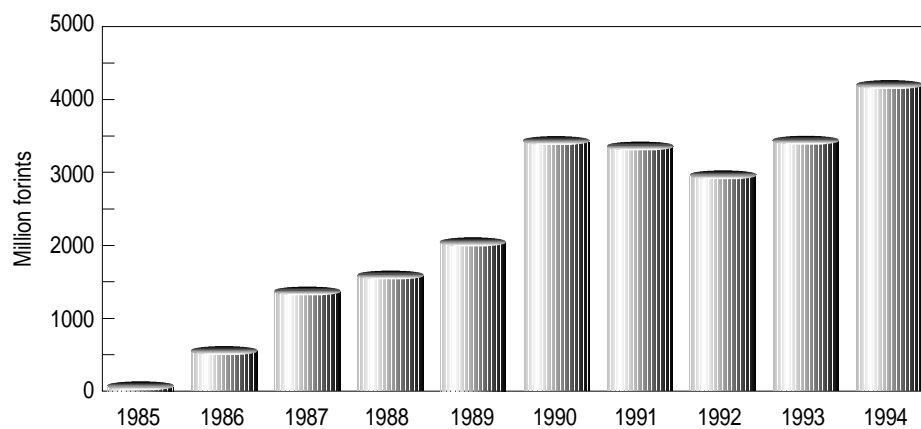
Another way in which Müszertechnika positioned itself to integrate into the market economy was through teaming up with foreign partners. Even from the early 1980s Müszertechnika realized that it needed foreign partners to provide source markets and suppliers. Therefore, Müszertechnika had always encouraged its employees to learn foreign languages and to look for an opportunity with foreign companies. Müszertechnika signed exclusive agreements with L.M. Ericsson of Sweden, Alcatel of Austria, and IBM and Word-Perfect of the United States. Foreign partnerships enabled Müszertechnika to diversify its product line and expand its markets. *Műszertechnika Exhibit 5* lists the strategic partners of Müszertechnika in 1994.

Many of its foreign partners had started as suppliers to Müszertechnika and later signed on to joint-venture projects. Joint projects were initiated by many foreign companies as often as Müszertechnika initiated them, primarily because Müszertechnika provided the local knowledge that was often very difficult for a foreigner to gain in Hungary. This included not only expertise in the computer and telecommunications fields, but also familiarity with the business culture, including the ability to deal with the government and, of course, knowledge of the language. Foreign partners brought the technical know-how and money. A successful joint venture normally lasted about five to six years, after which time Müszertechnika, having been paid a lucrative premium, gained much technical knowledge and the ability to stand on its own, while the foreign partner gained a market presence. However, the former foreign partner, now with the local knowledge and the market share, could become a competitor after such a project. Bárdossy responded, "That is the way of doing business; five years is a long time, and we get paid a lot for it."

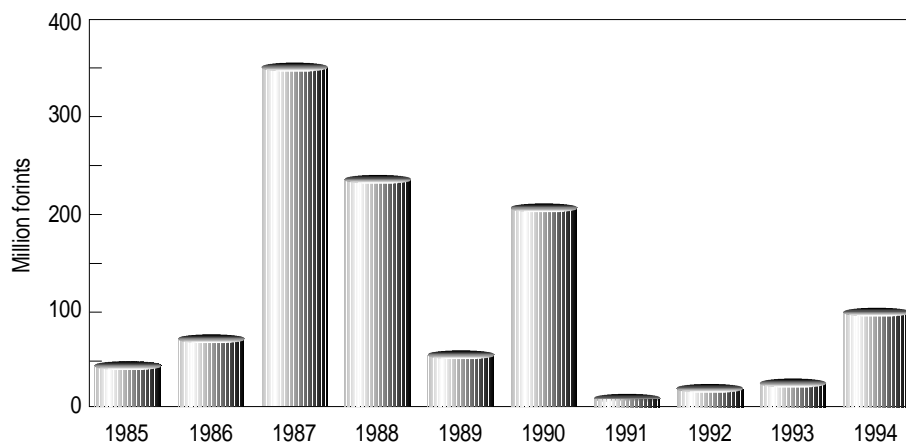
Műszertechnika, however, did not jump on each opportunity that arose. It was highly selective of its partners and of the activity it would enter into in the joint venture. There were some activities that Müszertechnika wanted to keep to itself, such as MT Visual. When asked why, Bárdossy responded, "We want to keep the market."

Cost trimming, joint ventures, crisis management – everything boiled down to the strength of management. Without solid people, Müszertechnika

would not have survived the turmoil in 1992 and 1993. At Müszertechnika, decisions were made at several levels, with executive activities and strategic planning led by the Board of Directors. (*Műszertechnika Exhibit 6* contains information on the managing board of Müszertechnika, and *Műszertechnika Exhibit 7* shows the consolidated balance sheet.) The managing board consisted of five members and all of them have been with the company since its early stage in the 1980s. Four out of five have degrees in electrical engineering, and everyone speak English fluently.



Műszertechnika Exhibit 1. Consolidated sales between 1985 and 1994 (in million Hungarian forints).



Műszertechnika Exhibit 2. Gross profits (in million Hungarian forints).

Műszertechnika Exhibit 3. Details on Procomp, a Műszertechnika subsidiary.

Műszertechnika's poor accounting operations extended into its subsidiaries, such as Procomp. For example, all the cash flow generated by Procomp-Hungary went back into Procomp-Switzerland to fund the marketing for a project being developed by Procomp-Germany. Thus the money left research and development, but never made it back to Műszertechnika, the holding company. MT lost nearly \$1 million in 1993.

As a result of losses such as these, the holding company began selling subsidiaries: Procomp-Germany and Procomp-Bratislava. The company sold off Procomp-Taiwan, and then sold Procomp-USA to another Hungarian company for an undisclosed sum. Műszertechnika elected to keep Procomp-Switzerland, mainly for financial transactions.

Procomp's difficulties emerged from three different problems:

1. There as an overall computer-industry recession.
2. Procomp was a single-product company. It produced excellent products, but it could not add more lines to the original before becoming outdated.
3. The liberalization of trade in Hungary resulted in more direct international trade. The subsidiary's most substantial profits had previously been generated when Procomp-USA bought components from Taiwan and exported them to Hungary. Procomp-Taiwan would not accept the Hungarian letters of credit, but did accept letters from Switzerland, bringing in Procomp-Switzerland. With more direct trade, such roundabout transactions became less necessary. In 1993, Procomp's bank debt to MT was around \$10 million, on consolidated terms.

Műszertechnika Exhibit 4. Organizational chart.

	Műszertechnika holdings		
	Telecom	Electronics	Finance
Computers			
MT Computer	MT Telecom	MT Office	MT Invest
MT Budapest	MT Datanet	MT Visual	MT Liz
MT Nationwide Network	Hungaro Digitel	MT Automatika	MT Libra
MT Hostware	Local Tecos		
MT Training			
Procomp			
PC World			

Müszertechnika Exhibit 5. Strategic partners.

Line of business	MT participation	Strategic partner	Country	Project/Product
Computers	MT Computer	Siemens	Germany	Computers
	MT Computer	Hewlett Packard	USA	Computers
	MT Computer	Fujitsu	Japan	Printers and peripherals
	MT Computer	WordPerfect	USA	Software
	MT Computer	Novell & 3COM	USA	Network products
Tele-communications	MT Telecom	Alcatel, UTS	Austria, USA	Engineering, Local telco operation
	Ericsson Technika	LM Ericsson	Sweden	Radio communication systems, Manufacturing of digital exchanges
	Hungaro Digitel	Radio Marconi	Italy	VSAT operation
Office automation	MT Office	Canon	Japan	Copy machines
		Ricoh	Japan	
	MT Office	Panasonic	Japan	Fax machines
Electronics	Control	Control	UK	Frequency converters
	Technika	Techniques		

Műszertechnika Exhibit 6. Management profile.

Gábor Széles, Chairman of the Board of Directors, Founder.

Széles, 49, has over 20 years of experience in the technical industry. He serves as President of Association of Hungarian Industrialists and is also a member of numerous Hungarian economic and business organizations. Széles is also the Chairman and CEO of Videoton, the largest electronic manufacturing company in Hungary. Széles graduated from the Budapest Technical University as an electrical engineer. He also attended Harvard University's postgraduate Executive Management Program. He is married, has two children, and is fluent in Hungarian and English.

Dániel Bárdossy, Vice-President, Investments, Strategic Planning.

Bárdossy, 40, has been with Műszertechnika since 1985. He serves as the Strategy Group Chairman at MT and is also an advisory board member for several commercial and economic associations in Hungary. He is a frequent lecturer, both domestically and abroad, on the subject of corporate strategy. Bárdossy is an electrical engineer and earned both his undergraduate and Ph.D. degrees from the Budapest Technical University. He has completed Harvard University's Executive Management Program. He is married, has two children, and is fluent in Hungarian, English, German, and French.

Zoltán Tánkó, Vice-President, Communications.

Tánkó, 37, has been with MT since 1984 and currently serves as the project specialist for large-scale long-term ventures. He is a member of the Presidential Board for the Budapest Chamber of Commerce and Industry and is also active in several telecommunication organizations. Tánkó graduated with an electrical engineer degree from the Budapest Technical University. He is married, has two children, and is fluent in Hungarian and English.

Mária Vissi, Vice-President, Finance, Accounting.

Vissi, 46, has been with MT since 1987 and her current responsibilities entail the coordination of finance and accounting for MT's domestic and foreign interests. She is an active member in several domestic and international economic and finance council symposiums. Vissi received her Ph.D. from the Budapest University of Economics. She is married, has two children, and is fluent in Hungarian, English, German, and Russian.

Péter Lakatos, Vice-President, Trade and Privatization.

Lakatos, 33, has been with MT since 1986. As an international trade and commerce specialist, Lakatos has an active role in MT's involvement in trade and privatization as well as the coordination of Soviet market activities and domestic office automation operations. He graduated from the Budapest Technical University with a degree in electrical engineering. He is married, has two children, and is fluent in Hungarian, English, German, French, and Russian.

Műszertechnika Exhibit 7. Balance sheet, 1994 (in million Hungarian forints).

<i>Assets</i>	
Current assets	
Cash and securities	423
Accounts receivable	955
Bills of exchange	56
Inventory	362
Total current assets	1,796
Noncurrent assets	
Land and premises	647
Machinery	103
Financial investments	96
Intangible investments	69
Total noncurrent assets	915
Prepaid expense 12	
Total assets	2,723
<i>Liabilities and equity</i>	
Current liabilities	
Accounts payable	412
Other short-term liabilities	430
Short-term credits and loans	20
Total current liabilities	862
Total long-term liabilities	5
Owners' equity	
Share capital	840
Capital reserve	515
Retained earnings	462
Total owners' equity	1,817
Accrued expenses	39
Total liabilities and equity	2,723

New World Publishing: Budapest Business Journal, Warsaw Business Journal, Prague Business Journal

The Budapest Business Journal has a simple editorial philosophy. We seek to peel back the abstractions which, in most business publications, pile up more quickly than blankets on a cold winter evening. We try to remember that an economy is not a mound of numbers, but an assembly of human decisions; that a business is not a concrete structure, but a fabric woven of human relationships. Our reporters push to strip every story back to its human core.

Henry Copeland
Editor

The *Budapest Business Journal* (BBJ) was founded in 1992 in Hungary by Mike Stone, an American who had been an editor for several regional business journals, including the *Orange County Business Journal* in California. Stone originally came to Hungary to work for the *Budapest Post*, an English-language newspaper that provided general local news for expatriates. After working there for a month he determined that there was a market for an English-language paper in Budapest that had a business focus. Based on this premise, the *Budapest Business Journal* was created. By October of 1993, Stone, an entrepreneur at heart, decided to move on to greener pastures. (Stone went on to start the *Mexico City Business Journal* right after the peso devaluation in 1994 and, as of 1995, was planning to start up a business journal in Vietnam.) The company was purchased by three young Americans with the backing of a group of primarily US investors. The two controlling partners were Steve O'Connor and Thom Barnhardt, with a smaller interest held by Douglas Wheeler. Both O'Connor and Wheeler had been employees of Stone and were responsible for much of the modest success that had occurred up to the point of purchase. Barnhardt, who received an MBA from the University of Virginia's Darden Graduate School of Business in 1992, first joined the paper, in the summer of 1994 as a consultant for one of the *Journal's* special publications, *Taking Stock: An Investor's Guide to the Budapest Stock Exchange*.

The partners' vision for the company was to replicate the success of the *American City Business Journals*. The founders of the *American City Business Journals* held that a market existed for business news that was locally focused. This idea spawned a string of successful business journals throughout the United States (these journals had the city or area name first,

followed by the words “Business Journal,” for example, *Charlotte Business Journal*). O’Connor, Barnhardt, and Wheeler saw an opportunity for developing a similar series of papers throughout Eastern Europe. These papers would emphasize business news, as the *American City Business Journals* did, and would be published weekly. The new approach was that these East European journals would be written in English, rather than in the language of the country in which they were located.

The decision to publish the business journals in English meant that the product would be necessarily targeted at a relatively narrow segment of the population. However, the partners viewed this a positive factor and made it one of the cornerstones of their corporate strategy. They saw that the rapid influx of English-speaking foreign managers after the collapse of Communism in 1989 had created a demand for a publication that provided insights into conducting business in the rapidly changing environment. Furthermore, in a part of the world where government had customarily maintained a tight rein over the content of published information, there was a great demand for local news that was unbiased and independent of the state-run news organizations. Finally, the partners felt that there was a large enough segment of the local population that was either fluent in English or wanted to be fluent in English that would purchase the paper, and that the segment would grow.

After establishing a strong base in Hungary with the *Budapest Business Journal*, the partners aspired to expand into other major cities across the former East bloc. This strategy called for rapid growth.

When the three partners acquired the *Budapest Business Journal* in 1993, there were three or four other English-language newspapers in Budapest. However, all but one failed, missing the mark in fulfilling consumer needs in this market. The one English-language publication that did succeed was the *Budapest Sun*, a newspaper whose editorial content emphasized general local news and that was targeted mainly toward tourists and foreigners living in Budapest. The only English-language competitor that provided business news was *Business Central Europe*, which was published by the *Economist* and addressed issues germane to all of Eastern and Central Europe. While this monthly magazine did provide English-speaking executives with comprehensive regional news coverage, it did not report and elucidate day-to-day business happenings within Hungary.

The *BBJ* was a unique selling proposition to those fluent in English but not in Hungarian; however, Budapest also had a more comprehensive business newspaper, titled *HVG*, that was published in Hungarian. Since *HVG* had a loyal Hungarian customer base, and was considerably less expensive than the *BBJ*, it was viewed by those at the *BBJ* as a potential stumbling block in acquiring a strong Hungarian national readership.

The key driving forces for profitability in the *Journal* revolved around advertising sales and paid subscriptions. These two components had a symbiotic relationship; as the number of paid subscribers increased, advertising revenues also increased. As advertising revenues increased, the *Journal* was able to afford a larger quantity of editorial content. With the increase in editorial content, new subscribers were acquired. The *Journal* had to somehow establish itself in this circle of events.

The partners' original focal point had been on increasing the subscriber base through the use of direct sales. This focus stemmed from O'Connor's previous strength as sales manager for the paper under Stone. As O'Connor pursued direct sales, he was also educating the local market on what exactly a business journal was. This strategy was initially effective and established the name of the *Budapest Business Journal* in the expatriate community, but the partners decided that direct sales were too slow and inefficient for their growth plans. They rapidly shifted emphasis from a direct-sales method to a direct-mailing system. This new marketing effort was headed by a young Canadian, Eric Presley.

Presley was given the task of substantially expanding circulation. Many of his efforts concentrated on direct-mail promotions targeted at English-speaking business executives. This was a challenge since good mailing lists were not readily available in Hungary in 1993 and 1994. Therefore, considerable time was spent on prospecting for lists and checking them for accuracy. Finding good mailing lists required some level of creativity as well. For instance, obtaining a list of leads from a foreign embassy often required trading a subscription to the *Journal* for a one-time use of the list.

Another facet of Presley's marketing efforts was geared toward marketing to business travelers in Hungary. This involved forging alliances with a variety of businesses. For example, Presley built relationships with managers at upscale hotels who would purchase *BBJ* subscriptions to offer free copies of the *Journal* at the front desk or in hotel rooms. Similarly, several major airlines agreed to purchase subscriptions for passengers on flights into and out of Budapest.

Early in 1995, the marketing department established a telemarketing unit to make sales calls to potential subscribers and existing ones whose subscriptions were lapsing. These calls were primarily follow-up calls to direct-mail solicitations. A major obstacle to this effort was finding reliable lists of leads with accurate telephone numbers. Telemarketing time had to be allocated beyond making sales calls to check the lists for accuracy. Gradually the telemarketing unit contributed to sales, in addition to slowly compiling a more reliable internal list of leads.

The one segment that was initially neglected as a primary recipient of the *BBJ*'s marketing efforts was the potentially lucrative English-speaking

Hungarian management population. While this group was generally more price sensitive than expatriates working for wealthy multinationals, it was obviously less transient than the primary target market, and therefore possessed more potential as a long-term loyal customer base. As increasing numbers of Hungarian managers began subscribing to the *BBJ*, it became apparent that they should be targeted more aggressively. To reach this audience, Presley mailed special-price promotions to lists of subscribers to *HVG*, and conducted more local promotions, such as a special deal for stock-brokers to celebrate the fifth anniversary of the Budapest Stock Exchange. By 1995 the *Budapest Business Journal* had established a moderate level of brand awareness among Hungarian managers as a high-quality business publication, and boasted that Hungarian managers comprised 40% of their circulation.

By the fall of 1994, the partners began looking to expand into a second market in Eastern Europe. Although uncertain about the success of *BBJ*, they felt that the relative risk of expansion was outweighed by the need to grow rapidly. Prague and Warsaw were regarded as the best options mainly because of their rapid growth and their efficacy in attracting foreign investment. Since Poland seemed to possess a larger market and lacked direct competition from the other newspapers, it was selected as the location for New World Publishing's second major publication, the *Warsaw Business Journal*. Another advantage to launching a product in Poland was that the country was just beginning to hit its stride in economic growth and the partners felt that they could gain an early advantage in this market. The Czech Republic had already reached a much higher level of development, and a business journal might be perceived as a latecomer rather than a novelty.

The first step the partners took to enter the Warsaw market in December 1994 was to find a Polish-American who was familiar with the local business environment. He owned a business in Warsaw and seemed to possess the initiative and market acumen to help them establish their new enterprise. They entered into a management agreement with him that stated that during the initial three months he would find office space, hire a staff, establish a circulation system, and produce a pilot issue. For this work, he would be issued a 5% ownership interest in the company. To cement this alliance, the *BBJ* would get 10% of his original company.

Soon after beginning to perform some of the agreed-upon tasks, the Polish partner demanded that he receive 50% of the entire company. Refusing to comply, the partners paid him a termination fee, and he signed a non-competition agreement. He immediately set up a competing paper, using the partnership's mailing list, format, and early advertising base. Polish law was not yet developed enough to protect against the contractual breach.

In December 1995, the company opened its third publication, the *Prague Business Journal*. Although the partners had earlier passed over the Czech Republic for a new product launch, in late 1995 they felt that industry conditions were now opportune for a New World Publishing business journal and that their East European business journal concept was well honed to compete in Pargue's developed market. In addition to launching a third business journal, by February 1996 New World Publishing had purchased a share in EPS, a software company, and was preparing to make its publications available on-line. Meanwhile, the partners continued to search for new markets.

The partners attribute their success in these early years to three factors:

- **Editorial Content:** The principal strategic business focus throughout New World Publishing's history has been on developing editorial quality and integrity and delivering it in creative ways. This focus allowed the company to position its publications as premium products and to develop a positive image reflecting the quality and integrity of the product.
- **Well-targeted Marketing:** The company used its positive image among consumers to market its products not only to foreign expatriates, but to the respective country's nationals as well. The success in this effort was reflected in reader surveys that revealed that 40% of the readers in both Budapest and Warsaw were local national.
- **Strong Advertising Sales Force:** Advertising sales was an area of weakness of many local competitors. The partners recognized that they could excel in this area; by committing resources to advertising sales early on, the *BBJ* was able to develop a strong advertising base. When expanding into new markets, the solid relationships built up with advertisers, combined with the editorial quality displayed in each new paper, allowed the company to offer regional deals to advertisers. One regional advertising contract in 1996 was with Scala International, a company that sell accounting systems.

Pick Szeged, Hungary

Pick Szeged's ability to learn quickly has helped the salami company make its transition from a planned Communist economy to the free market. Forced to adapt to capital markets in Hungary, it learned to listen to market demand and how to promote its products. In short, it became a capitalist enterprise. Pick has worked to build a strong market position in both the domestic and export markets. Pick's future growth, however, could be constrained by the decreasing number of livestock in Hungary, and its real challenge lies in its ability to manage growth through efficiency.

Pick Szeged celebrated its 125th anniversary in 1994. In 1869, Mark Pick started salami production in Szeged on the banks of the Tisza River in the southern part of Hungary. Its product is often called winter salami, because the production of salami was limited to the winter months until the introduction of a cooling system in 1920. After World War II, Pick, along with all the companies in Hungary, was nationalized. In 1992, Pick became a public company with its shares listed on the Budapest Stock Exchange. In 1994, Pick acquired the Herz Salami Factory, which was its main competitor in Hungary.

Pick is Hungary's leading meat processor and salami producer. Its main activities are divided into two categories – red-meat and dry-meat production. In 1994, Pick processed approximately 42,000 pigs and 10,000 cows. Its products range from red meat and ham to various sausages and salamis. Pick is best known for its winter salami, which is the most profitable line, accounting for approximately half of its turnover. Pick is the largest producer of salami (12,000 tons in 1994) in Hungary. The next biggest salami producer was Herz (4,000 tons), which is now owned by Pick.

Until 1987, Pick belonged to the Animal Trading and Meat Industrial Trust, which was composed of the 21 largest Hungarian meat-processing enterprises. Each company distributed meats to an assigned region throughout Hungary, and the Trust allocated all profits generated by meat companies. The company had no control over its operation and production level, as the Trust dictated everything. The market was not a real market, because the Trust told the companies where they could sell products. Consequently Pick, even though it had originally been only a salami company, under Communism added other meat-processing activities. Export was also dictated by the Trust and was heavily subsidized, so that the meat prices paid by the CMEA trading partners were artificially low.

The Hungarian meat industry has been facing difficulties due to decreasing quantities of domestic livestock. In 1994, because of lack of raw materials, Pick had to reduce slaughtering from two shifts to one. *Pick Szeged Exhibit 1* shows that the supply of livestock has been drastically decreasing

in Hungary. As supplies of raw materials have been decreasing prices have been increasing. The increase in the price of pigs is shown in *Pick Szeged Exhibit 2*. This is a serious problem because meat companies must increase prices in a market where the consumers are already price sensitive.

In 1994, Pick's total turnover was Ft17.5 billion (a 35% increase over the prior year), and profit before tax was Ft1.4 billion (a 27% increase). The overall breakdown of sales is shown in *Pick Szeged Exhibit 3* and *Exhibit 4*. Over half of sales comes from dried-meat products. In the Hungarian market, Pick operates eight outlets of its own and supplies other food retailers and wholesalers. Pick dominates the Hungarian dried-meat sector, as it accounts for about 95% of total salami production. In the raw-meat market, Pick's main competitors are Gyulai Huskombinat and Bacshus Rt. in the Szeged region and Zalahus and Papai Huskombinat in the Budapest area.

Exports constitute 36% of Pick's total sales, and over 80% of exports are dried-meat products, such as salami. Germany is the major export market, accounting for 76% of total exports of dried-meat products in 1994. Prior to 1994, all exports were handled by Terimpex which had also been a state-owned company, so Pick had no knowledge of its exports. "We had no idea who we sold our products to and how much [they bought]," said Zoltán Masa, Assistant Manager of Exports. Pick set up its own export department to handle every aspect of exports, from seeking out markets to shipping.

As the company sees little growth potential in the domestic market, it is looking to increase its export, especially of more profitable products like salami. The management sees EU countries as a big potential market, but is also exploring a new market – the Far East – with a major Japanese food distributor.

The Hungarian State Property Agency initiated the privatization of state-owned companies in 1989. Pick was faced with different privatization options. The first possibility was to find a strategic investor who could bring in cash and business knowledge to help the company become competitive. However, the SPA rejected this idea because it felt that Pick's trademark should remain Hungarian. The second option was a management or employee buy-out, but the SPA thought that the company was too valuable for such a choice. "Also we did not have money in our pockets to buy a company like this," stated Lukács Vámosi, the Financial Director. Instead, the SPA suggested that Pick, a healthy, sizable business, become a public company. Pick was one of the very few Hungarian companies that the SPA viewed as a good candidate for a public offering.

The management agreed to the SPA's plan, even though it felt it needed one or two years to clean out the company before going to the public market. "The stock exchange was a new thing, and we were thrown into the water and had to learn to swim," Vámosi stated. To attract investors, especially

foreign investors, it was important to create a good image of the company. To begin, Pick formed a new company structure to reflect a more market-oriented approach. The company split into two strategic business lines – meat producing and dry meat – because they were in different markets. New marketing and export departments were set up, and the former structure, with many different activities under one umbrella, was reorganized. Management divided various activities into independent units, including a trucking company, livestock-fattening companies, and butcher and processing companies. A public listing also meant that Pick needed to change its accounting system in accordance with international accounting standards, and the company needed to be valued. “These were all important to prepare the company for the big change,” Vámosi stated.

A year later, in 1992, Pick became a public company with an initial capitalization of Ft2.724 billion. Hungary granted Pick a five-year 100% tax holiday and a 60% tax holiday for another five years. At least 30% of Pick’s shares had to be sold to foreign investors to qualify for the tax holidays.

Since privatization, Pick has been successful in building the foundations of a modern company – the first necessary step to integrate into the world economy. An important step was the development of a marketing strategy, which did not exist in a centrally planned economy. Pick’s strategy included heavy marketing of the trademark to associate it with quality. Since the meat business generates very low margins, Pick has recognized that its profit must come from higher margin products such as salami.

Pick first designed a new company logo, because previously there had been no brand name for its products. Whereas two years ago no one at Pick understood marketing, now everyone has seen its value. Vámosi admitted, “When the marketing manager is in the room with us [other managers], we complain about how much money is spent on marketing, but when he is not in the room we talk about how successful the marketing investment has been and how we should spend more money on it.” As part of the campaign for brand-name recognition, Pick opened its own retail shops to sell and promote Pick products. These shops are not only good for marketing; they also help to attract foreign investors.

Pick spent over Ft700 million to develop and improve its competitiveness in 1994, purchasing modern machines for meat processing, storing, and packaging. In addition, three of Pick’s company stores began using the barcode system. With the foreign investors in mind, these investments are an important part of constantly upgrading the company.

In 1994, Pick purchased the Herz Salami Factory, the other important Hungarian salami producer, which had gone bankrupt. To Pick, this was an opportunity not only to increase its production capacity, but also to improve its competitive position in sausage production. Pick bought 96.4%

of Herz for Ft918 million; the remaining shares are held by the State Property Agency. Pick plans to upgrade the plant, improve product quality, and sell goods under a separate brand name.

Pick also acquired a majority interest in Iliker, a retail chain with 20 shops based in Szeged. Through such acquisitions, the company hopes to meet its objective of increasing its presence in the domestic market.

“As a share company we are expected to grow,” notes Vámosi. Pick recognizes the need to expand its market presence through heavy marketing. Building brand recognition and acquiring businesses have been part of Pick’s plan to grow, in both the domestic and international markets. In the export market, Pick is gearing up for Hungary’s future entrance in the EU. Hungary’s participation in the EU will mean both bigger market opportunities and more fierce competition as more firms enter the meat industry. In anticipation of this, Pick has been preparing itself to be more competitive, believing that the path to competitiveness is through increased size and brand-name recognition. This is another reason why Pick acquired Herz and is looking for more acquisition opportunities. The Pick trademark is now known in other West European countries, and its standard of quality must conform to those markets. But Pick realizes that it is a small company when compared with the international companies with whom it will soon compete. *Pick Szeged Exhibit 6* and *Exhibit 7* show recent financial statements and *Pick Szeged Exhibit 8* gives the background of senior managers.

Pick will face two main challenges in the future. In the domestic market, Pick must deal with the decreasing numbers of livestock. Because of the decrease, meat prices in Hungary have increased recently, and are expected to rise further. *Pick Szeged Exhibit 2* indicates that in 1994 alone, pig prices almost doubled. Clearly, the company’s growth is limited by the raw materials available to it. The problem of decreasing livestock production is said to be due to inefficient pig and cattle raising and production techniques introduced under Communism. So far, the company has met the demand for its product by engaging in long-term contracts with suppliers and by helping suppliers raise livestock. Yet the question remains, How can the company manage to grow when the number of livestock is simply shrinking and price is rising? The same problem exists in the export market, even though the salami prices are still relatively low compared with West European products.

Although Pick recognizes that it needs to grow through exports, this strategy also presents challenges. Products with a very distinct flavor are even more difficult to export. Masa explains that “export is difficult, because the taste of meat differs from country to country, even from region to region. Some countries are not familiar with salami.” By joining up with foreign partners, Pick hopes to gain access to new and unexplored markets. For example, Pick has found a Japanese food distributor that will import

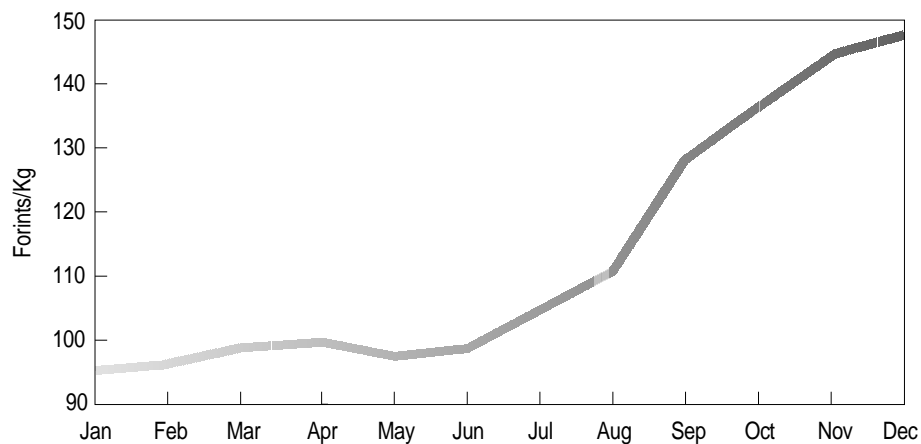
salamis and distribute them through its network. Masa further emphasizes the importance of having the right foreign partners. He indicated that a company such as Pick knows all the ins and outs of its domestic market, but it has to rely heavily on its foreign partners' expertise with regard to exports.

Pick now has control over its export sales, but maintaining control will be a big challenge for Pick because it is at the beginning of its learning curve. To prepare itself for world integration it must learn quickly. Pick has been negotiating a joint venture with a long-time import partner in Germany, believing that joint ventures will improve its penetration of export markets.

Pick Szeged Exhibit 1. Livestock in Hungary between 1990 and 1994 (in thousands).

	1990	1991	1992	1993	1994
Pigs	8,000	5,993	5,364	5,001	4,356
Cattle	1,571	1,420	1,159	999	910

Source: Presentations at the Annual General Meeting of Pick Szeged, 1995.

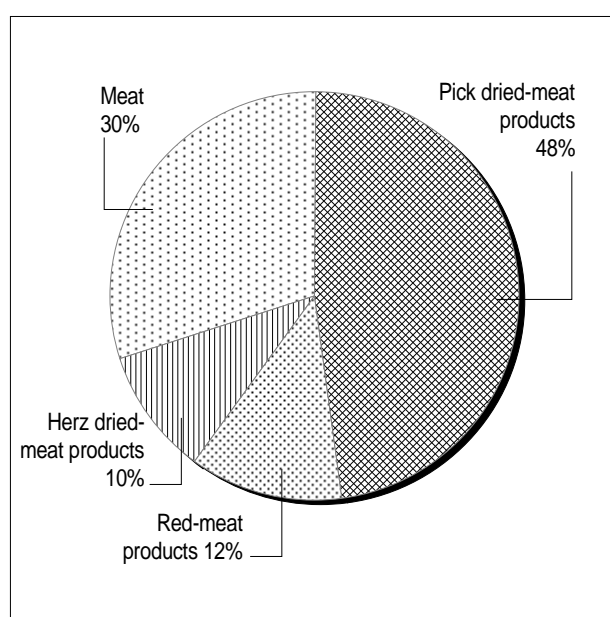


Pick Szeged Exhibit 2. Average price of pigs in Hungary 1994. Source: *Pick Szeged Annual Report*, 1995.

Pick Szeged Exhibit 3. Breakdown of net turnover and sales, between 1992 and 1994 (in million Hungarian forints).

	1992	1993	1994	1994–1993
Domestic	6,916	7,722	11,178	144.8%
Export	4,008	5,291	6,286	118.8%
Total	10,924	13,013	17,464	134.2%

Sources: Presentations at the Annual General Meeting of Pick Szeged, 1995; *Pick Szeged Annual Report*, 1995.



Pick Szeged Exhibit 4. Breakdown of sales. Sources: Presentations at the Annual General Meeting of Pick Szeged, 1995; *Pick Szeged Annual Report*, 1995.

Pick Szeged Exhibit 5. The Pick Group.

Pick Transport Ltd. (100%)
 Pick Farm Pig Fattening Ltd. (100%)
 Pick Central Pig Fattening Ltd. (100%)
 Herz Meat Products and Dried Meat Products Ltd. (100%)
 Szegedi Eliker (96.40%)
 Herz Co. (55.10%)

Pick Szeged Exhibit 6. Balance sheets (in thousand Hungarian forints).

	1994	1993	1992 ^a
<i>Current assets</i>			
Cash	429,583	121,462	55,846
Accounts receivables	1,337,330	1,511,481	1,092,850
Inventories	3,067,753	2,440,066	1,792,674
Other current assets	343,917	412,841	183,281
Total current assets	5,178,583	4,485,850	3,124,651
<i>Fixed assets</i>			
Long-term receivables	119,869	8,820	12,798
Investments	40,303	43,238	40,293
Property, plant, and equipment	4,932,604	3,818,212	3,177,232
Intangible assets	575,783	19,909	8,888
Total fixed assets	5,668,559	3,890,179	3,239,211
Total assets	10,847,142	8,376,029	6,363,862
<i>Current liabilities</i>			
Accounts payable	872,576	803,639	487,974
Short-term debt	508,473	1,272,884	644,569
Current maturities of long-term debt	154,900	305,821	159,772
Other current liabilities	671,928	559,044	351,824
Total current liabilities	2,207,877	2,941,388	1,644,139
Long-term debt, less current portion	25,900	328,465	607,410
Minority interest	208,707		
<i>Shareholders' equity</i>			
Share capital	2,657,000	2,270,000	2,270,000
Capital reserve	3,138,934	1,197,338	1,061,345
Treasury shares	-48,154	-11,707	-2,450
Retained earnings	2,656,878	1,650,545	783,418
Total liabilities and equity	10,847,142	8,376,029	6,363,862

^aFigures are for the six-month period ending 31 December 1992.

Pick Szeged Exhibit 7. Income statements (in thousand Hungarian forints).

	1994	1993	1992 ^a
Net sales	16,877,001	12,948,654	5,994,229
Cost of goods sold	12,398,375	9,326,582	4,165,113
Gross profit	4,478,626	3,622,072	1,829,116
Selling and administrative expense	3,352,233	2,564,900	1,318,457
Export subsidies	288,074	274,942	108,230
Other operating income	311,531	199,796	190,426
	2,752,628	2,090,162	1,019,801
Income from operations	1,725,998	1,531,910	809,315
Net interest expense	407,680	426,545	273,438
Income before income taxes	1,318,318	1,105,365	533,877
Provision for income taxes	18,242	11,791	229,543
Income after taxes	1,300,076	1,093,574	304,334
Dividend declared	291,516	226,447	226,447
Minority interest	2,227		
To retained earnings	1,006,333	867,127	77,887

^aFigures are for the six-month period ending 31 December 1992.

Pick Szeged Exhibit 8.

János Takács, Director of Corporate Development, engineer, 55.

Takács received his GCE and diploma as technician in 1958. He obtained a diploma in mechanical engineering from the Miskolc Technical University and became a design engineer in 1964. After holding various positions with previous employers, he joined Pick as Chief Engineer in 1986. In 1990, he was promoted to Technical Director and on 30 June 1991 to his present position. In 1992, he received a diploma in marketing management.

Lukács Vámosi, Director of Economic Planning, economist, 44.

Vámosi graduated from the University of Economics in Pécs in 1976 and received a diploma as a chartered accountant in 1984. He joined Pick in 1987 and was later appointed Accounting and Financial Manager and External Finance Director before he attained his current position.

András Kühn, Director of Meat, engineer, 49.

Kühn joined Pick in 1963. While working at the company he graduated from the Szeged Special Technical School for the Food Industry in 1967 and received his engineering diploma in 1973 from the College of Food Industry. In 1969, he was appointed Chief Technologist. He was promoted to Head of the Abattoir in 1975, to Production Manager in 1988, and to his current position in 1991. In 1992, he received a diploma in marketing management.

Karoly Pataki, Director of meat products, economist, 60.

Pataki graduated from the Faculty of Industry of the University of Economics in

Budapest in 1957. He joined Pick in 1963. His positions with Pick have included Deputy Head of the Commercial Department, Head of the Economics Department, Director of Economic Planning, and Director of Production and Sales. In 1991, he was appointed Director of Meat Products.

Vilmos Bihari, Executive Director, 48.

Bihari obtained a degree at the Finance Faculty of the University of Economics, Budapest, in 1969. In 1980, he was awarded the chartered accountancy diploma. Bihari joined Pick in 1969 where he has held various positions in the finance department. He held the post of Director of Economic Planning prior to his appointment as General Manager in 1990.

Price Waterhouse/Hungary

By the summer of 1995, Price Waterhouse was involved in a consulting partnership with 23 firms globally. The two largest firms were the European firm and the US firm. Price Waterhouse has maintained an office in Hungary since 1989, and has advised corporations in both the public and private sectors as well as multinational companies.

Price Waterhouse/Hungary divides its practice groups into three distinct services: Audit and Business Advisory Services, Tax and Legal Services, and Corporate Finance and Recovery.

The Audit and Business Advisory Services group provides many of the accounting services that are related to accounting. These services are broken down into Audit and Accounting Services, Due Diligence Reviews, Operational and Working Capital Reviews, Internal Audit Services, and Computer Information Services. In 1995 there were five partners in Audit and Business Advisory Services; one is a Hungarian speaker, one was from the United States and had extensive auditing experience, another partner was fluent in Hungarian, and the last two were from Britain and the United States.

Tax and Legal Services was broken down into two divisions: Taxation Services and Legal Services. Some members of the Taxation Services team had served with the Hungarian Tax Office and the Ministry of Finance, and others have extensive international experience. The Legal Services group was responsible for advising multinational and Hungarian corporations on a wide range of legal and technical questions, which included joint-venture agreements, incorporation, intellectual property, leases, registration, licensing, and interpretation of legislation. The managing partner of Price Waterhouse/Budapest was a lawyer by training, but none of the three partners in Tax and Legal Services were lawyers; two of these partners spoke Hungarian.

Corporate Finance and Recovery assisted in transforming Hungary from a state-run economy to a market-governed economy. Corporate Finance and Recovery was divided into the following activities: Acquisitions, Disposals, and Finance Raising; Privatization Advice; Corporate Recovery; Asset and Business Valuations; Real Estate Services; and Human Resources Consulting. There were two partners in Corporate Finance and Recovery. The partner in charge of this department was Andrew Turner.

Turner had extensive experience in crisis and recovery management, some of it in bankruptcy work in the United States. Turner once owned a consulting firm in Beverly Hills, California. An American citizen, Turner was born in Hungary and speaks fluent Hungarian.

Price Waterhouse has actually been in Hungary since 1987, when the Canadian Partnership of Price Waterhouse won a bid for a World Bank project to design an executive information system for a major utility. This

initial presence was followed up by the establishment of a permanent office in Budapest in 1989. This office, which was established by the European Partnership of Price Waterhouse, was the first permanent, foreign consulting firm in Hungary. The office initially had three consultants. Turner has been with Price Waterhouse in Budapest since 1990, when the firm had 50 employees. By 1990, KPMG, Ernst & Young, Arthur Andersen, and Coopers & Lybrand were established in Hungary. Deloitte & Touche, the remaining Big Six firm, entered the market a short time later.

Early on, Price Waterhouse established a policy of hiring as many young Hungarians as possible. By 1990, however, only half of the employees were Hungarian. Most consulting work at Price Waterhouse was done by engagement teams flown in from other Price Waterhouse partnerships on a case-by-case basis.

By the summer of 1995, this was no longer the case. Less than 10% of the employees at the Budapest office held foreign passports. Although this transformation has been rapid at the low levels of the organization (mid-level consultants and support staff), it is not as evident at the partnership level, where only one of the partners is a Hungarian national. However, five of the partners speak fluent Hungarian.

The key employment challenge for Price Waterhouse/Hungary has been balancing “local skills” with “technical skills.” Hungarians generally have the local skills, such as knowledge of Hungarian processes and customs. In addition, Hungarians have the language advantage. Foreigners generally have more proficient technical skills: one acquires these skills through experience and formal education. Price Waterhouse/Hungary appears to have made the assumption that it is easier to teach Hungarians technical skills than to teach foreign consultants local skills.

Price Waterhouse has a policy of training and promoting staff internally. In the Corporate Finance and Recovery area this policy is evidenced by the fact that by the summer of 1995 50% of the local consulting staff had MBAs (most of the foreign consultants had MBAs). The average age of the consulting staff is under 30.

The period between 1989 and 1991 was a gold-rush period in Hungary, especially in Budapest. Large multinationals would often have their annual meetings in Budapest to check Hungarian opportunities firsthand. Hungarian expatriates and foreign “prospectors” were arriving by the planeload. There were many get-rich-quick schemes, and there were more business opportunities than could be taken advantage of. By 1995, the Hungarian market for consulting had come full circle. This maturing process was characterized by increased competition from local consulting firms and savvy on the part of clients of what can and cannot be expected from a consulting firm.

Price Waterhouse's major competitors in 1995 were the remaining five of the Big Six accounting/consulting firms. In addition, local consulting firms, investment banks, law firms, and other international management consulting firms were becoming competitive.

Another challenge was to maintain a balanced portfolio of clients. Large multinational companies were initially the most desirable clients, and would always constitute a significant part of Price Waterhouse/Hungary's business. However, it was expected that most future growth would come from adding large Hungarian companies to the client list (MATÁV, MOL, MALEV, and so on). Price Waterhouse/Hungary was trying to increase its business through local contacts and a strong Hungarian presence in its Budapest office. International business would continue to be developed and enhanced by the established position that Price Waterhouse had with the home offices of major international companies that conduct business in Hungary.

Hungary is very network oriented, with considerable emphasis placed on personal contacts. Many national leaders have known each other since their student days. When Turner first returned to Hungary he asked a friend from the apartment complex where he used to live as a boy to set up meetings with some influential Hungarians. His friend arranged 170 meetings with the newly established "movers and shakers" in Hungary.

Turner emphasized the necessity of keeping close contact with a wide variety of influential people. Business executives make up the core of this group, but the group also includes a strong contingent of politically powerful individuals. These political contacts are (and will continue to be) especially vital given the government's strong influence in the Hungarian business world during the mid-1990s.

SBG&K Patent and Law Offices, Hungary

Founded in 1969 as an independent law/patent office, SBG&K was originally known as Law Office 16 under the Communist regime. In 1989 it became an international law office and changed its name to SBG&K (after the first letter of each principle's last name).

By the summer of 1995, SBG&K had grown substantially. Whereas 30 people would be a fairly large law firm in Hungary, SBG&K employed 104 people – 14 partners, 11 associates, and 79 support staff. This growth was aided by the fact that SBG&K was both a general law office and a patent law office. In Hungary there is a distinction between lawyers and patent attorneys, and a firm combining both is rare. Eight of the partners were patent attorneys and six were lawyers. Primary specializations included business law, competition, and intellectual property. SBG&K was responsible for 25% of the 2,340 patent applications sought in Hungary in 1994. In addition, of the 1,900 trademarks registered and published in Hungary during that same time period, SBG&K was responsible for 22%.

Some 90% of SBG&K's clients were large multinationals with offices in Budapest. SBG&K has direct client contact with multinationals, and it did not maintain exclusive relationships with any foreign law firms.

SBG&K Law Office was governed by a five-member Board of Directors. Three of the members were lawyers, and the remaining two members were patent attorneys.

Katalin Szamosi was a member of the board, and has extensive experience in Hungarian and international law. Her interest in law stems from the influence of her father, who was a famous Hungarian lawyer. She attended the University of Law in Budapest, then started working at SBG&K. After three years as an associate, she was selected to become a partner. After a further three years, Szamosi was selected to join the five-person board that governed SBG&K. Szamosi was the only woman on the board. Her practice has focused on business establishments of primarily German and Swiss corporations in Hungary.

Using a competitive analysis, the different layers of SBG&K's competitive advantage can be divided into bargaining power of suppliers (prospective employees), threat of substitutes and new entrants (other law firms), and bargaining power of buyers (clients). Szamosi discussed each of these layers in-depth.

In most law firms in Hungary in 1995, a patent attorney could not become a partner. However, at SBG&K patent attorneys made up over 50% of the partners. This situation increased the talent pool of SBG&K and differentiated it from its closest competitors.

In addition, SBG&K had a reputation as the leading domestic law firm, increasing its ability to recruit the most promising legal minds in Hungary. This advantage, along with the size advantage mentioned previously, resulted in SBG&K having a significant power advantage over its prospective employees. According to Szamosi, competitors to SBG&K fell into two categories: patent and trademark firms, which tend to be local; and business law firms, which tend to be from the United States.

Since the large companies that SBG&K targeted as clients tended to want a one-stop solution to all of their Hungarian legal problems, SBG&K's use of both patent attorneys and lawyers gave it a significant competitive advantage over pure patent and trademark firms. There was only one other large patent and trademark firm in Budapest, and it did not have any specialists in other forms of law. Therefore, it could not provide the full range of services that large international corporations have come to expect.

Given their superior resources and international expertise, large US law firms such as Baker & Mackenzie and Weil & Gotshall presented serious long-term challenges to SBG&K. However, SBG&K possessed three competitive advantages over these firms. SBG&K had more experience in Hungarian legal procedures than the large US firms; it had a highly recognized presence among clients in Hungary; and language was not an obstacle as 85% of the partners and associates were fluent in English or German or both.

The clients of SBG&K were divided into two primary groups: companies interested in "industrial property protection" (intellectual property) and companies interested in obtaining the legal assistance necessary to found an affiliate company in Hungary. Clients that engaged SBG&K for industrial property protection tended to be large foreign manufacturing concerns, such as pharmaceutical companies from the United States and Western Europe, and producers of industrial and technical products from East Asia (primarily Japan and South Korea). These companies considered only law firms that had high levels of local and international exposure and expertise. Companies that were interested in establishing a business tended to have had prior contact with SBG&K, primarily through the industrial property protection practice. In addition to the pharmaceutical companies and companies interested in industrial and technical products that the industrial property protection business introduced, the business foundation practice tended to have clients from the food and chemical industries.

SBG&K's strong customer focus was due to the highly competitive nature of the legal service industry in Hungary. However, the relative bargaining power of clients was fairly low during the time period directly after the fall of Communism in 1989. Established law firms with a presence in Hungary were relatively rare, and there was a huge demand for accurate

legal and business advice during this gold-rush period. By the summer of 1995, the overall influx of new clients had slowed down, and SBG&K had begun to focus on the key factors that differentiated the firm from its main competitors.

Another important key to SBG&K's success was its international name recognition. The firm had spent considerable time in promotional activities since as far back as the 1960s. These activities included attendance at all important conferences and lectures involving intellectual property and membership in all international intellectual property organizations. For example, SBG&K was a member of INTA, the International Trademark Association, the largest organization for trademarks and patents. Representatives of SBG&K regularly attended the organization's annual meetings, even though they were held in the United States. Another example is the firm's membership in the International Bar Association. Finally, client exchange programs with firms overseas were other ways that SBG&K continued to maintain its leading presence in the Hungarian market.

SBG&K has faced many of the same challenges that most service firms in Eastern Europe have faced. The firm has had to divide resources between acquiring international clients, who paid in convertible currencies, and continuing to perform legal work. This activity was particularly apparent at the partner level.

Travel time depended upon the partner involved. Language ability and personal preference were important factors. For example, one partner was fluent in English, German, and French, but he was afraid of air travel. This obviously reduced his overall travel opportunities. However, on average, partners traveled approximately 10 weeks each year.

Associates progressed to the partnership level through a petition process. After three years, the petition can be answered in one of three ways: yes, no, or continuation of the associates program for another three years.

SBG&K was originally located on Dalszinhaz Street, near the Budapest Opera. As the staff grew, it was necessary to move into a larger office. In December 1994, the firm moved to offices located in a renovated turn-of-the-century villa, located on Andrassy Avenue, near Heroes Square. SBG&K placed a great deal of emphasis on keeping the exterior of the office building true to the original intent of the architects, while designing a modern interior; the offices had direct access to the Hungarian Ministry of Justice computer databases and internet access has been hardwired into the building. SBG&K uses the location, appearance, and functionality of its offices as an opportunity for conveying its success, especially to international clients.

From 1980 to 1995, there were significant changes in the types of clients that SBG&K served. Obviously, after the changes in 1989 the foreign presence increased and client work shifted to an international focus. The type of

work that SBG&K performed for these international clients changed as well. The year 1990 was the high point of the boom in Hungary. Domestic and foreign investors wanted to start companies or subsidiaries, and the possibilities appeared to be unlimited. However, the Hungarian economy slowed down between 1991 and 1994, and other markets with greater opportunities emerged. Clients were now seeking legal solutions to established business problems.

The future presents challenges to SBG&K, primarily in the form of foreign competition. Regulations of the Budapest Bar Association state that although foreign firms can hire Hungarian lawyers, they cannot be a law firm *de jure*. Foreign firms can only open representational offices, through which they may work with Hungarian attorneys, creating a *de facto* law practice.

According to Szamosi, SBG&K has ambitions to become still larger in the future. Its main needs included employing qualified lawyers, especially those who can deal with the rapid technological changes and have the requisite language skills. Szamosi expects revenue growth to be moderate over the years from 1995 to the turn of the century.

A final interesting development was the establishment of a limited liability corporation, "Tarsulas Kft.," to supervise the capital and other investments of SBG&K. The necessity of Tarsulas Kft., acting as a sort of financial management company for SBG&K, demonstrates the difficulty of managing all aspects of a service corporation. Tarsulas and its five employees were placed under the direct supervision of the Managing Director of SBG&K: the corporation was founded by the partners of SBG&K.

Senior Vaci Kötöttarugyar Rt., Hungary

Senior Vaci Kötöttarugyar Rt. is a large, vertically integrated knitwear manufacturing company, headquartered north of Budapest in Vác, Hungary. The company produces 100% cotton and cotton mix (cotton/lycra, cotton/polyester) sportswear, leisurewear, and fitness clothes for adults and children.

Founded in 1885 in Budapest by Beno Leichter, it is the first Hungarian textile and knitwear company. In 1889 the company held a ceremonial opening of its first manufacturing plant in Vác. Over the following years the company enjoyed an increase in capital and sales, and was noted for its competitiveness and high quality. It was awarded a gold medal in the Millennium Ceremony Competition in 1896. However, by 1918 the company was facing severe difficulties due to the grave political and economic situation following World War I. In 1919 the Hungarian Soviet Republic workers took over the factory.

During the decade following the Trianon Peace Accord of 1919 and the dissolution of the Austro-Hungarian Empire, the textile industry became increasingly independent and emerged as the most important sector of industry in Hungary. The postwar boom allowed the company to modernize the factory, but the economic crisis and the shrinking of markets during the Great Depression of 1929–1933 forced management to decrease production significantly. In 1934 management took steps to liquidate the company, but the factory was able to continue to operate with a reduced work force and assistance from county and city authorities. The following years and through World War II the company enjoyed slight growth in production and was again able to modernize. In 1944 the company was moved west to Linz, Austria, by the retreating German army for a short time, but was moved back to Vác in 1948, at which time the factory was nationalized and was brought under state control. Orders from the Soviet army contributed to significant growth in production between 1948 and 1988.

In the 1980s, the Hungarian textile industry enjoyed strong financial performance. Major players invested heavily in their operations, and came to rely on the strong infrastructure that had grown up around the industry. There were several very large mills that used 10 to 15 primary distributors to allocate their products through well-organized channels.

Internal and external demand for textiles was strong. Domestically the industry existed in a protected market; government-imposed import quotas kept demand for textiles artificially high. Meanwhile, export demand was heavily subsidized by the Soviet Union for its own large market.

The owner-government had long supported this industry with new investments, but in the early 1980s the textile industry was given more

autonomy. This situation meant that new investments depended on individual company profits and bank loans for capital, but it also implied that textile companies were freer in areas such as annual planning, wage and investment policies, and diversification. It also meant liberalization of foreign and domestic distribution, including the opportunity for some companies to market their goods abroad directly, and not through the state-trading companies as was customary under central planning. Therefore, not only did textile companies enjoy artificially high demand; they were able to develop some strength, autonomy from the government, and direct relationships with Western companies.

By the end of the 1980s, Senior was one of the largest textile mills in Hungary, and employed about 2,400 people. The company was consuming about 3,000 tons of raw materials per year, and was producing to 4 million pieces annually. Exports played a significant role in the company's success; half of the production was sold in the domestic market, and half was exported. In this way Senior was able to benefit from the Hungarian- and Soviet-government-supported demand, while developing a healthy external clientele.

The company attempted to balance its domestic and export sales at a 50-50 ratio because few of the raw materials necessary for production were available domestically. During the 1980s, Hungary imported almost 95% of its artificial fiber needs, 100% of its cotton requirements, and 60% of its wool needs. Forced to import such a large proportion of raw materials, Senior was subject to foreign exchange risk; as the Hungarian forint devalued, it became increasingly expensive to purchase these raw materials from outside the country. The company counterbalanced this risk by targeting half of its sales in convertible currencies; although it did not have a competitive advantage in raw materials costs, it did enjoy the advantage of low labor costs.

During the late 1980s, Senior Rt. developed strong working relationships with many important Western wholesalers and retailers as they began to sell in the Hungarian market. Levis, for instance, became well established in Hungary when it began producing jeans during the 1970s. While Levis sold both jeans and knitwear within Hungary, it produced only jeans in its factories. Levis outsourced its knitwear products because high-quality products were available locally. Furthermore, since Hungary is landlocked, lead times were much lower from within Hungary than from East Asia, and it was generally less risky to be supplied from within Hungary. Similarly, Adidas began moving into Hungary on a large scale in the mid-1980s, and eventually opened its own shops there. Other Western clients included the German firms Arena and Reusch. Senior benefited greatly from the relationships with these large, global firms.

In the early 1990s, the Hungarian textile industry practically collapsed. Several major events nearly devastated the industry. First, the Soviet Union completely stopped purchasing Hungarian textiles as that country's economy collapsed; this situation eliminated a substantial portion of external demand. Second, changes in the Hungarian government regulations in 1990 considerably altered domestic demand, when nearly all import barriers were eliminated. The market was attacked by imports from the East Asian companies, which, by 1995, were the primary competitors. Imports from Western Europe also provided stiff competition. Consequently, in addition to losing much of their export market, the textile industry also lost much of the domestic market, including many of its principal customers.

A third major change was in the system of domestic trade. Wholesalers and retailers became decentralized and grew to number in the thousands. The distances between clients were often substantial, and lines of communication were poor, requiring heavy investment and coordination in distribution by the main mills. Because of their weakened financial position, however, these mills were unable to react quickly and lost many clients.

In 1990, almost within a year, Senior Rt. had lost most of its markets, and was forced to eliminate much of its work force. Whereas at one time it produced 3 to 4 million pieces, by the end of 1990 it was down to between 10% and 15% of that. Senior had lost virtually all of its domestic market to foreign competitors. Senior's export markets were in a similar state of havoc since the Soviets could not afford to buy goods and the West European clients did not wish to risk doing business with a weak Hungarian textile company. By 1992 Senior was almost bankrupt. Although its sales began to increase slowly as the Hungarian economy improved, the company had to support substantial fixed costs, in addition to the payments on the debts incurred from investments made during the 1980s. Finally the factory was repossessed by the Budapest Bank, its major creditor bank.

During this time, most of Senior's domestic competition went bankrupt. The remaining domestic mills generally produced goods for markets other than the ones in which Senior competed. For instance, one mill produced items such as terry and pajamas (products which Senior Rt. does not sell) that are generally of inferior quality. Another Hungarian mill was purchased by an American company, and produced only T-shirts. Senior Rt.'s international competition came mainly from East Asia. These products were less expensive than the domestically produced ones, but they also tended to be of lower quality.

In 1994 and 1995, Senior Rt., which was down to 700 employees, reorganized its production and laid out a plan for regaining domestic and international clients. The company's goal was to achieve a 50-50 ratio of domestic and export sales by 1997.

Senior's export strategy was to sell to former clients in small orders to prove that it was again reliable enough to serve its Western customers. It regularly attempted to increase order sizes as it made good on previous trial lots. Senior first targeted the large, well-known clients that produced brand-name products. These clients were seeking quality and were able to pay for it. Furthermore, their satisfaction would lead to positive references about the company for other customers, particularly those abroad.

This strategy seemed reasonable to executives at Senior Rt. since its clients already had strong relationships with the company. Furthermore, the company had very good designers and technicians and a tradition of workmanship among factory workers. Senior Rt. had always purchased the highest-quality raw materials, including yarns, chemicals, and dyes. Therefore, the company was certainly capable of delivering high-quality goods.

In addition to selling brand-name products to major clients, in 1994 Senior Rt. launched its own brand, Fibri. This brand, which was purchased by many wholesalers and retailers, was less expensive than the other products it manufactured, but of the same quality. The brand offered a "basic collection" of year-round clothing in standard colors.

During the early to mid-1990s, demand for clothing in Hungary changed dramatically. Initially consumers were exposed to a wide range of imports. Demand for these clothes was very high, since they were cheaper than domestically produced items, and were appealing because they were foreign. Consumers wanted to try many new things at that time. However, economics served to segment the market more definitively. Unemployment, which was unheard of before 1989 during the 40-year-old Communist regime, rose substantially during the early 1990s. Inflation increased to 30% per annum; there was virtually no inflation before 1989 because prices were controlled.

During the transition from central planning to a market economy, many Hungarians experienced a reduction in their standard of living; a small group of entrepreneurs became very rich; and a sizable middle class emerged. The very wealthy were willing to pay a high price for clothing and were consumers of the latest fashions. They spent considerable amounts of money on Western brands such as Levis, but were also drawn toward haute couture. Those with the lowest standard of living shopped mainly on price, and became strong consumers of products imported from East Asia. It was difficult for Senior Rt. to produce goods cheaply enough to serve this segment. The middle class demanded a medium standard of quality and fashion at a reasonable price. This was the segment that Senior Rt. targeted both with its own brand and with its brand-name clients. The size of this segment dropped initially, but then increased.

From 1992 through 1994 Senior Rt. was able to regain its reputation domestically and turn toward recapturing the export business. Its strong

relationships with brands like Adidas facilitated a move back into international markets, such as Germany.

By the end of 1994 and into 1995, production was up to 1 million pieces, and 90% of Senior's sales were on the domestic market and 10% were on the export market. Senior was one of the few surviving domestic mills, and it had successfully identified a healthy consumer segment that demanded its products. While a long road to recovery lies ahead for Senior Rt., several factors can be attributed to the company's success thus far.

The first is the company's past strengths: its client base and its value-added, high-quality products. Its strong client base and its tradition and reputation for high-quality products enabled Senior to restore relationships with its largest clients. Capitalizing on Senior's strengths allowed the company to develop and execute a reasonable strategy for recovery.

A second important element in Senior Rt.'s recovery was timing. The real collapse of the industry occurred in 1990 and 1991. However, Senior Rt. was stronger than many mills at the time, and did not suffer as much until the end of 1992. By that time many competing mills were already in the process of liquidating. Since textiles production was a national industry, the government could not conceive of liquidating one of the last surviving textile mills when unemployment was high and rising. Therefore the government, which then owned Budapest Bank, Senior's primary creditor, was somewhat lenient on the company and helped facilitate recovery.

A third major success criterion was ownership by the Budapest Bank and the personality of Lajos Bokros, who was the CEO of the Budapest Bank in the early to mid-1990s; Bokros went on to become Hungary's Finance Minister in 1995. The Budapest Bank's vision for Senior Rt., as directed by Bokros, was not just to keep the company, but to nurture it and slowly sell shares back to the company's management. By the end of 1995, the bank's ownership decreased to about 25%. About 60% of the shares were sold to management and the remainder stayed in the hands of other shareholders. Bokros's long-run perspective demonstrated his confidence in Senior Rt.'s employees and managers, and its long tradition in the textile industry. Rather than liquidating the company, Bokros allowed it to seek a plan for recovery.

Zwack Unicum, Hungary

In 1990, Peter Zwack and Emil Gunderberg, a German drink distributor and Zwack's longtime family friend, formed Peter Zwack & Consorten AG. This company was to own 50% plus one share of Zwack Unicum Rt. as part of its privatization. In its effort to integrate into the world market, Zwack Unicum recognized the importance of international business concepts, such as marketing and quality control, and incorporated them into its domestic business. In fact marketing has been one of the keys to success at Zwack, and it is one of the main reasons that Zwack Unicum has been able to capture a two-thirds share of the Hungarian spirits market.

Zwack Unicum Rt. began in 1840 when József Zwack founded the first Hungarian liqueur factory. He introduced a unique drink from a secret family recipe called Unicum, and quickly became the official supplier to the Habsburgs. After World War II, the Zwack family left the country with the secret recipe when the family factory was expropriated. The distillery then operated as a state company, but without the original recipe. Peter Zwack, the fifth generation in the family business, continued production outside Hungary until 1989, when political and economic changes in Hungary enabled him to buy back the company. Zwack and Gunderberg, owner of a German spirit company, then formed Peter Zwack & Consorten AG (PZAG), and the original Zwack Unicum was reintroduced to the Hungarian market in 1990. In 1993, PZAG acquired Hungary's largest producer of spirits, the Budapesti Likőripari Vállalat (Budapest Liqueur Factory). The current company structure is given in *Zwack Unicum Exhibit 1*.

The Zwack Unicum Group integrated into the world economy in two ways: its products were represented in markets outside Hungary, and it represented foreign products in Hungary. As Hungary's largest producer and distributor of alcoholic beverages, with more than 80 products, Zwack Unicum has dominated the Hungarian spirits market. Unicum, an aperitif and digestif made from more than 40 herbs, is a historic product, and has significant name recognition, especially in Hungary. Other alcoholic beverages, such as címeres barack pálinka (apricot brandy) and vilmoskörte pálinka (pear brandy), have also been major products of Zwack Unicum.

Zwack Unicum also imports foreign products into Hungary. In 1993, the company exchanged a 26% ownership interest for an exclusive license with International Distillers and Vintners (IDV), a subsidiary of the Grand Metropolitan PLC, giving Zwack the rights to distribute IDV products in Hungary. IDV, one of the biggest producers of spirits in the world, wanted a presence in Hungary, and Zwack Unicum was a natural partner. Among the brand names that Zwack Unicum now distributes in Hungary are Smirnoff Vodka, J&B Scotch, Baileys Irish Cream, Cinzano, and Gilbey's Gin.

The Hungarian domestic spirit market has been characterized by declining demand and increasing competition. Although per capita alcohol consumption has declined, the trend toward higher-quality alcohol has heightened (*Budapest Business Journal*, 1993). Due to a lack of reliable statistics, it is difficult to quantify the spirits market in Hungary. According to Managing Director Imre Sivó, however, Zwack Unicum has over a 50% market share in Hungary. *Zwack Unicum Exhibit 2* presents the market share estimation provided by Zwack Unicum. Zwack's main competitor is BUSZESZ, which has been acquired by the Mautner Markhof Group of Austria. Besides BUSZESZ, no other distillers are big enough to significantly threaten Zwack Unicum, but another source of competition in the Hungarian spirit industry is the black market. According to Sivó, approximately 30% of alcohol consumed in Hungary is distributed through the black market. Unfortunately, Zwack cannot ignore the black market, but it cannot fight it either. Sivó reported, "As a company, there is not a lot you can do to control the black market. You have to heavily rely on the State and lobby."

In 1994, the total net turnover and profit for Zwack Unicum Co. were Ft1.1 billion and Ft525 million, respectively (see financial statements in *Zwack Unicum Exhibit 3*). The sales revenues represent a 10% increase from 1993. Domestic sales account for 95% of all sales. In the domestic market, Zwack sells both brand and nonbrand products. Brand products, such as Unicum, account for approximately half the total sales revenue. Unicum, which is targeted toward the luxury market, by itself contributed 8% of total sales in 1992.

The word "integration" has a different meaning in the Zwack case. As of 1994, most of Zwack Unicum's revenues came from domestic sales. It is fundamentally a Hungarian company with Hungarian products that cater to Hungarian tastes. Even though the company's long-term plans call for increased international exposure, it remains predominantly a domestic company. What makes this company's integration interesting, however, is that "it is a domestic company with international thinking," as Sivó stated. Zwack, for example, having lived abroad and conducted international business, brought back and applied his business knowledge and experience to the company. Zwack Unicum has proved the effectiveness of applying traditional capitalistic business thinking in an economy that had been centrally planned. Among the many international tools brought into Hungary, sales and marketing efforts and quality management have been the most important and have become the backbone of success at Zwack.

In 1992, Zwack Unicum established a new sales strategy to penetrate the domestic market. According to Sivó, the company has the biggest alcohol distribution network in Hungary. By 1995, there were seven regional distribution centers and 60 salespeople. Through this network of distribution

centers, Zwack Unicum services wholesalers and directly sells to retailers such as restaurants and hotels.

Zwack Unicum was the first among the Hungarian distillers to establish marketing as a separate function. Marketing did not exist under Communism because there was simply no competition. However, as Hungary shifted toward free-market competition, marketing concepts became crucial to continued success. Through its own marketing department, Zwack Unicum implemented a brand strategy, and emphasized brand image. It was important to upgrade the image of Unicum because the Unicum produced by the state-owned company did not resemble the real Unicum. The strategy has helped to make brand products from commodity goods.

To draw on ideas and expertise in business, the company is constantly in touch with international advisers. "This would be hard to do without foreign help," Sivó stated. Having two foreign arms, IDV and Gunderberg, which are also major players in the spirits industry, makes it easier for Zwack to integrate marketing into the business. Regarding international marketing Sivó indicated that their "two international arms" help Zwack Unicum integrate into the export market. With IDV's coverage of English-speaking areas, Gunderberg's presence in German-speaking areas, and Zwack in Eastern Europe, the company plans to expand its market with high-quality, unique Hungarian products. IDV already distributes Unicum in the international market, including the United States.

Zwack Unicum became the first Hungarian liquor company to be awarded the ISO-9100 international quality standard certificate in 1995. To receive this certificate a company must go through a series of tests to ensure a high standard of quality and production process. The company believes in the importance of quality regardless of where the products are sold. "Brand image should live up to the high standard of quality," Sivó indicated.

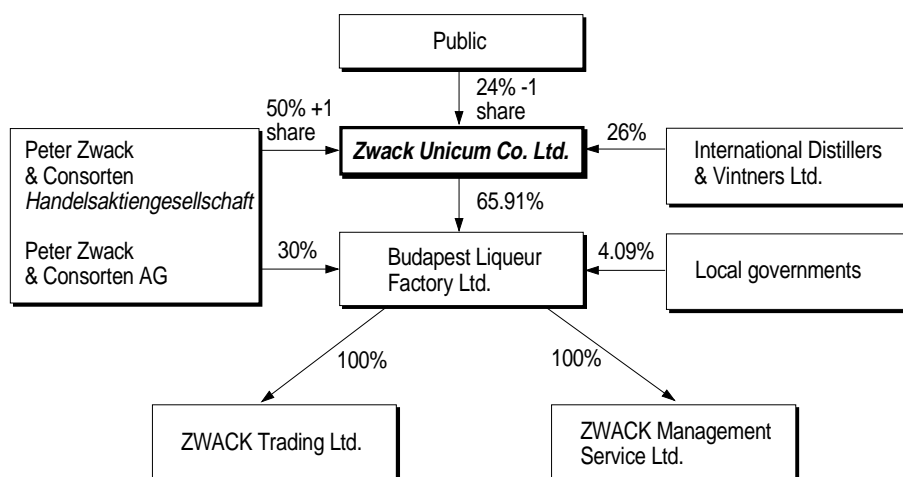
The combination of high-quality products and intensive marketing efforts has been key to the successful restoration of Zwack Unicum as a leading company in Hungary. Integration, however, has not been without difficulties at Zwack, and the company believes in continuous improvement. The most difficult challenge Zwack faces is in internal matters, particularly human resources. Not surprisingly, this problem is found in many companies that leap suddenly from state ownership to private enterprise. The transition of the employee's work mentality from that of a centrally planned economy to that of a free market does not happen overnight. "It's a matter of changing the corporate culture. It takes a lot of management effort," Sivó stated. To integrate into today's world market, workers should change their way of thinking and working. The company deals with this problem by hiring and training the "right" people. "Young, talented people are very important to us," said Sivó.

External integration presents further challenges to Zwack Unicum. Because Hungary is a small country with a limited domestic market, it is difficult to depend solely on domestic sales for the company's growth. Furthermore, it requires a great deal of long-term investment and effort to be recognized in international markets among so many different products, especially with products very specific to the taste and culture of Hungary, such as Unicum.

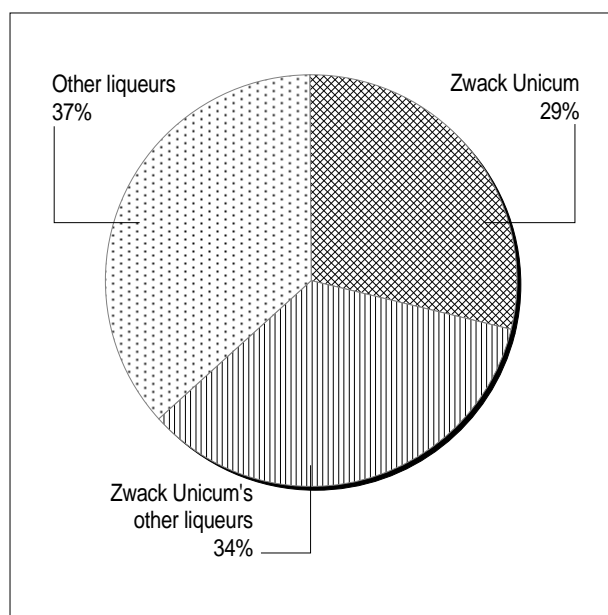
At the same time, the import business can often be vulnerable to certain economic or other changes. Factors such as import duties or currency devaluation, for example, may help its exports but it simultaneously hurts imports. Zwack Unicum must deal with these factors on both sides.

One of the keys to Zwack's success lies in its staff members who can apply their international business knowledge. Following the acquisition of the company in 1989, the number of employees decreased from 1,400 to 740, and currently the management is made up almost completely of people who have been hired since privatization. It is important to the company to have international owners such as Gunderberg and IDV, because they provide the necessary know-how in integrating into the world market. "Hungarians learn it and transfer the know-how from the Hungarian company to the domestic market," explained Sivó. The profile of the company's management is included in *Zwack Unicum Exhibit 4*.

The long-term plan of Zwack Unicum is based on the theory that Unicum should be present everywhere. As the company remains the dominant player in the domestic market, with its brand products such as Unicum and various brandies, it sees its growth potential in neighboring East European countries. Unicum is also becoming more popular in the Far East for its curative effect.



Zwack Unicum Exhibit 1. Ownership structure.



Zwack Unicum Exhibit 2. Main segments of the Hungarian liquor market in 1992.

Zwack Unicum Exhibit 3. Financial statements (in thousand Hungarian forints).

	1993	1994
<i>Balance sheet</i>		
Liquid assets	21,308	9,895
Prepayment and accrued income	123	928
Receivables	895,922	875,988
Inventories	111,577	222,900
Total current assets	1,028,930	1,109,711
Intangible assets	210	895
Tangible assets	234,994	262,717
Financial investment	1,970,500	1,971,333
Total fixed assets	2,205,704	2,234,945
Total assets	3,234,634	3,344,656
Liabilities and equity		
Advance payment	8,953	
Trade accounts payable	17,091	35,559
Short-term bank loan	89,701	111,215
Other short-term liabilities	215,181	172,619
Total current liabilities	330,926	319,393
Long-term liabilities	400,000	4,282
Total liabilities	730,926	323,675
Accruals and deferred income	3,988	10,148
Provisions for risk, liabilities, and charges	2,463	1,936
Equity	2,497,257	3,008,897
Total equity and liabilities	3,234,634	3,344,656
<i>Profit and loss statement (for the year ending 31 December 1994)</i>		
Net turnover	1,032,662	1,136,864
Other operating income	56,163	71,882
Own work capitalized and work-in-process	25,083	71,321
Material and other external charges	447,309	610,777
Staff costs	83,670	117,743
Depreciation	12,771	17,812
Other costs	169,205	118,360
Other operating expenses	40,305	47,718
Trading profit	360,648	367,657
Financial income	126,370	255,332
Financial charges	10,308	16,707
Operating results before tax	476,710	606,282
Income tax	28,649	81,186
Profit after tax	448,061	525,096

Zwack Unicum Exhibit 4. Management profile.

The Board of Directors manages company business, handles company affairs, represents the company in court before authorities and third parties, and exercises employer's rights. Currently the Board of Directors of Zwack Unicum Rt. consists of six members. Four members were elected upon transformation of the company in September 1992 and the other two in March 1993 for a term of four years.

Peter Zwack, 66, Chairman of the Board. Studied in Budapest, Milan, and the United States. Awarded degree in economics from New York University. Has been managing the affairs of the Zwack family since 1970.

Rudolf Kobatsch, 52, economist and Deputy Chairman of the Board. Currently Chief Executive Officer of Schlumber Ag where he has been employed since 1972.

Herman Matzer van Bloois, 52, marketing specialist, Director of IDV. Responsible for developments since 1988. Between 1980 and 1987 Managing Director of Selviac Nederland BV.

Róbert Horváth, 31, Managing Director of IDV Hungaria since its foundation in 1991. Formerly Mr. Horvath was Deputy Head of the export department of Hungarovin for three years.

Éva Schleicher, 53, Deputy General Manager of Zwack Unicum Rt. since 1992. Has been employed in the liqueur industry since graduating from university. Upon establishment of Zwack Unicum Kft. she was appointed Managing Director.

Imre Sivó, 39, chemical engineer. General Manager Zwack Unicum Rt. since May 1992. Formerly Deputy General Manager of Taurus Tire Works.

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