Eastern Europe:
The New Investment Frontier

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Eastern European countries have strong industrial traditions, much like those of the West, but their economies have been severely distorted by the mismanagement of the now-discredited communist system. Therefore, investment opportunities in the region are often clouded by significant issues:

• Inflation and general economic malaise

• A lack of political, social, and economic institutions

• Fragmentary business infrastructures

• Incomplete or nonexistent commercial and property legislation

• Remnants of the old bureaucracies

• Nasty brush fires in the form of civil wars, border disputes, and ethnic strife

Nonetheless, for careful investors, opportunities abound. Central and Eastern Europe is vast, stretching from Vilnius to Vladivostock, from Murmansk to Macedonia, and populated by more than 400 million people. Furthermore, these are not Third-World countries, but industrial economies with high educational and social standards, long traditions of technology, and labor forces with advanced scientific and engineering skills. These are the countries that pioneered such diverse breakthroughs as rear-engine cars (Tatra), satellites (the Sputnik), and lithium alloys. The chief difference between these countries and the West is that many aspects of their industrial development have been deliberately suppressed for decades.

Large and small Western companies, recognizing the region's opportunities, are rushing to establish operations in various Eastern countries, spurred by the promise of new markets and new sources of productivity. For these pioneering firms, Eastern Europe has all the makings of a new frontier: demand for goods and services is largely unmet; laws and institutions are rudimentary, fluid, malleable, and human and natural resources abound. But settling any frontier requires maps – i.e., strategic concepts. Without careful strategic planning, investors face a maze of economic, political, and ethnic problems. In this article, we first offer an overview of key considerations for entry strategies, then suggest specific guidelines for negotiating.

Developing Entry Strategies

Successful strategies for investment in Eastern Europe involve three basic steps:

• Choosing the most promising country(ies)

• Developing a clear strategic rationale

• Tailoring entry methods to the business and the strategy

In addition, investors need to monitor other countries continuously for their market potential.

Choosing the Most Promising Country(ies). In Eastern Europe, key criteria for investment targets are tolerable levels of political and economic risk and access to large markets in the West and the East. By these criteria, Hungary, Poland, and the Czech and Slovak Federal Republic (C.S.F.R.) are the priority markets.

Both the European Community (EC) and the United States have very high political stakes in the success of these three countries. If Hungary, Poland, and the C.S.F.R. cannot make the transition to modern, free-market economies that provide reasonable living standards, they will seriously question the whole idea of democratic capitalist societies. Therefore, we believe these countries will be rapidly absorbed into the European economic sphere. Associate EC membership for them is imminent, and fall membership is plausible before the end of the decade. Not even the EC farm lobbies will long be able to resist the strong commitment by the West to the Eastern democracies.

Further, all three priority countries have been building frameworks of modern commercial institutions. Much of the basic legislation is in place. The economics of the free market are taking over, and there is an increasing tendency to establish and run businesses along Western lines, with special treatment for foreign firms and their managers. The private economy is growing far more rapidly than statistics suggest, and currencies are freely convertible for business transactions. Ironically import duty protection is generally lower in these three countries than in their Western neighbors.

In addition, hourly wage rates for skilled labor tend to be about one third to one quarter of Ireland's and roughly the same as Hong Kong's or Taiwan's. Engineers and scientists are proportionately even less expensive.

Finally all three countries are geographically well positioned. They enjoy proximity to the EC market, with its 350 million consumers. They also are physically and commercially close to the vast Eastern region of the former Soviet Union, now the Commonwealth of Independent States (C.I.S.). Their citizens (the potential employees and partners of Western firms) are accustomed to dealing with C.I.S. customers and markets. When matters begin to improve in the C.I.S., it will be the people of these countries and other former satellites who are best positioned to spearhead the development of C.I.S. markets.

While Hungary, Poland, and the C.S.F.R. all share Western „safety nets" of modern commercial institutions, low-cost labor, and favorable geographic positions, they also differ significantly (see the exhibit).

Hungary. With 10 million people, Hungary is the smallest but ethnically the most homogeneous of the three countries. It is also the most advanced economically, in large part because it had a significant head start over Poland and the C.S.F.R., having begun to edge toward a market economy in the 1970s. As a consequence, it developed a significant privately held small-business economy long before the others.

Partly for this reason, Hungary's per capita income is the highest among the three priority countries, at around $3,000. (Economic measures such as GNP and unemployment are not accurate for any of these countries, since their statistical systems cannot yet cover the growing private and black economies).

Hungary's inflation is the lowest among the three countries, at about 35 percent annually, and it seems to be holding steady. Unemployment is probably near 10 percent and may increase.

Despite its relatively strong inflation, Hungary's currency the forint, is holding fairly steady. Like the Polish and C.S.F.R. currencies, the forint is linked to a mix of the ECU and the U.S. dollar. (All three currencies are essentially freely convertible for the foreign investor).

The C.S.F.R. The 15 million people of the C.S.F.R. include some 10 million Czechs (inhabitants of Bohemia and Moravia) and some 5 million Slovaks. The two republics differ so fundamentally in history economic structure, and (to a degree) language that a break-up is a real possibility.

The winner in that case will be the Czech Republic, with its larger population, relatively strong industrial base, strong Western orientation, and traditional work ethic. Slovakia, by contrast, suffers from too many outdated industries (it is a big producer of heavy military hardware), relative geographic isolation, and greater political fragmentation.

Per capita income in the C.S.F.R. is about midway between the levels for Hungary and Poland, at around $2,500. Unemployment is just above 10 percent, but much higher in Slovakia than on the Czech side. Chances are that there will be higher unemployment before any improvement occurs.

Inflation was around 60 percent in 1991, but it has been dropping sharply in 1992. As a result, the C.S.F.R. currency the koruna, has held quite steady against both the U.S. dollar and the ECU for nearly two years.

Poland. In area, Poland is only slightly smaller than Germany, and its nearly 40 million people constitute a large consumer market. Poland is potentially a major European economy.

Poland also has a substantial agricultural sector. The relative poverty of its rural areas depresses its per capita income to about $2,000, the lowest of the three countries, but the urban economy and especially the private and black market economies, are flourishing. Poland boasts some of the most dynamic small entrepreneurs of the three Central European countries.

Poland pioneered inflation control with its 1990 „Big Bang," which eliminated hyperinflation almost overnight. Its currency, the zloty has remained relatively stable, with periodic crawling-peg adjustments. Poland's chief problem is its lack of political consensus. For every two Poles, there seem to be three political parties Indeed, about 29 parties are represented in the Sejm (Parliament) and government continuity has not yet been achieved.

Lack of consensus has put new pressures on the state budget as unemployment (estimated at well over 10 percent) increases. In turn, this has caused inflation to increase to about 80 percent, highest of the three countries. Will Poland's political dissonance push the country back toward the bad old times? The possibility cannot be excluded. However, even the casual observer is struck by the entrepreneurial dynamism of a large segment of the population. In our opinion, Poland will turn into a Western-style market economy (at worst with some delay) despite its current political problems. The country has gone too far down the road toward democracy and free market institutions to make a reversal plausible.

Despite their various political and economic difficulties, all three countries have demonstrated their determination to convert from state-run economies to the free-market system. All three are actively pursuing privatization measures. Both the C.S.F.R. and Poland use so-called voucher schemes. These are based on the conviction that ownership of state-owned enterprises should be given to the people, essentially free of charge. The two schemes differ in policy and implementation. Their common problem is that they are as yet untested,

During the next 10 to 12 months, we will see whether they work as intended or lead to speculation, fraud, and disillusionment. Hungary has chosen not to take the voucher route, but to handle the privatization of larger enterprises through direct, case-by-case negotiations.

A Snapshot of Poland, Hungary, and the C.S.F.R.

	Poland	***Hungary***	***C.S.F.R.***
Key Measures, 1992*			
Population (millions)	40	10	16
GDP per capita ($)	2,200	3,700	2,400
GDP growth (%)	0	-2	-3
Debt per capita ($)	1,100	2,200	580
Inflation (%)	35	15	10
Private sector as a % of GNP	50	30	25
Foreign direct investment ($ billions)	2.1	2.5	1.0
Trade balance ($ millions)	+400	+400	+300
Unemployment (%)	13	8	6
Political stability (1 = lowest, 10 = highest)	6	9	7

** A mix of real remits for January through May 1992 and Arthur D. Little forecasts for the rest of the year. Political stability assessment is an Arthur D. Little judgment.*

Sources available upon request.

Importantly none of the privatization schemes are intended to discourage foreign investment. These countries badly need Western capital and technology. And they are well aware of their needs.

Developing a Clear Strategic Rationale. Many investment strategies for Eastern Europe aim to obtain low-cost positions for goods or services to be sold elsewhere, but also in local markets. Low-cost, skilled labor in the East was a major motivation for Siemens' investment in Skoda Pilsen to make railroad and power plant equipment in the C.S.F.R. and for ABB'S investments in Poland and the C.S.F.R. to make power-generation machinery. Low wage and labor costs provide financial scope and time to train the new partners in Western business and management methods. Chances are that a well-managed partnership of this kind can be mutually

beneficial. The aim is to keep increases in productivity well ahead of wage and salary increases.

Another popular strategy is to be the first Western competitor in the market. Experience shows that being the first established brand yields an advantage that can be sustained for many years. For example, Nestle's aggressive investment in confectionery in Hungary, the C.S.F.R., and several other countries is likely to make Nestle a household word in the East as it is in the *West.* Similarly Pepsi's Snack Foods Division managed a coup in Poland when it acquired a controlling interest in the Wedel Chocolate Company, one of the few surviving consumer-recognized brands. Other first-in-market strategies have been executed or attempted by Procter & Gamble, Unilever, Colgate, and United Biscuit.

A third strategic concept involves geographic positioning for access to „megamarkets." The vast markets of the EC and the C.I.S., coupled with a total lack of market saturation in Eastern European countries, have proven irresistible to the automotive industry. The huge Volkswagen investment in Skoda cars in the C.S.F.R., the GM and Fiat investments in both Poland and Hungary, and the Mercedes Truck investments in the C.S.F.R. are good examples of „megamarket" positioning.

A fourth strategy, as yet less common than the others, is technology acquisition. Eastern Europe's advanced technology was developed largely within the system of Academies of Science, which was established during the Soviet era. This system mandated country-by-country technological specialization. Hungary, for instance, was encouraged to conduct research in computer science and electronics. Digital Equipment Corporation established a leading market share in Hungary by acquiring a controlling interest in a Hungarian firm with advanced know-how in software and computer manufacture. Market penetration through technology acquisition requires a lot of homework to identify complementary know-how, strong organizational skills to make it all happen, and patience, but the rewards can be substantial.

Tailoring Entry Methods to the Business and the Strategy. The investing firm's business, and its strategy must shape its method of entry. Until recently most Western companies, acting on instincts honed in Western markets, have sought joint ventures or strategic partnerships in the East, to the exclusion of other entry methods. In most strategic partnerships, the Eastern partner needs a lot of help from the Western investor, usually a mix of financing (critical), access to markets, and new technology. In return, the local partner contributes know-how, experience in other Eastern markets, facilities (often dilapidated), and skilled people.

Our experience suggests that it is tactically advisable for the Western partner to enter such ventures not with a large majority interest, but with a strong minority or bare majority interest. Reserving a large interest for the Eastern partner caters to national pride and softens impressions of a foreign invasion. However, it is essential that the Western company insist on a management contract. There will be follow-on investments that will need to be protected. Further, it is likely that the Western firm will end up with a substantial majority ownership anyway. In some countries, especially Poland, where unions and works councils are strong, it is advisable to provide a minority interest to the workers.

Strategic partnerships require appropriate partners and reasonable cost structures. Lacking one of these elements, there are alternative entry methods – for example, starting a greenfield operation. Such operations are most feasible for businesses such as light manufacturing or service businesses that do not depend on massive fixed assets, the most famous (and successful) example being McDonald's in Russia. In the face of bureaucratic obstacles to – and sometimes outrageous asking prices for – the privatization of existing state properties, greenfield alternatives are increasingly popular. Since labor is readily available in most places and construction is not generally a problem, this option is relatively easy to implement, although it requires a serious organizational effort. In general, greenfield operations encounter fewer bureaucratic delays and require shorter negotiations than do asset acquisitions. One word of caution: In many places, property rights, especially to land, are not yet fully defined. It is therefore critically important to get a clear picture of the nature of your title. Is it, for example, a long-term lease or full ownership?

A second alternative to joint ventures is resource acquisition. This category includes not only natural resources – oil, minerals, and agriculture – but less obvious „knowledge resources" – know-how-intensive businesses such as software development, design engineering, and contract R&D. In our view, acquiring such resources in Hungary, Poland, and the C.S.F.R. is a very promising entry strategy. Several Western firms are currently seeking venture arrangements for software production, especially with Hungary and Poland.

Keeping an Eye on Additional Markets. In the last few years, the only constant in Eastern Europe has been change itself. Chances are good that this „suddenness of the unexpected" will continue for some time. Especially with respect to the C.I.S., it is too soon to think in terms of scenarios, let alone firm forecasts. In terms of potential investments in the currently high-risk countries of Eastern Europe, it is wise to keep in mind three basic criteria: stability, the development of institutions, and relationships with the EC.

Stability concerns the degree of political and economic continuity that can be expected in a given country. In this respect, Slovenia and Bulgaria currently rank high; Serbia and Tajikistan do not.

Institutional development refers to the establishment and growth of privately owned businesses, modern commercial law and property systems, at least the rudiments of independent banking systems, and infrastructure. For example, can you make telephone calls and send faxes? Can you rely on airplane service? Albania may currently rank at the bottom of this list.

Relationships with the EC are fundamental because it is the nearest and largest market and investment source for most of the Eastern countries. In this respect, historical ties may be as important as economic interests. For example, Germany has a strong interest in helping the Baltic States; Slovenia, through the efforts of Austria, Italy, and Germany, will almost certainly be drawn into the Western European orbit in the near future.

Regardless of the targeted country or the chosen entry strategy investors in Eastern Europe will need to hone their negotiating skills.

Negotiating for Success

Entering Eastern European markets is never simple. In our experience, the errors most frequently made by foreign investors occur during the pre-negotiation and negotiation phases.

The most basic pitfall has to do with attitudes. Eastern negotiating partners of all types and on all levels are proud and sensitive. They are keenly aware of their countries' current weaknesses. At the same time, they are highly educated and cultured, and they deeply resent any allusions to Third-World status. Invariably, they have been exposed to varying degrees of Western arrogance. The Eastern European negotiating partner should be treated as an equal.

With mutual respect firmly in place as a starting point, negotiators should observe a number of key principles. Among the most important, in our experience, are:

• Establishing common goals

• Finding out who is in charge

• Timing the purchase offer

• Hedging your bets

• Getting the price right

Establishing Common Goals. Today most partial or total acquisitions of going businesses take the form of auctions. However, it is uncanny how well-informed each bidder seems to be about the prices offered by all others. Hence, factors other than purchase price may well decide the winner. For example, during most of 1990, several Western European companies carried on negotiations with Technoplyn, the dominant Czech producer of industrial gases. But only Linde, a relatively small Western competitor, made efforts to get close to Technoplyn as a company. Linde staff members visited all of Technoplyn's factories, held long talks with technical management, and supplied some critical raw materials when a shortage occurred. When it was time to make a bid, Linde not only offered money but had a technical development plan ready. Although other bidders matched (and even exceeded) Linde's offer, the latter's bid won. Cabot Corporation, a multinational producer of carbon black, used a similar approach to win DESA in the Czech Republic. Eastern company managers and government representatives are vitally interested in the competence of the foreign investor and in its plans for the company it will control. The best way to demonstrate one's intentions is to do as Linde and Cabot did.

In the process of getting to know the future partner, it is useful to begin plotting a common future. At this writing, as reported in *Business Eastern Europe*, several Western firms, including Daimler-Benz, DAF, and Renault, are negotiating the purchase of a 63 percent interest in Ikarus, the leading Hungarian bus producer. Ikarus has a strong ambition to get a foothold in Western markets. Daimler-Benz views Ikarus as specializing in the East. For lack of a compromise – on strategy, not price – Daimler appears to have lost the deal.

Finding Out Who Is in Charge. Most negotiations for acquisitions or joint ventures involve three or four parties, including the management of the potential partner. A second party may be the employee council, especially in Polish companies. Then there are the ministries of privatization (in Hungary, the State Property Agency) and ministries of industry. It is frequently impossible to know who (if anyone) is the main decision-maker.

For example, a U.S. beverage company had been negotiating the acquisition of a subsidiary of an Eastern European fruit-juice producer. After months of discussions, the deal had gone nowhere. The U.S. firm was unaware that the employee council of the potential partner had a strong influence on the choice of the new owner. The employee council wanted a plan ensuring an orderly press of productivity improvement linked to relative job security. However, no one communicated this desire to the potential buyer, and the Eastern firm let negotiations collapse.

In another case, the Polish Privatization Ministry was eager to find a Western partner for a producer of engine components, a firm with good technology and a strong balance sheet. The management, however, did not particularly want the firm to be sold or to have new bosses. They were able to resist pressures to sell out, despite attractive offers by Western companies.

Frequently, foreign investors negotiate primarily with the management of the potential partner. Recognizing that one of the foreign firms not only will win the deal, but will be the new „bosses," existing managers often must act as both chief negotiators and future subordinates. The Ministries of Privatization and of Industry recognize the conflict but are often unable to intervene effectively for lack of qualified staff. As a consequence, they sometimes hesitate to approve any deal or waffle between competing offers.

In this situation, the foreign investor should stay in touch with all parties to the transaction and keep them informed. We have found it very helpful to develop career plans for existing managers early in the negotiating process. If appropriate, the plan should be communicated to them. If current managers are considered incompetent, the potential buyer should avoid discussing the management issue, while focusing the negotiations on the other power bases.

Above all, the investor needs to learn how to live with uncertainty. In many cases, it is hard to know how long the negotiations will last, how much power the various parties to the process have, or even how final a decision is. Most Western companies know how to deal with uncertainties in their own environments. For example, U.S. pharmaceutical companies have learned how to live with Food and Drug Administration (FDA) approval processes, because they understand the rules and risks of the game. However, in Eastern Europe the rules and risks are not only ill-understood by foreign investors, but subject to frequent change. Even so, such varied companies as Air France, IKEA, McDonald's, Philip Morris, Philips, Reemtsma, Sara Lee/Douwe Egberts, and U.S. West are negotiating and succeeding.

Timing the Purchase Offer. As we have seen, negotiations can be complex and protracted. The foreign investor, through its own acquisition team and outside advisers, must stay in close, frequent touch with many parties. In this process, one of the most critical judgments is when to disclose the final offer.

In almost all situations where several foreign bidders are involved, the investor should assume that very little information is kept confidential. Organizations in Central and Eastern European countries are highly leaky. We have seen a great many instances of virtually identical financial bids. If at all possible, therefore, the final offer should be submitted only when all other parts of the negotiating strategy are in place.

In some situations, the investor may wish to delay the offer for other reasons. For example, a relatively modern foundry was to be privatized through a trade sale to foreign investors. It was known that the company was well equipped and had access to some Western markets. Due to a prolonged liquidity crisis in its country (no one was paying any bills), the foundry was running out of cash. Determining the point at which the foundry could be acquired cheaply – but still functioning – required careful judgment.

Hedging Your Bets. There are at least two ways investors may want to hedge their bets. One of these is to develop alternatives and target more than one opportunity, usually in different countries. This means pursuing two targets roughly in parallel. The other is to side-step environmental or other unwanted liabilities.

Dual-track negotiations require more manpower on the part of the investor, but they may save considerable time. For example, one of the horror stories of failed negotiations concerns a Hungarian toiletries company Caola. When Caola began negotiating with a serious Western partner, it had about a 75 percent market share. Due largely to bureaucratic delays, negotiations dragged on for nearly 15 months, during which time Caola's market share dropped to 15 percent because foreign competition had invaded its home turf. The Western firm terminated discussions.

While the loss of the deal was no doubt disappointing, the loss of 15 months' time was even more serious. Therefore, if the investor can mount the effort, and if it can find more than one attractive target, a two-track strategy is a good hedge against lost time.

The second type of hedging is rooted in environmental liabilities that are often potentially large but unpredictable. For example, a Czech chemical company manufactures a large assortment of synthetic resins. The company has operated on the same site for 135 years. Several foreign partners were interested in joint-venturing, but feared the potential liabilities inherent in the history of the site. The solution was a 50-50 marketing joint venture. The foreign partner contributed the working capital and the Czech firm its current market position. The new joint venture will have exclusivity in Eastern Europe and will buy and market products from both partners. It will also have technology support from both partners. In the future, the foreign partner could invest in local production.

Sidestepping environmental liabilities while still accessing market opportunities is an important aspect of negotiations in the East due to the enormous neglect of ecological issues during the communist decades.

It is equally prudent to sidestep unwanted social burdens. Many of the larger Eastern European companies own workers' housing, hospitals, recreational facilities, and other assets not directly related to the factory. Large numbers of staff are employed in these ancillary activities. The old communist system encouraged the model of the large enterprise as a social environment. Typically, the value put on the company by the sellers includes the social assets. The sellers would like to leave the burden of disposing of them to the foreign investor. This means the investor not only pays a higher asset value, but also incurs potential costs and labor unrest when the social side is liquidated. To avoid these potentially costly issues, many foreign investors prefer to establish new companies, as Siemens did when it bought a part of Skoda Pilsen. In effect, the new entity is a joint venture between the foreign investor and the desirable parts of the Eastern European company.

Admittedly, this approach leaves the Eastern authorities with the burden of dealing with social infrastructures of former state enterprises. But can the foreign investor really be expected to clean up the remains of the old social system?

Getting the Price Right. In most instances, local authorities use net asset value as the main basis for pricing state enterprises. There are several problems with this approach. First, net asset values are often wildly inaccurate. How does one set a value on obsolete equipment with uncertain purchase dates and maintenance records? Furthermore, the market value of a given business may change during the negotiation period (as we have seen) because of liquidity problems or competitors' moves. Also, many investors are not interested primarily in assets. They are looking for skilled workers, local management, market share, and similar strategic assets. This perspective, although common among investors, is still poorly understood in many Eastern ministries. It is therefore important that the investor know what its main strategic goals are and that it be able to convince potential partners of the benefits of its own strategies to the host country.

The value of benefits, of course, is in the eye of the beholder. Even a deal that offers clear potential for growth in employment, local sourcing, exports, and taxes on profits may hinge primarily or entirely on a high purchase price. For example, an American company wanted to buy a Czech business making electric harnesses for motor vehicles. It was clear to local management and to the investor that the company might not be able to survive on its own. The basic issue was who the real beneficiary of the deal should be; the local company, the government, or the Czech people, who needed to secure a competitive industrial base. Arthur D. Little, as counsel to the government, valued the company on the present value of its future earnings, assuming that it would be bankrupt within five years if left to its own devices. However, although this income valuation of the company was significantly below book value, the government demanded book value.

Go East?

Conditions in many parts of Eastern Europe are unsettled, even chaotic. No one can predict either the direction or speed of developments. This uncertainty suggests the frontier image – the „Wild West" character – of the area.

At the same time, Eastern Europe is the only large industrial area with totally unmet demand. Regional industrial traditions indicate that, given the right catalysts, the population can be motivated to „bootstrap" itself into prosperity.

Western investment can be such a catalyst. The two economic spheres have much to offer each other. For Western companies, forever seeking growth, Eastern Europe may offer the greatest expansion challenge – and opportunity – of all.

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