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PETOFI PRINTING AND PACKAGING II

HUNGARY

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TABLE OF CONTENTS

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In the spring of 1994, Stephen Frater could look back to the last four years with some satisfaction. Under his leadership as Managing Director, the Compagnie Financière Pour L'Europe Centrale S.A. ("COFINEC") was reaping the rewards of the collapse of communism in Eastern Europe by boldly seizing opportunities in the printing and packaging industry. Led by its acquisition from the Hungarian Government of Petofi Printing House in November 1990 -- Hungary's premier printing company -- the investment had been followed up by the purchase of Kner, also a state-owned company and a significant competitor of Petofi in certain market segments. A deal to acquire Krpaco a.s., a Czech printing company, was closed in December 1993. Frater also served as Chairman of the Board of Petofi and Krpaco. Although frustrated by the amount of time that it was taking to negotiate with the Polish government, the acquisition of a large Polish printing house owned by the government was under negotiation. COFINEC was also considering an investment in Romania. From his Vienna office, Frater saw the accomplishments in a personal way.

> I came into this from the perspective of an investment banker, where you do a deal and walk away, and that's it. The biggest thrill I get now is to walk down the shop floor at Petofi or Kner, watching those machines, the size of locomotives, seeing the people taking pride in their jobs. We're really creating something here, creating jobs, creating an industry leader. It's a great feeling, to have this personal commitment to a long-term industrial strategy.

It was, Frater reflected, a long way from the time he had set up an office at the Gellert Hotel in Budapest in 1989, examining a range of attractive investment options, looking for good pickings among the wide array of companies that the Hungarian Government was putting up for sale. At that time, the Compagnie Hongroise Financière S.A. (COHFIN) that he headed for Italian financier Carlo De Benedetti had made investments in a Hungarian porcelain company, Alföld Porcelain Tableware Ltd., and in a Budapest office building. There was no doubt from the beginning, however, that Petofi was the jewel of De Benedetti's crown in the small, but expanding, Hungarian domain. The increasing and even greater potential demand for high quality Western-style printed and packaging materials had been part of Frater's consideration in purchasing Petofi from the beginning. But it quickly became apparent to him and to others in the Benedetti group that a packaging and printing powerhouse was there for the making in Eastern and Central Europe. Frater had energetically seized the initiative. And what started off

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as primarily financial and opportunistic investment quickly evolved into a strategic industrial play. The objective: establish one of the top five European printing and packaging companies and the dominant player in Eastern and Central Europe. The key question facing Frater: how to finance this objective.

Frater knew that financing decisions had played an instrumental role in the success of COFINEC's companies, particularly Petofi which had served as a model for the others. A number of the group's financing was considered ground breaking, such as the 1991 European Bank for Reconstruction and Development (EBRD) loan to Petofi for Deutchmark (DM) 10 million which had been the very first EBRD loan to a private company in Eastern Europe. Once again, however COFINEC faced a critical financing decision. Despite its Eastern European expansion, financing decisions were still being made on an individual company basis, sometimes confusing potential investors or lenders, Frater believed. Although there was some overlap in ownership between the three printing and packaging companies controlled by COFINEC, all three had different shareholders. Potential investor uneasiness with this arrangement was clear to Frater. In theory, these companies were competitors, potentially giving COFINEC theoretical leeway to favor one over the other (and therefore one set of investors to another).

Frater also knew that the capital markets were not particularly enamored with holding company structures. If COFINEC was going to raise the additional capital that it would need in the future for its continued expansion, it would be better off to be perceived as an integrated producer rather than as a financial holding. That would probably require bringing all the individual investors under the COFINEC umbrella. One possible way of accomplishing this was to swap stock in the individual companies (e.g. Petofi, Kner) for COFINEC stock. This idea had already been discussed with some of the investors and had received non-committal but interested responses. Besides, at some point, the original investors would want to be cashed out, probably through a public share offering. Was taking any of these companies public in their respective local stock markets a good strategy?

On the other hand, placing Eastern/Central European-based company on a western stock exchange could be risky. While several Hungarian companies had already gone that route successfully, the recent decline of emerging market stocks had to be considered. And although Frater did not see it as a critical issue, investors might be very uneasy about the election of ex-communist regimes in Poland in 1993 and in Hungary in May 1994. Other political and economic events might force a significant risk premium on Eastern European equities. At any rate, Frater had decided that, at some point, increasing COFINEC's capital base through an equity placement would be necessary. The issue was one of timing and the exact mechanism to implement it. How to raise additional capital for the group was perhaps the most import issue facing COFINEC.

Financial Performance

Thus, by the spring of 1994, much of that had been attained. A Vienna-based holding company, COFINEC, had been organized in May 1992 to replace country-specific investment companies such as COHFIN. Exhibit 1 illustrates administrative structure of the COFINEC group. COFINEC was now among the top ten printing and packaging companies in Western Europe (See Exhibit 2). At Petofi, COFINEC had taken a number of important steps to restructure the company. The general manager at Petofi had been replaced, as had the initial Chief Financial Officer (CFO) brought in by Frater. In fact, the top ranking officers at Petofi were all new, although some had been promoted internally. Three unprofitable subsidiaries had been sold and worker's rolls were trimmed through the divestitures. A number of worker training programs had been put in place to continually increase production quality. Equally important, a $30 million dollar capital investment program had been completed, providing Petofi with state-of-the art equipment and technology. A similar process was undertaken at Kner.

Under COFINEC management, Petofi increased sales considerably in volume and value -- from Hungarian Forints (HUF) 2.6 billion in 1991 to HUF 3.3 billion in 1992 and HUF 4.7 billion in 1993. Sales for 1994 were projected in the HUF 7 billion range (approximately $70 million). Although the pace of growth of the last few years would inevitably have to slow down, significant growth was expected beyond 1994. Despite a large drop in income in 1993 because of extraordinary circumstances (e.g., costs related to the establishment of a marketing arm and a large foreign exchange loss associated with a hard currency loan that was now repaid), the company was profitable and on a sound footing.[1] Income for 1991, 1992, and 1993 was HUF 272 million, HUF 395 million, and HUF 186 million, respectively. Earnings in 1994 were expected to rebound back to the HUF 400 million range ($4 million). Kner's turnaround was especially rewarding. Sales in 1993 increased by over 30 percent to HUF 3.4 billion. After a 1991 loss of approximately HUF 30 million prior to privatization, the company registered net income of HUF 42 million in 1992 and HUF 222 million (approximately $2 million) in 1993. Net income projections for 1994 were HUF 333 million ($3.1 million). Exhibit 3 provides financial highlights for Petofi and Kner. Exhibit 4 presents financial statements for Petofi, Kner, and the COFINEC Group through December 31, 1993.

Background

Economic Reform in Hungary Since 1991

From 1991 to 1994, Hungary's path towards a free market economy was a mosaic of contrasting

[1]Despite the reduction in income, earnings before taxes and interest expenses (EBIT) increased in 1993 to HUF 528 from HUF 431 in 1992. Numbers are not adjusted for inflation. Annual inflation in Hungary was 35% in 1991; 23% in 1992; and 22.5% in 1993.

facts and perceptions. In many ways, Hungary had surpassed its neighbors. Since 1990, the country had attracted over US$7 billion in foreign investment -- by some estimates more than all of the rest of the former Eastern bloc combined, including Russia. During this time, the basic pillars of a market economy had been put in place. By mid-1993 there were approximately 17,000 foreign joint ventures in Hungary. A legal and regulatory framework for business transactions was for the most part established that conformed to European Union (EU) norms. The reforms involved the introduction of international corporate accounting standards, as well as laws on bankruptcy and liquidation procedures to provide financial discipline at the micro level. The Government of Hungary (GOH) had nearly completed the liberalization of product, service, and capital markets, as well as the deregulation of economic activities. By 1992, most consumer and producer prices were free of government intervention (all but about 5 percent), with controls remaining for only a few basic commodities and utilities. On the foreign trade front, Hungary significantly reduced tariffs and import restrictions and shifted the bulk of its trade from the COMECON countries to the EU. In 1991, it signed an association agreement with the EU which provided for the establishment of free trade within ten years.

While Hungary's "gradualist" privatization strategy emphasized identifying strategic investors and generating hard currency revenue over the quicker, mass-scale privatization programs implemented by other countries in the region, privatization was instrumental in increasing private sector participation in the economy. Between 1990 and 1994, the program had generated over US$2 billion in cash sales. Of the approximately 2,000 state-owned enterprises existing in 1990, approximately 500 had been privatized as ongoing enterprises and about 400 had been liquidated (asset sales) as of May 1994. By the end of 1993, the private sector accounted for approximately 55-60 percent of GDP (depending on how the contribution of the informal sector to the economy is weighted).

But there was another side to Hungary's economic transformation. As in other ex-communist countries, the process was considerably more painful than originally expected. Hungary had yet not achieved economic growth in any single year. Since 1989 the economy had declined by over 20 percent. Open unemployment increased from negligible levels in 1989 to nearly 13 percent at the end of 1993 and was unevenly distributed. Budapest's six percent rate contrasted sharply with Miskolc's rate of over 25 percent. In some rural, one-employer villages, the rate approached 80 percent after plant closings. Most importantly, the benefits of reforms had not trickled down to the general population. For the majority of Hungarians, income had dropped over 20 percent since 1991. By 1994 many Hungarians had become disillusioned with the economic transformation process. Polls showed that two out of three were not satisfied with the direction of economic changes and that only 18 percent of Hungarians thought that they are better off than when economic transformation began. The proportion of those believing in a fully free market economy dropped to 33 percent, compared to 43 percent in 1991. In this context, it was not surprising that, as in Poland the year before, the May 1994 general elections resulted in a significant victory for the ex-communist, now Socialist Party. Voters had thrown out the center-right coalition that had ruled Hungary since 1990 and returned a Socialist Party that most people associated not with communism, but rather with less painful reforms and with more efficient management. Significantly, however, the Socialists campaigned on continuing economic reforms, including privatization and more incentives for investment and for entrepreneurs. Still, the size of the Socialist victory (54 percent of the vote compared to 28 percent for its nearest competitor) and their complete gain of control of the Parliament made the business community uneasy.

The Hungarian Printing and Packaging Industry

The printing and packaging industry in Hungary (and in other countries in Eastern Europe) was a classic example of a process that seemed to be taking place throughout the region: the creation of two parallel economies co-existing side by side -- one prosperous and increasingly linked to the West and one stagnant, linked only to a past that had nearly disappeared. The industry experienced a major decline in the traditional sectors such as carton board packaging. Between 1989 and 1990, annual consumption of paper and carton board on a per capita basis fell to 28.39 kilograms (Kg.) from 32.45 Kg. Production statistics for folding cartons, published by the Hungarian Printers' Trade Association, show 24,686 tons in 1990, 21,646 tons in 1991, and 18,975 in 1992. Other industry segments also declined.

At the same time, however, significant investments by U.S. and European companies in the consumer goods sector and increasing consumer interest and demand for quality packaged goods fueled demand for high quality packaging materials, creating a boom for companies that could meet the high quality expectations of the multinationals. In effect, the industry had changed from one that was production-led to one that was customer-oriented. Despite the traditionally cyclical nature of the industry in most countries, since 1990 the high value added segment of the industry experienced significant growth. The outlook for the high value added segment of the industry was undoubtedly bright. For example, demand by multinationals in the flip-top carton segment had increased ten-fold between 1992 to 1993, with another ten-fold increase expected by 1995.

The Growth of Petofi and COFINEC

From Opportunistic to Strategic Investor

Although the attractiveness of the printing and package industry in Eastern Europe had been clear to Frater and the Benedetti group from the time that the acquisition of Petofi was first considered, its real potential soon became apparent. The original decision to purchase Petofi from the government had been backed by an analysis of the Spanish and Portuguese industries before and after joining the EC. Frater had been encouraged by the consultants' conclusion that the same 50 percent growth in high value added printing and market segments that had occurred in those countries was likely to occur in Eastern Europe. Indeed, per capita consumption for these segments had increased significantly and was likely to continue to increase in the future. Domestic demand was expected to grow even more when the recession ended. The integration of Hungarian food and consumer goods companies into Western multinationals companies, by joint venture and direct foreign investment, was likely to continue to provide additional opportunities for Hungarian companies to compete for pan-European supplier relationships. New product segments such as high quality printing on micro corrugated cartons and multi-layer packaging materials, represented significant opportunities for growth. Finally, the GOH offered numerous attractive incentives in manufacturing and sectors that it considered strategic for economic transformation. Foreign investment was accorded a 100 percent corporate tax holiday for five years, until 1995.[2] In addition, the printing and packaging industry was granted an additional five-year tax benefit of 60 percent until the year 2000.

Whether searching for opportunistic investments, and especially after evolution to strategic investors, an operating tenet of COHFIN and later COFINEC was to retain management control of any company in which they invested. This philosophy would be an important consideration in COFINEC's financing decisions. As Frater noted:

> One of the things that differentiated our group from the beginning was that, even when our strategy focused on 'opportunistic investments,' we still wanted to make sure that we had complete management control. A lot of people came to Eastern Europe dropping a million here and a million there, hoping that someone else would make money for them. We didn't believe that Eastern Europe was a place for that. We were determined to control our destiny.

Responding to Market Trends: Market Strategy, Organization and Operations

Petofi's strategy was focused on securing a customer base of large, multinational clients that were investing in Eastern Europe. COHFIN moved quickly to attract new international clients including Olivetti and Valeo (from the De Benedetti Group), as well as Mars Chocolates, Sara Lee, Henkel, Neckermann, McDonalds, General Electric (Tungsram), Philip Morris (Marlboro cigarettes), R.J. Reynolds (Camel cigarettes), Seita (Gauloises cigarettes), and Shell Oil. It was these multinationals who demanded the profitable, high value added segments of the market (which no other Eastern European firm could readily meet). Accordingly, equipment purchases and the company's organization was geared to supporting the customer-driven strategy.

On the operational front, Petofi had been divided into three divisions prior to privatization: (1) books, newspapers, and traditional labels; (2) flexible packaging and adhesive labels; and (3) folded carton products (see Exhibit 5 of the 1991 Petofi Case Study). In 1992, however,

[2] The tax rate for most Hungarian companies is approximately 40 percent.

8

operations were restructured along five different divisions which better reflected Petofi's business and the market place. Run by independent group managers as separate profit centers, the divisions were, in rough order of priority for Petofi: (1) folding cartons -- made from carton board and used for consumer retail packaging; (2) flexible wall packaging -- polymer and aluminum-based, used primarily in the food industry including coffee, chocolate, candy, pastas, ice cream, and margarine; (3) self-adhesive labels -- paper and plastic-based and used mainly in the cosmetics and pharmaceutical industries for labeling cartons; (4) conventional labeling -- used mainly in the brewing and tobacco industries for labeling cartons; and (5) non-packaging goods -- books, magazines, and newspapers.

Accounting for roughly 46 percent of sales in 1992 and with a 50 percent market share in Hungary, folding cartons was clearly Petofi's priority business. Folding cartons was also a key area for multinational consumer goods companies and therefore an integral part of the multinational-oriented strategy. Similarly, foreign investment in the food processing sector was increasing demand for flexible wall packaging. Petofi's market share for this product was 14 percent and there was potential for significant expansion. The remaining three divisions were perhaps relatively less attractive over the long term, but with considerable market share (a leading position with nearly a third of the domestic market for the conventional and self-adhesive labels and 13 percent for non-packaging goods), the divisions had high margins, were profitable, and increasing their sales. In the case of non-packaging goods, the company briefly considered closing down the division until an attractive equipment leasing agreement was reached with the German Axel Springer group, thus saving the jobs of approximately 100 workers without ignoring profitability. Exhibit 6 provides additional information on Petofi's product groups.

By 1993, Petofi had achieved its strategic objective of having a predominant multinational client base. Multinationals accounted for 66-75 percent of all sectors. Enhanced quality was the key to this effort. In 1992 and 1993, Petofi was awarded the highly coveted Eurostar Award, as well as the Worldstar Award by the Paris-based World Packaging Organization for the group of packages manufactured for General Electric-Tungsram. In 1993 Petofi also received the ISO 9002 standard for quality packaging. While the company originally had over a thousand customers, the top ten customers in all sectors now accounted for roughly 70 percent of sales. Strategically, this was an important accomplishment: a more concentrated customer-based resulted in longer production runs, thereby reducing operating costs.

The Search For Post-Privatization Capital

After making the decision in November 1990 to purchase 50 percent of Petofi Printing House from the State Property Agency (SPA), Frater had brought in the Hungarian-American Enterprise Fund, the First Hungary Fund and the Hungarian Investment Co. Ltd. as long-term institutional investors to buy the remaining government interest in Petofi. He knew that he had to move quickly to establish Petofi in what would be an increasingly competitive environment. Beyond the managerial and operational changes that would be required, obtaining the capital to finance a $15-30 million program for a major expansion of Petofi's machinery was imperative. This included modern equipment to enhance its capacity and quality in promising segments such as folding cartons (which already accounted for nearly half of sales in 1991 and where Petofi held a fifty percent Hungarian market share) and flexible wall packaging. Only a small part of this amount could be internally generated. Accordingly, Frater knew that the capital markets would be instrumental for the company's growth. Indeed, for the next two years an active financing policy linked to its strategic objectives would be a major characteristic of Petofi's development.

Enter the EBRD

In 1991, the recently operational EBRD was under some pressure to move funds and was actively scouting for clients among the small but growing number of Eastern and Central European firms. The London-based financial institution had been established the year before by its members (primarily the G-7 countries) to give a jump start to the economies of the former Eastern bloc. Although its mandate was to support private enterprise, bankable firms that provided a reasonable credit risk were hard to identify in the region. At the same time, Frater saw very limited options to finance the necessary capital equipment program for Petofi. Significant capital from COHFIN was not available. Hungarian banks were charging interest rates that exceeded 30 percent. And Western financial institutions had expressed little interest in lending to Eastern European upstarts. In sum, the coming together of the two organizations with negotiations that began in the summer of 1991 was an ideal match for both. Petofi was in a position to assume long-term credit which was not available elsewhere. EBRD recognized the packaging industry as a priority sector, and Petofi's international ownership structure and competent management made the company an excellent choice to initiate its private sector loan portfolio.

A DM10 million, five-year loan at Libor plus two percentage points interest rate was executed in November 1991. It was the first loan provided by the EBRD to a private firm. This was the first of several ground breaking financings for Petofi. Of course, there was a foreign exchange risk in taking a DM loan (particularly for a company whose revenues were essentially in Hungarian Forints). Still, management reasoned, it was a gamble worth taking. Hungary's exceptionally strong current and capital surpluses in 1991, together with the GOH's stated commitment to reduce the deficit and curtail inflation, pointed to a relatively strong Forint in the future. The hard currency rate made the loan very attractive compared to Hungarian corporate lending rates which were at the time in the high 20s. Besides, as Frater would reflect later, the truth was that Petofi had little choice. Term financing was simply not available from other sources.

Raising Additional Equity

By early 1992 Petofi was required to raise additional equity capital for the modernization program. The EBRD loan represented only part of Petofi's planned capital expenditures. A private equity placement was arranged through Morgan Stanley International, raising $8 million, primarily from the original institutional investors, although it also brought in a small participation from Baring's Chrysalis Fund and Baring Global Emerging Markets Fund, as well as the Morgan Stanley Group. Petofi's ownership structure after the placement is illustrated in Exhibit 5. In addition to providing the required capital, this was one of the first private placements for a Hungarian firm in London, increasing COFINEC's exposure in the capital markets.

Changing the Corporate Culture

COFINEC undertook numerous measures to improve managerial performance and change Petofi's culture. Management considered it essential that workers understand that there was now real ownership for whom they must perform and on whom they depended -- a simple concept, yet one that was not clearly understood when Petofi was a state-owned enterprise. At the same time, the workers received approximately five percent of voting shares (and nearly seven percent of preferred shares) under an employee stock ownership program to make workers feel that they had a real stake in the company. Management also initiated a number of training programs. More importantly, both blue collar and white collar workers were made to understand that they were no longer responsible for production quotas but to customer demands. As Monika Keszei, Petofi's Hungarian-American Chief Financial Officer (since January 1993) emphasized this point:

> If GE Tungsram is implementing a new On Time Delivery Inventory System, you had better gear up to provide their products when they need them and not when it fits your own production schedule. That was one of the things that people here had to adapt to.

In addition to the modernization of its plant and equipment, instilling among the work force the ability to respond to customer interests and demands was perhaps the most important contribution of the new management.

Petofi's existing staff was technically competent, and management took pride in the fact that it was not been forced to lay off any workers since privatization. The company's General Manager was replaced, its six satellite plants spun off into independent companies.[3] That management had the luxury of being able to avoid layoffs undoubtedly eased the implementation of the new corporate culture. In addition to the employee stock ownership program, Petofi management rewarded employees with one of the highest industrial salaries in Hungary. Moreover, some of

[3] The number of employees was reduced by over 300 as a result of the spin offs.

11

the new equipment helped facilitate the more difficult manual tasks of blue collar workers (especially women). According to a number of observers, Petofi was not only the premier employer in Kecskemét, it was one of the better industrial employers in Hungary.

Enhancing Technology: Gearing Up for High Quality, Low Cost Production

The funds raised through the EBRD November 1991 loan and the May 1992 private equity placement permitted Petofi to implement its $30 million capital investment program. Equipment purchases supported the high value added lines, permitting Petofi to develop a world class printing and packaging facility at Kecskemét. Investments were made in the folding box sector (gluing, printing, and diecutting machines). Capacity was increased by 50 percent from 10,000 tons to 15,000 tons per year. By 1993 the equipment was running at full capacity. Primarily to supply growing foreign investment in the Eastern European cigarette business, a top of the line Bobst-Lemanic production line was installed at a cost of approximately $7.5 million. In addition, state-of-the-art Asitrade microcorrugated board production line was put into operation in late 1992, significantly increasing the quality of carton packaging. Capacity of flexible packaging material production was doubled by 1993 with the addition of a W+H Starflex flexographic printer and a Kroenert solvent-free laminator. Both these machines permitted penetration into the rapidly growing, high value added thin-foil market segment. No major investments were made for the labeling and non-packaging divisions, although low-cost investments were made in both to increase productivity and expand production. Rapid growth was anticipated in both.

Petofi now had what it believed no other printing and packaging company in the region could match: western quality and eastern cost advantages.

Purchasing Kner: Strategic Expansion in Hungary

The decision to purchase Kner Rt. in May 1992 from the GOH, Frater would reflect on later, was one that evolved out of strategic necessity. COFINEC purchased 51 percent of the shares of Kner Rt., together with Petofi investor Hungarian Investment Company Limited which purchased 26 percent of the shares (followed, as in Petofi, by a 10 percent stock contribution to the management and employees). Kner and Petofi had been strong competitors across many product segments. Kner competed directly with Petofi in certain product lines, including folding cartons (where it had a 29 percent market share, compared to 50 percent for Petofi). But there were also important differences that raised the potential synergy between the two companies. For example, about half of Kner's carton output was dedicated to higher value added pharmaceutical packaging, where it was the market leader, as well as high quality and finishing grade with a high proportion of lacquered, metal foiled and embossed products. In 1992 Kner was the market leader in the traditional labels segment, with a 40 percent market share. It was also an important producer in the flexible packaging area with roughly a 10-15 percent market share. Kner's production was geared toward short and medium product runs of high quality and product complexity. Petofi, on the other hand, was most effective at producing larger orders of relatively lesser quality. Kner's non-packaging production included book printing, where the Kner name was synonymous with the most beautiful books in Hungary. In 1992, it had assets of approximately $10 million dollars. Ownership of both companies by the group would also increase the efficiency of both plants by permitting specialized production.

Kner had in fact been one of the many firms that COHFIN, COFINEC's predecessor, had considered at the time that it was looking for opportunistic investments in the GOH's privatization program. For COFINEC, the decision to go after Kner was not a complicated one. A merger of the two companies would provide significant market share in Hungary.[4] But it was not just an offensive play. Frater realized that if a major Western European competitor were to purchase Kner (and most of them had expressed some interest in the company), Petofi's strategic position would be seriously challenged. Petofi was particularly vulnerable since it obtained most of its supplies precisely from these competitors. An aggressive, vertically integrated competitor willing to use creative transfer pricing to provide Kner with cheap raw materials would prove to be a dangerous competitor. As Frater noted, "This is a pretty simple business. Seventy percent of costs are raw materials. You don't have to be a financial or strategic genius to realize that the business is about how efficiently you transform that 70 percent of costs into a finished product."

To raise capital for the planned modernization of Kner, COFINEC returned to the EBRD. The Bank provided a DM 10 million loan on terms similar to the Petofi loan. In addition, the EBRD took a 20 percent equity stake in Kner with HUF 270 million (approximately $3 million). The funds received from the capital increase went to the modernization of the prepress and the gravure facility for the production of flexible packaging materials and to remediating environmental problems.

The EBRD Exits: Financial Restructuring

Though Stephen Frater recognized that the EBRD had played a critical role in providing term capital to both Petofi and Kner when few options existed, by the end of 1992 the costs of dealing with a lender of last resort were becoming clearer. Two fundamental problems existed with the loan. First, the steady, unforeseen devaluation of the Hungarian Forint made the loan increasingly costly. In 1992, the National Bank of Hungary devalued the Forint five percent against the Deutchmark. In the first six months of 1993, three devaluations decreased the value of the Forint by nearly seven percent. By late 1992, the Libor plus two rate on the DM issue

[4] COFINEC's Hungarian market share after the purchase was an issue to which the GOH was sensitive. See Case Notes.

13

raised the effective Forint rate to well over 30 percent. "We were simply getting eaten alive on the exchange rate," recalled Frater. Besides the interest rate costs, there was an additional high price for the EBRD loan: strict management oversight. Being the first EBRD loan to a private company, the bank insisted on numerous loan covenants to guard its investment. In addition to standard financial covenants relating to restrictions on the issuance of dividends and taking additional debt, the EBRD insisted approval of numerous management decisions. As Frater told the Emerging Markets EBRD Daily in April 1994:

> My view was the [EBRD's] covenants were so Draconian that if they chose to, they could interpret you as being in technical default the day after you signed an agreement with them. You give them rights which you would not give any other lender, extensive rights which control the ability of management to take steps to handle common situations.

The point was seconded by Monika Keszei, Petofi's CEO: "I understand the need for [the EBRD] to try to minimize risks. But this is a fast pace business in a very competitive environment where you have to react fast to customers. You have to make quick decisions." Adds Keszei, "That's *exactly* what management is for, to make those decisions." Growing frustrations with the need for EBRD to take decisions to its Board strained relations between the organizations. COFINEC wanted out of its EBRD loans.

Debt or Equity?

By the beginning of 1993, Petofi had accomplished a major strategic objective: it had a proven production and financing record which would permit it to access local and international capital markets. A financing to replace the EBRD loan and provide additional capital was necessary. The critical question was whether to issue additional equity or to leverage the company and issue less expensive debt -- and if debt was issued, what kind of instrument should be issued. COFINEC also was concerned about the financing decision's affect on its management control and the strength of its current stockholders' equity position.

COFINEC management engaged investment bankers Credit Suisse First Boston (CSFB) to review financial alternatives. Looking first at a possible listing on the Budapest Stock Exchange (BSE), CSFB delivered a clear message: a successful listing on the BSE would require company valuation based on no more than three to four times earnings -- the average multiple of successful BSE listings. However, while P/E rations remained low on the BSE, exchanges in Prague and Warsaw were soaring. (Exhibit 7 provides information on regional stock markets.) Still, Frater, CFO Keszei, and the minority investors agreed that the timing for a public stock offering was not right. They expected turnover to grow at over 50 percent per year for the next several years and thus considered the company worth much more than what a public offering would provide. Besides, further leverage through a $10-11 million debt issuance would leave Petofi with a debt-

14

to-equity ration of 50 percent, still relatively healthy for a growing company.

An innovative, breakthrough financing: The "Dividend" Bond

The growth of the Hungarian commercial debt market since 1991, together with the generous tax advantages granted by the GOH to privatized companies and companies in selected industries, had, by 1993, helped promote opportunities for constructive financial engineering that had previously not existed. Petofi's five-year, HUF 135 million (approximately $11 million), 17 percent "dividend" bond issued in May 1993 was among the most innovative issuances in the Hungarian market, and a precedent setter for other companies (including Kner later that year).

Called redeemable preference shares by some or "income notes" by others in Budapest's financial community, the bond engineered by CSFB and Petofi management was highlighted as "Petofi's Hungarian tax arbitrage" by a leading Eastern and Central European finance journal.[5] On the surface, the securities resembled the HUF denominated bonds that had been issued by McDonald's, Levi Strauss, and other multinationals in Hungary in the previous two years. But rather than pay regular interest coupon payments, the securities paid interest to investors in *after-tax* earnings.[6] Given Petofi's five-year tax holiday (and a 60 percent tax holiday after that), holders of the bonds would receive these payments on a tax free basis (dividend earnings are not taxed in Hungary). Accordingly, the bond could be issued for a lower interest rate and still be competitive with the higher taxable yields of other commercial bonds.[7] In other words, the bond combined Petofi's own tax free status with the tax-free status of "dividend" payments to the bonds holders to save Petofi over $500,000 from a conventional loan. Perhaps more important, by using part of the proceeds to replace the EBRD loan and using local currency financing, Petofi saved hundreds of thousands of dollars over the life of the EBRD loan. Although the cost of the bond would rise after Petofi begins paying some taxes in 1995 (since it could not use the debt to reduce it's taxable income), the bond represented a significant savings for Petofi.

On July 1993, four months after signing the Kner equity and debt deal with the EBRD in February 1993, COFINEC repaid the Petofi loan in full (principal payments had not been scheduled to start until July 1993), taking a foreign exchange loss of approximately $350,000 in the process. In November of 1993, ten months later, a similar dividend bond was issued for

[5] *Central European*, September 1993.

[6] In the event of insufficient yearly profit to pay the required interest payment, Petofi must pay bondholders from retained earnings. In the event that these are insufficient, bondholders can recur to the repayment of principal in full. The notes are essentially unsecured *pari-passu* debt treated at the same level on the balance sheet as any other senior debt, except for secured credits. The bonds also contained call and put options in years three and five.

[7] Petofi would have had to pay approximately 21.25 percent interest for a conventional taxable bond.

Kner. As had been the case with Petofi, on December 1993 the debt portion of the Kner deal with the EBRD was also repaid in full. Senior EBRD staff expressed public satisfaction with Petofi and Kner's "graduation" to the private capital markets

Providing Income to Shareholders: a Buy-Back of Shares

In addition to repaying the EBRD loan, approximately $5 million of the dividend bond's proceeds were used to repurchase 11.6 percent of shares from the existing shareholders.[8] For Frater, the share buy-back was an innovative way to repay shareholders for their support, to get some of their money back and to effectively place excess cash from the bond issue. Nonetheless, Frater's enthusiasm was not shared in full by some of the minority stockholders. As long-term investors, they preferred to see the cash kept in the company to finance the company's expanding need for working capital, given its significant growth. "It made no sense when the company clearly had major needs for working capital," noted a representative of one of the minority investors. "But COFINEC wanted the cash, and their interests were put ahead of Petofi's. That's normal, I suppose. They've done a lot of very good things, and I guess that it's something you have to accept if you're a minority investor, with little control." At any rate, the company did experience working capital difficulties in 1993. Like many companies experiencing significant growth without a large cash surplus, it had to incur expensive short-term financing which hurt it's bottom line in 1993.

Expansion in Eastern Europe: A Breakthrough in the Czech Republic, Negotiations in Poland, Possibilities in Romania

Frater's decision to expand into the rest of Eastern Europe, like the decision to purchase Kner, was not part of a grand initial strategic plan, but rather was part of COFINEC's evolutionary strategy. Having done its best to secure the Hungarian market, it was a natural progression to look for other opportunities in the region. Strategically, there was another issue. As Frater commented:

> Strategically we were in good shape in Hungary. But you have to take one of two approaches. You can decide you're going to be the top guy in a little country like Hungary, or you can decide to build sufficient scale to compete with the big guys across a wider spectrum. The problem with the first approach is that you're always exposed to the companies who have sufficient economies of scale to compete, specially if they move into Eastern Europe and they neutralize your advantages. We decided that we had to keep moving in one direction and take

[8] Under Hungarian law, the treasury shares have to be reissued within three years or they have to recorded as an investment.

> the second approach. We couldn't really build more capacity in Hungary. We had to go elsewhere.

After extensive negotiations, Frater finally struck a deal on December 1993 to purchase 50 percent of Krpaco a.s., a folding carton subsidiary of Krkonosske Papirny, a.s. a large paper group in Eastern Bohemia which had been privatized through the Czech Republic's coupon privatization program in September 1992. Discussions were underway for a debt/equity financing facility to permit a doubling of Krpaco's capacity, and a doubling of sales of folding cartons from $8 million to $16 million. Krpaco, which essentially produces just one line of product, would also serve as a marketing vehicle for the flexible packaging products of Kner and Petofi, enabling Krpaco to approach multinational customers in the Czech market with a wider assortment of products.

In Poland, negotiations with the government were painfully slow due to the cumbersome privatization program, but Frater was continuing his efforts for a breakthrough. At any rate, whether through the privatization program or a greenfield investment, an Eastern European strategy required a presence in the large Polish market. "Somehow, we'll have a deal in Poland in 1994," vowed Frater. COFINEC was also actively looking for expansion in other countries such as Romania where trading relationships were evolving into potential investments. For Frater, the important thing is that COFINEC would have wide Eastern European coverage and continue it's objective of being a "one-stop" shop to service the printing and packaging needs of multinationals in the region.

A Decision on Future Financings

The evolution of COFINEC's investments in Eastern Europe reflected the Group's ability to make the most of perceived opportunities. As Frater noted:

> We responded to opportunities and to what had to be done to get to the next step and to take full advantages of those opportunities. The tax breaks and other incentives that are provided in Eastern Europe, those things are short term in nature and will soon be gone. You don't build a business based on them. It's what you *do* with those opportunities, however, that will make you or break you.

Frater and COFINEC had done a lot to take advantage of those opportunities. The Central European Economic Review had recently informed him that it would name him business person of the quarter in its summer issue. But like any good businessperson in a competitive environment, he knew that COFINEC could ill-afford to stand still. The high margins in the region were increasingly attracting heavyweight competition. Westvaco, the packager of Marlboro cigarettes in the U.S., had recently announced plans to build a state-of-the-art plant in the Czech Republic. Krpaco would require additional capital. So would the planned Polish venture and Romania. Financing was once again critical.

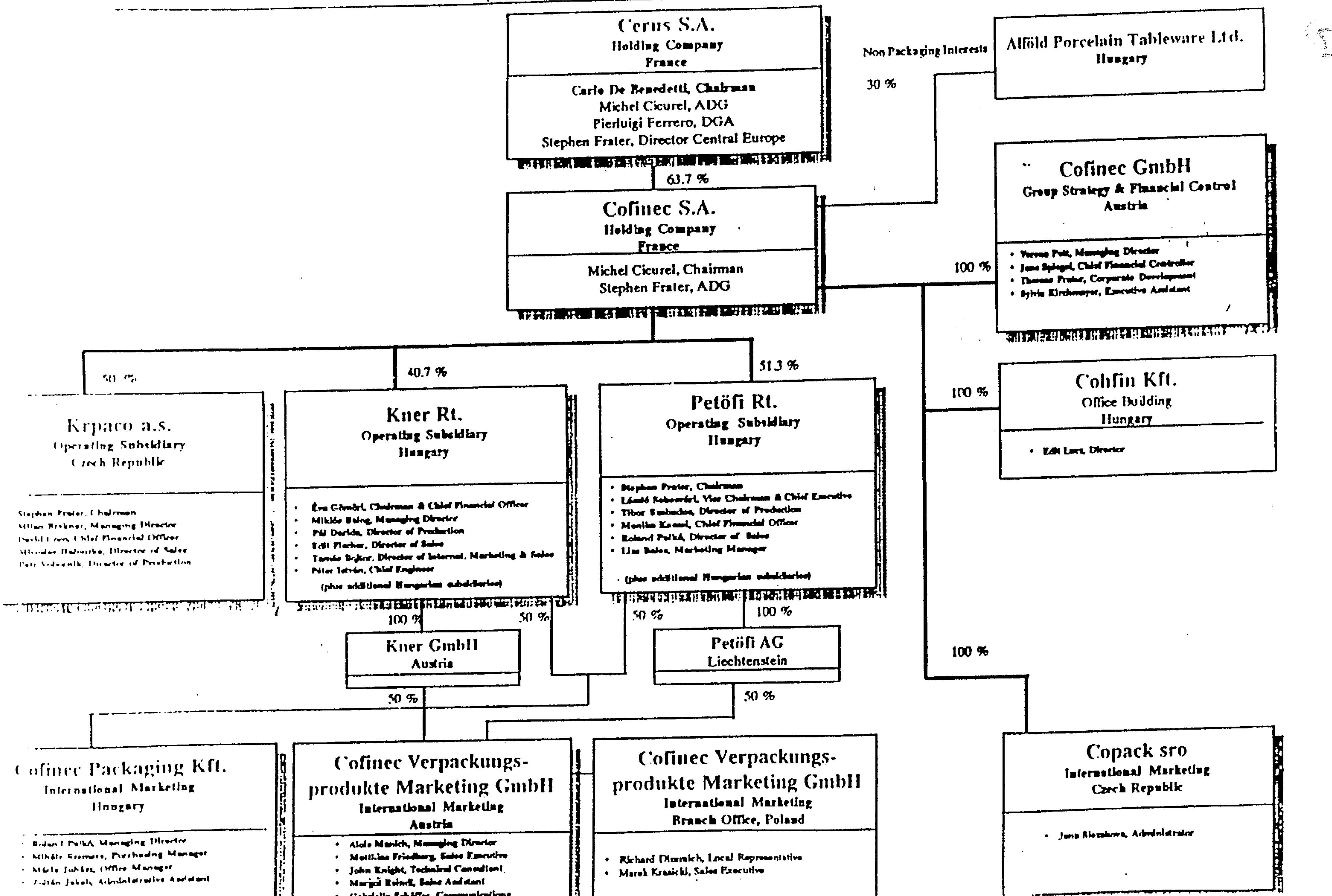
Frater concluded that COFINEC, and not the individual companies, should be the vehicle through which funds should be channeled, including new equity. The real issue was one of timing and the specific mechanism to be used. Given the existence of country-specific funds that could only invest in individual countries (e.g., the Hungarian-American Enterprise Fund) would it make sense to raise company-specific equity in the new ventures such as in Poland? That might be a more appealing vehicle over the short term, but would it complicate things later?

If capital was raised directly for COFINEC, would it make more sense to do a private equity placement first, before taking the company public? For all its success, Petofi still did not provide returns to investors substantially above its weighted average cost of capital. Strategic investors understood the need for a long-term perspective. Would that be the case for investors participating in a public offering? There was another consideration. COFINEC's shift from an opportunistic to a strategic investor had been facilitated by the fact that the first two companies it acquired were relatively sound. This might not be the case in future ventures where major restructuring might be required. Would this be taken into consideration by investors in a public offering? Frater knew that while a lot had been accomplished, a lot was also riding on the decisions of how to finance future expansion.

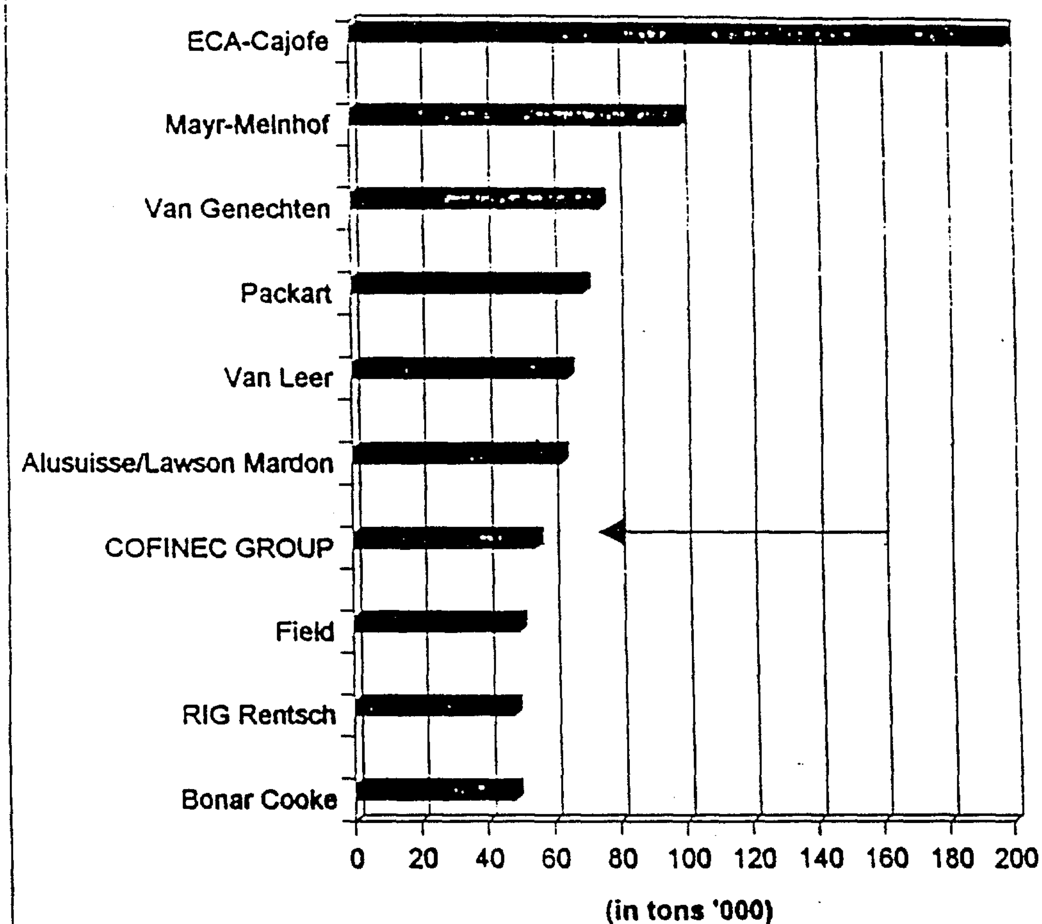
EXHIBIT 1

4/27/94, 10:30 AM

COFINEC GROUP



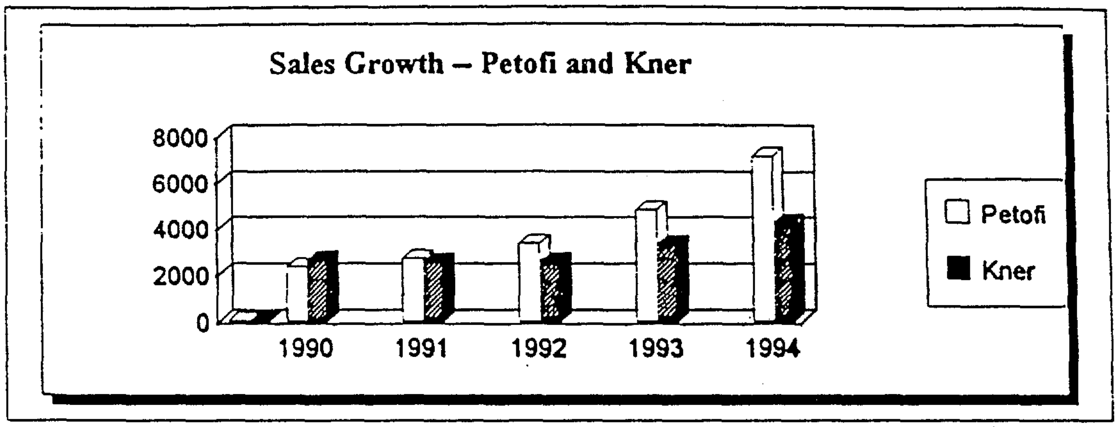
Ten Largest European Folding Carton Producers

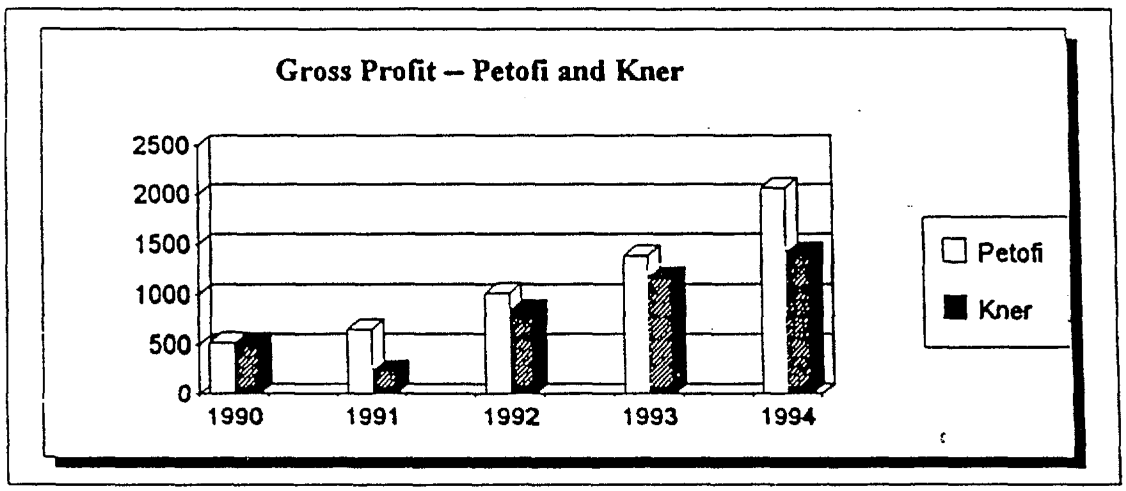


Source: COFINEC management

SUMMARY OF OPERATIONAL PERFORMANCE
Petofi and Kner

	1990	1991	1992	1993	1994 (proj.)
Petofi Total Sales	2,304	2,667	3,333	4,793	7,132
Gross Margin	23%	24%	28%	29%	29%
Kner Total Sales	2,608	2,537	2,563	3,390	4,234
Gross Margin	20%	10%	14%	30%	34%





Source: COFINEC management

Figures in HUF Million

PETOFI PRINTING AND PACKAGING, R.T.

CONSOLIDATED BALANCE SHEET AS OF 31 DECEMBER 1993
(Before appropriation of results)

(In HUF '000)	31-Dec-93	31-Dec-92
Inventories	440,000	346,000
Trade receivables	828,000	486,000
Other receivables	141,000	81,000
Marketable securities	392,000	-
Cash and banks	200,000	556,000
Total Current Assets	**2,001,000**	**1,469,000**
Intangible assets	31,000	-
Tangible assets	3,307,000	2,481,000
Financial assets	39,000	31,000
Total fixed assets	**3,377,000**	**2,512,000**
TOTAL ASSETS	**5,378,000**	**3,981,000**
Current maturities of long term debt	94,000	129,000
Trade accounts payables	579,000	432,000
Other short term liabilities	376,000	123,000
Bank loans and overdrafts	-	160,000
Total current liabilities	**1,049,000**	**844,000**
Minority interests	129,000	70,000
Long term debt	1,535,000	584,000
Other long-term liabilities	16,000	16,000
Total minority interest and LT debt	**1,680,000**	**670,000**
Share capital	1,683,000	1,683,000
Paid-in capital and retained earnings	780,000	784,000
Translation adjustments	-	-
Net income for the year	186,000	-
Total shareholders' equity	**2,649,000**	**2,467,000**
TOTAL EQUITY AND LIABILITIES	**5,378,000**	**3,981,000**

Source: 1993, Petofi management; 1992, CSFB bond offering

PETOFI PRINTING AND PACKAGING, R.T.

CONSOLIDATED STATEMENT OF INCOME AS OF DECEMBER 1993

(Before appropriation of results)

(In HUF '000)	31-Dec-93	31-Dec-92
Net sales	4,793,000	3,333,000
Cost of sales	-3,406,000	-2,385,000
Gross margin	**1,387,000**	**948,000**
Operating expenses	-952,000	-577,000
Other income and expenses - net	93,000	60,000
Operating income	**528,000**	**431,000**
Investment income	-	1,000
Interest income	34,000	61,000
Interest expense (includ. bonds, dividends)	-220,000	-97,000
Exchange differences - net	-88,000	-
Income before tax and non-rec. items	**254,000**	**396,000**
Non-recurring items (inc. minority div.)	-68,000	-1,000
Total taxes	-	-
NET INCOME	186,000	395,000

Source: 1993, COFINEC management; 1992, CSFB bond offering

Exh B - 40

KNER NYOMADA RT.

CONSOLIDATED BALANCE SHEET AS OF 31 DECEMBER 1993
(Before appropriation of results)

(In HUF '000)	31-Dec-93	31-Dec-92
Inventories	382,219	293,991
Trade receivables	349,484	341,444
Other receivables	84,975	99,695
Marketable securities	427,508	-
Cash and banks	233,964	146,816
Total Current Assets	**1,478,150**	**881,946**
Intangible assets	64,755	68,176
Tangible assets	2,301,777	1,667,697
Financial assets	36,563	31,681
Total fixed assets	**2,403,095**	**1,767,554**
TOTAL ASSETS	**3,881,245**	**2,649,500**
Current maturities of long-term debt	60,000	59,311
Trade accounts payables	205,510	226,081
Other short term liabilities	95,611	88,383
Total current liabilities	**361,121**	**373,775**
Minority interests	3,534	3,942
Long-term debt	944,792	404,792
Total minority interest and LT debt	**948,326**	**408,734**
Share Capital	1,447,000	1,055,000
Share premium and retained earnings	902,801	769,075
Translation adjustments	14	-
Net income for the year	221,983	42,916
Total shareholders' equity	**2,571,798**	**1,866,991**
TOTAL EQUITY AND LIABILITIES	**3,881,245**	**2,649,500**

Source: COFINEC management

24

KNER NYOMADA RT.

CONSOLIDATED STATEMENT OF INCOME AS OF DECEMBER 1993
(Before appropriation of results)

(In HUF '000)	31-Dec-93	31-Dec-92
Net sales	3,390,730	2,563,274
Cost of sales	-2,380,274	-2,210,799
Gross margin	**1,010,456**	**352,475**
Operating expenses	-641,616	-137,962
Other income and expenses - net	-66,981	-74,932
Operating income	**301,859**	**139,581**
Interest and dividend income	21,223	28,158
Interest expense (exc. bond dividend)	-97,984	-117,344
Exchange differences - net	6,671	-
Non-operating income - net	2,939	2,651
Income before tax and bond dividend	**231,769**	**53,046**
Corporate income tax	-823	-
NET INCOME	230,946	53,046

Source: COFINEC management

COFINEC GROUP

CONSOLIDATED BALANCE SHEET AS OF 31 DECEMBER 1993

(In French Francs '000)	31-Dec-93	31-Dec-92
Inventories and work in progress	54,900	41,991
Trade receivables	71,977	54,444
Other receivables	12,140	11,842
Marketable securities	25,030	-
Cash and banks	34,097	48,946
Total Current Assets	**198,144**	**157,223**
Intangible assets	4,343	-
Property, plant, and equipment	400,161	303,859
Investments in non-cons. companies	8,038	9,937
Other investments	1,865	1,564
Total fixed assets	**414,407**	**315,360**
Deferred charges	6,554	-
TOTAL ASSETS	**619,105**	**472,583**
Current maturities of long-term debt	9,785	12,392
Operating liabilities	44,387	42,508
Other short-term liabilities	35,463	22,724
Short-term debts	34,988	33,314
Total current liabilities	**124,623**	**110,938**
Minority interests	201,335	156,797
LT non-convertible bond debentures	114,169	-
Other long-term loans	34,583	64,861
Other long-term liabilities	910	1,100
Total minority interest and LT debt	**350,997**	**222,758**
Share capital	105,300	103,200
Paid-in capital and retained earnings	34,605	29,736
Accumulated translation adjustments	-1,148	2,195
Net income for the year	4,728	3,756
Total shareholders' equity	**143,485**	**138,887**
TOTAL EQUITY AND LIABILITIES	**619,105**	**472,583**

Source: COFINEC management

COFINEC GROUP

CONSOLIDATED STATEMENT OF INCOME AS OF DECEMBER 1993

(In HUF '000)	31-Dec-93	31-Dec-92
Net sales	498,604	392,387
Cost of sales	-352,246	-319,021
Gross margin	**146,358**	**73,366**
Operating expenses	-106,149	-51,978
Other income and expenses - net	3,823	7,185
Operating income	**44,032**	**28,573**
Interest income	6,884	6,916
Interest expense	-33,230	-17,238
Income before tax	**17,686**	**18,251**
Corporate income tax	-61	-672
Income before tax and non-rec. items	**17,625**	**17,579**
Non-recurring items	-	-264
Net income before minority interests	**17,625**	**17,315**
Minority Interests	-12,897	-13,559
NET INCOME	4,728	3,756

Source: COFINEC management

Petofi Printing and Packaging Company
Ownership Structure
(as of December 31, 1993)

Shareholder Owner.	Common Stock No. Of Shares	% Ownership	Non-Voting Preferred Stock No. Of Shares	/%
Compagnie Financiére Pour L'Europe Centrale S.A. (COFINEC)	14,778	51.3%	600	37.4%
The First Hungary Fund Ltd.	3,738	13%	196	12.2%
The Hungarian American Enterprise Fund	3,112	10.8%	120	7.5%
The Hungarian Investment Company, Ltd.	2,333	8.1%	122	7.6%

COFINEC is majority owned by Cerus S.A. (French holding company of the De Benedetti Group). Other significant shareholders include: UAP and AGF (two major French insurance companies), Groupe Suez, Banque Nationale de Paris, Lehman Brothers, Banco Zaragozano and Recchi.

The First Hungary Fund Ltd.: Incorporated in 1989 with paid-in capital of US$76 million. The objective of the privately-held FHF is to make equity investments in Hungarian companies.

HAEF is a private, non-profit US Corporation founded in 1990 to promote the development of private enterprise in Hungary. The U.S. Congress is providing US$60 million to HAEF over three years, under the provisions of the Support for Eastern European Democracy (SEED) Act.

A closed-end investment company registered in Jersey (UK) with both its equity and warrants traded on the International Stock Exchange, London. Starting capital was US$100 million.

Petofi Employees	1,543	5.4%	94	5.9%
Shares owned by the employees were issued at the time of privatization and are managed by a trust.				
Hungarian Commercial and Credit Bank	1,487	5.2%	61	3.8%
K&H became a shareholder at the time of privatization through a debt-for-equity swap.				
Baring Chrysalis Fund	956	3.3%	---	---
A closed-ended investment company advised by Baring International Investment Management Ltd. The Fund is registered in the Cayman Islands.				
Baring Global Emerging Markets Fund	347	1.2%	---	---
An open-ended fund managed by Baring International Fund Managers (Ireland) Ltd. And advised by Baring International Investment Management Ltd.				
Local Authorities	519	1.7%	234	14.6%
The local authorities were allocated Petofi common stock upon the foundation of Petofi and exchanged ownership of Petofi's plant site in Kecskemét for non-voting preferred stock. Additional shares were provided for land adjacent to the plant.				
Treasury Stock	3,242	---	178	---
TOTAL	**32,055**	**100%**	**1,605**	**100%**

Source: COFINEC management

PETOFI PRODUCT LINES

Product Line Contributions to Total Sales by Value

Product Line	% of 1990 Sales	% of 1991 Sales	% of 1992 Sales
Folding Cartons	41.2%	45.5%	46.4%
Self-adhesive labels	16.6%	13.3%	11.6%
Conventional labels	15.6%	15.4%	13.9%
Flexible-wall packaging	11.7%	13.6%	15.1%
Non-packaging (books, news)	14.9%	12.2%	13%
TOTAL	**100%**	**100%**	**100%**

Petofi's Hungarian Market Shares for Selected Product Lines

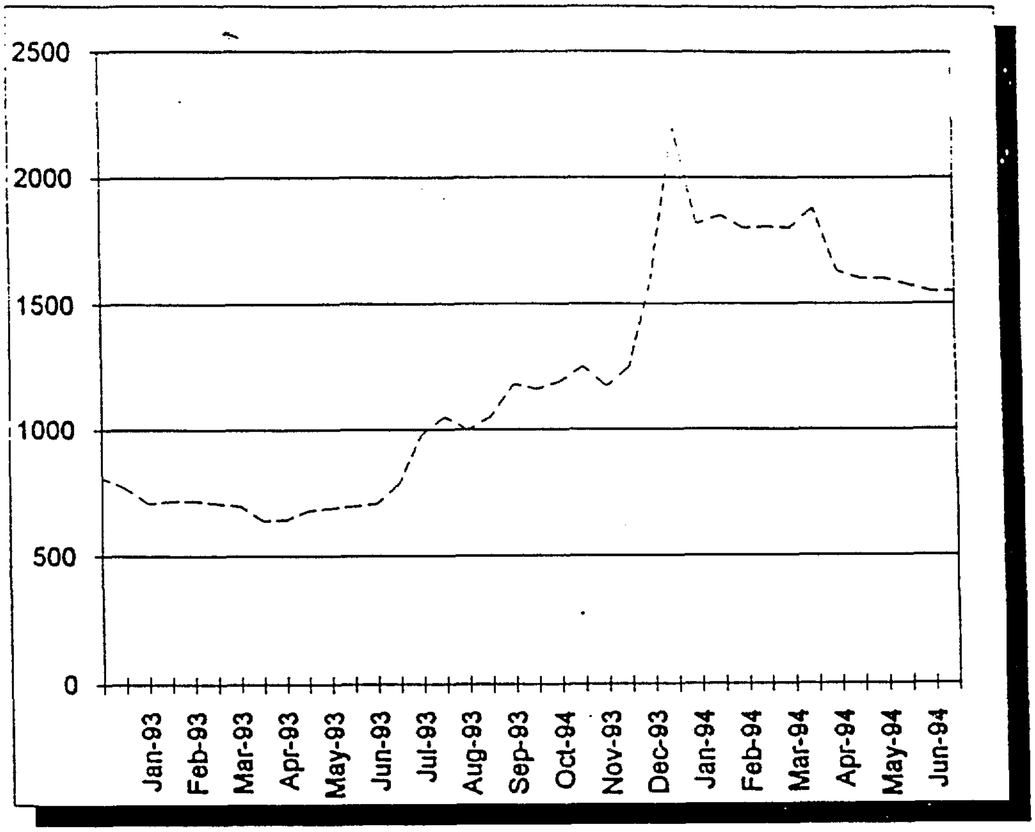
Product Line	1990	1991	1992
Folding cartons	41.9%	45.8%	50%
Self-adhesive and conventional labels	26.2%	30.3%	32.8%
Flexible-wall packaging	--	10.3%	13.9%

Source: Petofi management

EXHIBIT A

BUDAPEST STOCK EXCHANGE INDEX

Performance from January 1993 to June 1994



Index as of 8/25/94:	1,700
Average P/E Ratio:	15.8
Est. Market Value:	US$1 bn
Weekly Turnover:	US$5 mn
Stocks Traded:	39

Source: CSFB, Budapest Sun

BUDAPEST STOCK EXCHANGE HIGHLIGHTS

- First opened in 1864, reopened in June 1990. Stock shares, government bonds and Treasury bills, corporate bonds, investment funds and the compensation vouchers issued by the government since 1991 are traded. Nearly 50 brokerage firms have a trading license. Thirty-nine companies are currently listed.

- Total capitalization as of March 1994 was US$1.2 billion. The capitalization of the market is highly concentrated: the capitalization of the ten largest companies account for approximately 66% of the market.

- Because the Government of Hungary (GOH) has chosen not to privatize through public offerings, but rather through sales to strategic investors, the BSE has remained small. Total turnover of the stock market was $82 million in 1993, which jumped to a monthly average of $63 million in the first two months of 1994.

- Given the limited number of companies traded as well as limited volume, the market is not highly liquid. Trade is highly concentrated. In the first months of 1994, some 90% of total turnover was contributed by just six firms: Danubius, Pick, Fotex, Prímagáz, Domus, and Globus. The lack of liquidity has been an important consideration for companies considering a listing on the exchange.

- Price to Earnings (P/E) ratios have climbed steadily since the market began its turnaround in the spring of 1993. At the end of 1993, the average P/E ratio was 12.6, compared to 15.8 in August, 1994.

- A forceful competition to the stock market has been and should continue for some time to be government Treasury bills due to their attractive rates and government tax incentives. The returns are therefore very competitive if measured against the share market.

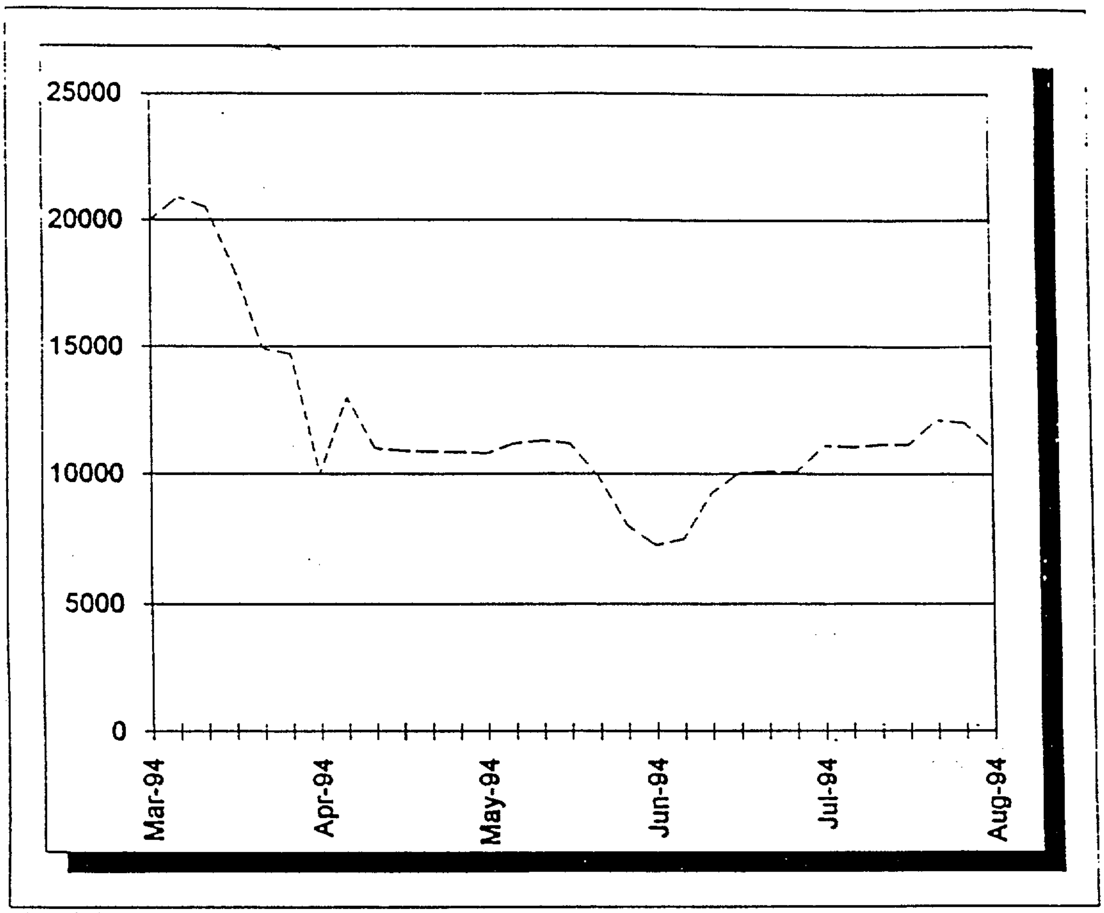
- The BSE Index measures the shares of nine companies deemed by the BSE Board to be representative of the market based on capitalization and liquidity.

- Twenty-three Hungarian companies that trade in the BSE also currently trade in markets outside Hungary, primarily in Vienna.

EXHIBIT C

WARSAW STOCK EXCHANGE INDEX

Performance from January 1994 to August 1994



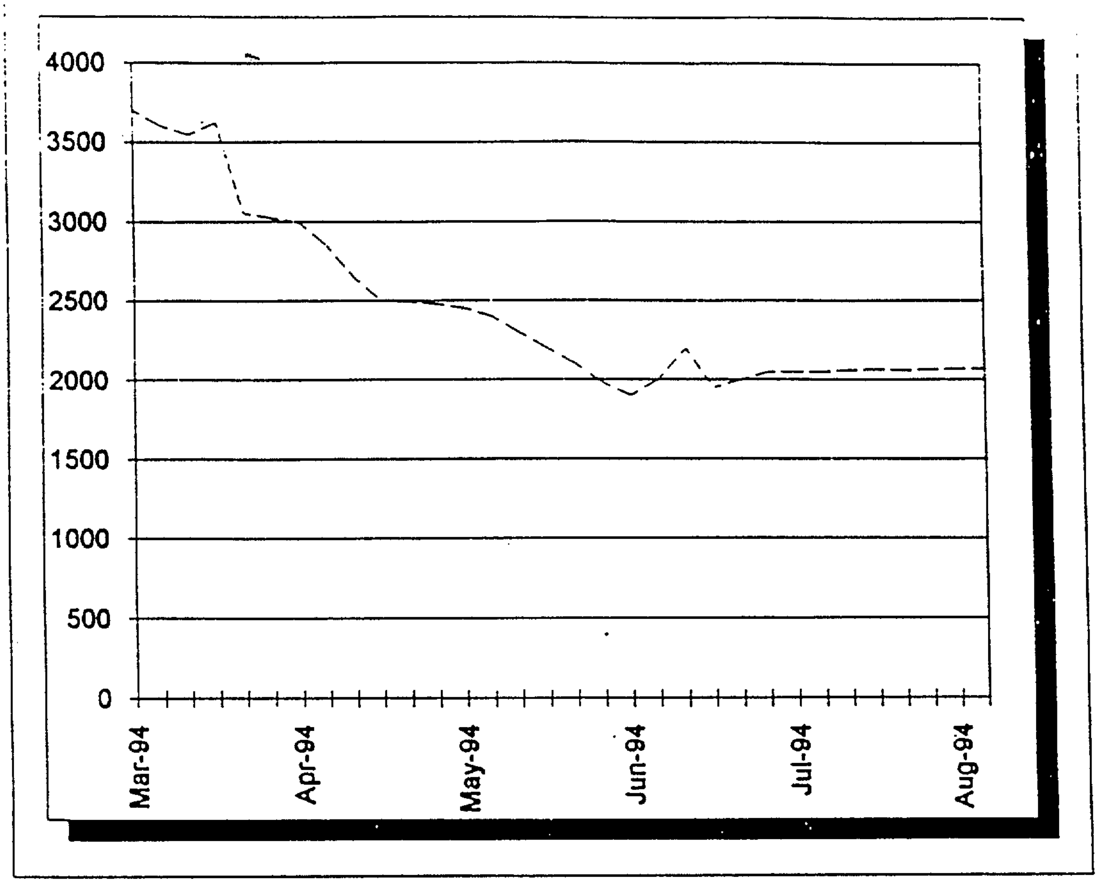
WIG Index

Index as of 8/25/94:	12,481
Average P/E Ratio:	30
Est. Market Value:	US$3 bn
Weekly Turnover:	US$150 mn
Stocks Traded:	22

Source: Budapest Sun

PRAGUE STOCK EXCHANGE INDEX

Performance from January 1994 to August 1994



Index as of 8/25/94:	2,066
Average P/E Ratio: (for listed stocks)	22
Est. Mar	US$14 bn
Weekly Turnover:	US$30 mn
Stocks Traded:	1,001

Source: Budapest Sun, USAID Prague

How to repackage an industry.

This announcement appears as a matter of record only

September 1990

COFINEC

Compagnie Financière pour l'Europe Centrale

has acquired a controlling interest in

Petőfi Printing Co. Ltd.

(a company incorporated under the laws of the Republic of Hungary)

as part of the First Privatisation Program by the

State Property Agency (SPA) of Hungary

This announcement appears as a matter of record only

November 1991

Petőfi Printing Co. Ltd.

(a company incorporated under the laws of the Republic of Hungary)

DM 10,000,000 Loan Facility

Provided by

European Bank for Reconstruction and Development

This announcement appears as a matter of record only

May 1992

COFINEC

Compagnie Financière pour l'Europe Centrale

and

Hungarian Investment Company Ltd. (HICL)

have acquired 85% of

KNER

Kner Printing House Co. Ltd.

(a company incorporated under the laws of the Republic of Hungary)

as part of the First Privatisation Program by the

State Property Agency (SPA) of Hungary

This announcement appears as a matter of record only

July 1992

Petőfi Printing Co. Ltd.

(a company incorporated under the laws of the Republic of Hungary)

International Private Placement of 6,046 Registered Shares of Common Stock of HUF 50,000 each

The undersigned acted as financial advisor to Petőfi on this transaction

Morgan Stanley International

This announcement appears as a matter of record only

July 1993

Petőfi Printing Co. Ltd.

(a company incorporated under the laws of the Republic of Hungary)

HUF 1,350,000,000 Dividend Notes Due 1998

The undersigned acted as financial advisor and sole manager to Petőfi on this transaction

Credit Suisse First Boston Budapest Rt

This announcement appears as a matter of record only

February 1993

KNER

Kner Printing House Co. Ltd.

(a company incorporated under the laws of the Republic of Hungary)

DM 10,000,000 Loan Facility

Provided by

European Bank for Reconstruction and Development

The undersigned acted as financial advisor to Kner Printing House Co. Ltd. on this transaction

Morgan Stanley International

This announcement appears as a matter of record only

February 1993

KNER

Kner Printing House Co. Ltd.

(a company incorporated under the laws of the Republic of Hungary)

Private Placement of 27,000 Registered Shares of Common Stock of Par Value HUF 10,000 each

The undersigned acted as financial advisor to Kner Printing House Co. Ltd. on this transaction

Morgan Stanley International

This announcement appears as a matter of record only.

October 1993

COFINEC

Compagnie Financière pour l'Europe Centrale

has agreed to acquire a controlling interest in

KRPACO a.s.

Printing and Packaging Company

(a company incorporated under the laws of the Czech Republic)

pursuant to a Share Purchase and Joint Venture Agreement with

Krkonošské Papírny a.s. of the Czech Republic

This announcement appears as a matter of record only

November 1993

KNER

Kner Printing House Co. Ltd.

(a company incorporated under the laws of the Republic of Hungary)

HUF 600,000,000

19% Dividend Notes Due 1998

The undersigned acted as financial advisor to Kner Printing House Co. Ltd. on this transaction

CS First Boston Budapest Rt

Four years ago Cofinec began investing in the emerging Central European markets, focusing on the packaging industry in particular. Today, in our product lines, we are the leading packaging manufacturer in Central Europe, and the eleventh largest in Europe overall, competitive with all the major players.

Recognising opportunities, finding the right companies and arranging effective finance is only part of the story. It also takes vision, committed management and the latest technology. Essential ingredients in helping the East become partners with the West.

The financings shown here represent a commitment of over US$80 million by Cofinec and its partners to the packaging sector in Central Europe which, to our knowledge, is more than anyone else in the industry.

COFINEC

Gußhausstraße 2/2, 1040 Vienna, Austria

Tel: (43 1) 504 28 60 Fax: (43 1) 504 28 60 60

PETOFI PRINTING AND PACKAGING II

TEACHING NOTE

Case and Audience

The Petofi Printing and Packaging case has been developed as a teaching case study for use in privatization and post-privatization training programs. Program participants are likely to be government officials with responsibility for privatization or post-privatization programs. Managers from the privatized companies also would likely participate in training programs utilizing this case study.

Learning Objectives

The Petofi Printing and Packaging case can be used to expose students to different interventions required in post-privatization management. In particular, this case highlights a number of key post-privatization issues, including:

I. The importance of financial decisions and the development of sound financial and capital markets in the success of privatized enterprises.

II. Related to financial and capital markets development, the importance of long-term institutional investors in nascent market economies.

III. Development of clear objectives and marketing priorities and understanding of the market in which a privatized firm will operate.

Discussion Questions

1. How important do financial decisions appear to be in Petofi's and COFINEC's early success? Should COFINEC direct future financing for group companies directly, or through individual companies? Why?

2. How important was the existence of long-term institutional investors to COFINEC and Petofi? What financial alternatives were available? What steps can governments take to encourage long-term institutional and strategic investors and other forms of equity capital?

3. Why do you think COFINEC evolved from a financial/opportunistic to a strategic investor? What factors appear to have influenced Petofi's success? What challenges is COFINEC likely to face in the future?

1. How important do financial decisions appear to be in Petofi's and COFINEC's early success? Should COFINEC direct future financing for group companies directly, or through individual companies? Why?

An important part of Petofi's success is clearly the result of their ability to attract both international debt and equity capital. The ability to obtain equity capital from Hungary's major institutional investors (at the time of privatization and in the 1992 equity offerings), together with the first EBRD loan to a private sector firm in Eastern Europe, not only provided needed financing but also provided market signals that solidified Petofi's image as one of Hungary's best industrial companies. Likewise, the innovative "dividend" bond in 1993 became a trend-setting issuance which not only substantially reduced Petofi's financial costs, but provided further signals to the market about Petofi's status as a dynamic company.

On the other hand, many business students place too much emphasis on financing per se. Even COFINEC's financially-savvy management agrees that what made financing a key to Petofi's success is that it leveraged underlying comparative advantages (e.g., good infrastructure, the premier position that the Hungarian printing and packaging enjoyed within the COMECON bloc) and competitive advantages (a clear corporate vision the market, low-cost, high quality workforce). Financing can play a very *supporting* role in the growth of a company -- but only that. One of the key points regarding financing for Petofi and COFINEC was how management continually reviewed their financing status, responding to opportunities as they developed. The best example of this is management's willingness to invest in substantial investment banking fees that ultimately produced large savings through the dividend bond and the replacement of the high-cost EBRD loan, i.e., management has been willing to explore a number of innovative financing tools, always seeking advise from firms and individuals with a thorough knowledge of Eastern European financial markets.

There are a number of other issues or approaches that an instructor may wish to take with respect to Petofi's financing decisions. Principal among these, of course, is the issue of future financing. By August 1994 Stephen Frater had already made up his mind that future financings would be done through COFINEC and not through the individual companies for the reasons cited in the case. Toward this end, COFINEC has begun purchases of the treasury shares to increase its holdings in Petofi and Kner. A COFINEC-based issuance of equity or/and debt is likely in the near future.

Exhibits 7a-d provide a partial justification for this approach that the instructor could guide students through. The weekly turnover of the Budapest, Prague, and Warsaw exchanges is minuscule by Western standard, as are the number of traded stocks (except in the case of Prague, although even that case is misleading since a handful of stocks account for a large percentage of market activity). This means, of course, that liquidity remains a critical issue for companies that are listed in these markets. Moreover, while P/E ratios in the Budapest Stock Exchange were extremely low in March 1993 when Petofi considered a public issuance, they are currently extremely high in all the exchanges (particularly Warsaw), suggesting a major correction sometime in the future. At the same time, the instructor may wish to question students about the attributes of a company-specific approach. **Attachment I** to the teaching note, an article from the Budapest Business Journal describes in more detail the problems facing the Budapest Stock Exchange, particularly the lack of liquidity. Under what conditions should a company consider a listing in a local exchange? A company that competes primarily in the local market is certainly a candidate, particularly if it is known in the country where the issue is to be placed but not in other countries. Two reasons why COFINEC may have considered individual company listings are the reduction of country risks (e.g., if the Polish economy goes sour, that may not be the case for Hungary or the Czech Republic). Another reason is to sanitize the successful Petofi and Kner companies from what are likely to be much more difficult ventures in Poland, the Czech Republic, and elsewhere (see below). Ultimately, however, the decision to raise capital through COFINEC has a lot to do with how COFINEC views itself: a Central European company whose client and investor base is primarily Western. Although not focusing on financing per se, **Attachment II** to the notes, the Austria Survey by the Business Central Europe Journal (an *Economist* Magazine publication) from its July/August issue describes the increasing attractiveness of Austria as a base for Eastern European business.

Another approach an instructor may wish to take is to examine the classic corporate finance issue of debt vs. equity that Petofi faced in 1993. Did it make sense to choose debt over equity? While the nature of the case limits the information available in this area, the instructor could ask if debt, even at 17% (the interest on the dividend bond) was cheaper than equity and why. The purpose of this discussion would be to show that interest payments on debt may affect cash flow directly, but that equity is *not* cheaper. Discussion could turn to calculating the cost of equity for Petofi (i.e., what does the company have to return to investors to get their capital?). A simple formula can be used for determining the cost of equity.

Expected return on a risky asset	=	Interest rate on safe government bonds	+	Risk premium

This formula yields a cost of equity of roughly 28-30%, assuming GOH debt instruments in the low 20s and a risk premium in the eight percent range. Still, debt made sense in 1993 given the companies use of debt to increase stockholder leverage and to avoid dilution of shares. Instructors could take this discussion further by a discussion on different measurements of the risk premium.

2. How important was the existence of long-term institutional investors to COFINEC and Petofi? What financial alternatives were available? What steps can governments take to encourage long-term institutional and strategic investors and other forms of equity capital?

The existence of long-term investors was instrumental in Petofi's growth, including the capital provided by the Hungarian-American Enterprise Fund as well as the EBRD as a provider of long-term debt. With respect to government-financed funds such as the HAEF (whose capital is provided by the U.S. Government), there has recently been some controversy regarding their objectives. Should they focus on providing equity capital to larger and middle market firms such as Petofi that can impact larger sectors of the economy? Or should they focus on small and

38

micro-enterprises which truly have no alternative sources of capital? Given the development of capital markets in Eastern Europe and in many other emerging markets, should government-subsidized funds be phased out? One argument for focusing on larger, or at least mid-size enterprises for equity investments is overall economic impact, as well as complementarity with other donors (such as EBRD) as was the case with the Petofi financing. **Attachment III** presents an article from *Business Central Europe*, on the Enterprise Funds, which argues that they are playing an important role in the region's capital markets.

Another area for class discussion are the steps that governments can take, through regulation or means, to encourage external capital flows. In the case of Hungary, the adoption of international standards of accounting and disclosure and establishing a sound regulatory environment (at least in relative terms) has been key to generating foreign investment. Given their generally passive nature, institutional investors must be insured that the major risks they face are the market, and not others such as fraud or lax regulation of markets. Likewise, Petofi's tax holiday (both as a privatized firm and as part of an industry denoted as strategic) was extremely important in obtaining support from investors as well as financial performance. What are the pros and cons of such tax holidays? Do they pit domestic against international investors and unfairly tip the competition scale in favor of the latter? What has been the experience of the countries that the students represent?

The instructor may wish to ask students to put themselves in the position of a manager at a major institutional investment fund. What investment criteria would they choose, and why? Possible criteria include the quality of company management, market share and potential for growth, political stability, government regulations, including taxation of dividends and capital, and competition.

The issue of EBRD's lending regulations is an extremely interesting one in this case. By Frater's own account, the EBRD provided vitally needed capital at a time when there were few alternatives. In exchange, it required considerable management oversight. What do students think of this policy? Does it make sense? What alternatives are there? For example, could the EBRD categorize firms according to risks, lessening oversight for less risky enterprises with sound management? Finally, how can international lending institutions such as the EBRD (which itself is expected to earn a "profit") protect their clients from currency exchange risks, particularly in countries where the risks are significant. Should this be their job or should currency risks be left "to the market"? Another article for Business Central Europe from its September 1994 issue discusses some steps the EBRD is taking to improve its lending practices, including the use of discount credit lines through local commercial banks. Under this program, these banks will have the responsibility of due diligence and maintaining normal banking relationships with clients, including (presumably) less oversight with better companies. The article is presented in **Attachment IV**.

3. Why do you think COFINEC evolved from a financial/opportunistic to a strategic investor? What factors appear to have influenced Petofi's success? What challenges is COFINEC likely to face in the future?

By Frater's account, the turn to strategic investor came when in the process of due diligence for their initial investment in Petofi, COFINEC realized how attractive the printing and packaging industry was in the process of economic transformation from a statist to a market economy The key point here is that investors of privatized companies must have a clear understanding of the market that they are getting into. Importantly, this is not just the market as it stands at the time of privatization, but what the market will be like in the near, mid, and long-term. It could be argued that this market vision was the most important contribution made by the post-privatization management.

Petofi's strategy was geared to increasing, and over time focusing, on Western consumer companies which were likely not to be affected by the recession of the Hungarian economy. Having met that objective, COFINEC realized that purchasing Kner (who's management did not want to be associated with Petofi for fear of losing their own identity) was extremely important strategically. Most people familiar with the packaging and printing industry in Hungary agree with Frater that Petofi would today face a very serious threat had a Western packaging and printing firm bought Kner. Although COFINEC's expansion in the rest of Eastern Europe is much riskier (see below), it is also makes sense that focusing exclusively on Hungary would be detrimental over the long term.

While Frater and COFINEC deserve considerable credit for their management of COFINEC, it undoubtedly true that Petofi and Kner are rather exceptional privatization stories. Both firms had relatively sound management. The labor force was not bloated, infrastructure was fairly sound (although COFINEC realized that major equipment investments had to be made).

Probably the biggest challenge facing COFINEC is that future expansion will not be nearly as easy and management has not been truly tested in the restructuring of a problem company or initiating a greenfield investment. For example, the plant being considered in Poland reportedly has the same turnover as Petofi, but approximately three times as many employees. At the same time, COFINEC's success has not gone unnoticed and Western packaging firms are once again actively exploring purchases of competitors in Eastern Europe. COFINEC understands that it will not be able to apply much of its Hungarian experience to these new ventures. Students may be asked what COFINEC attributes may be applied to the newer ventures. These may include market vision, support from successful companies in Hungary (e.g., attracting a client base by permitting these companies to sell Petofi and Kner-made products), sound financial management.

Additional Background Information: Government Intervention, Anti-trust, Monopoly issues

NOTE. The role of government intervention is a teaching point beyond the scope of this case. The material below, however, adds to the case leaders' greater understanding of the entire circumstance.

As discussed above, tax regulations with respect to investment in privatization and strategic industries have played a major role in COFINEC's growth, as has the development of sound financial and factor markets through regulations. Given its strategic importance to COFINEC, the GOH decision to permit its purchase of Kner was also very important.

For the GOH, COFINEC's Kner play presented a tough decision: should it be concerned with promoting internal competition by not permitting the concentration of such a large market share (i.e., not selling Kner to the group that controlled Petofi)? Or should it strengthen the domestic printing industry by going forward with a sale that permitted the realization of economies of scale? There was also the question of Globus, the third largest printing and packaging state-owned enterprise which was also set for future privatization. It was unlikely that the GOH would find buyers for a company whose main competitor had a predominant market share in most market segments.

The GOH chose to sell to a buyer that would provide economies of scale for the Hungarian printing and packaging industry, persuaded at least in part by Frater's arguments. First, low tariffs for packaging and printing products in Hungary in part nullified the competition argument. The issue was not *domestic* competition, but competition from any source. As Frater told the case writer, "We explained to the government that there were state-of-the art plants in Austria, only a few hours driving distance from Budapest. What would happen if we jacked up prices tomorrow because our so-called monopoly? With the liberalization of Hungary's trade regime, it was clear that foreign firms would move in and that we'd be out of business if we tried something like that.". In short, at issue was whether it made sense for a small country with a liberal trading regime to implement large country competition policies. Second, if the government didn't permit a strong domestic printing industry, Frater argued, individual domestic plants, even supported by foreign capital, would not be able to compete effectively with larger European firms since the real market was not Hungary but the entire region.

In the end, Frater's arguments won the day, though the issue is still controversial. Recent articles in Hungarian publications have questioned the wisdom of permitting a single company to have such a large share of the market. The issue of market definition is one that has attracted considerable attention in U.S. anti-trust rules and regulations. COFINEC argues that the "market" is indeed not Hungary, but the region and even parts of Western Europe. Petofi and Kner both export an increasingly greater share of their output outside the country. By this standard, their "market share" is considerably smaller than what critics claim it is. To date, there is no indication that the joining of the two firms have affected pricing negatively.

JOURN

INFO

[illegible] 1994

How big will the BSE get? Not very

By Jon Carroll
Staff Reporter

When major Hungarian companies look for capital, where do they turn?

Try Vienna, Frankfort, London and even across the Atlantic to the monster of all financial markets Wall Street in New York City.

Few have a major presence on the thinly traded, largely illiquid fledging Budapest Stock Exchange which trades less than eight hours a week.

The four-year-old exchange is sorting out what and who it best serves and what its long-term future might be.

The BSE is 120% higher than last summer as foreign investors pumped \$60 to \$80 million on the trading floor and into the exchange's 30-some companies.

But even though the market has grown, the question these days is how much new capital can the exchange raise for Hungarian-based companies.

Recently, foreign investors in Matáv Rt – the state phone company – blocked the state's plan to offer Ft 2.78 billion (\$27.4 million) exclusively on the BSE. The U.S. "Baby Bell" Ameritech Corp and Deutsche Telekom, which own 30%, wanted to delay the offering, in part, so the issue could be also sold in foreign markets at potentially higher prices.

"We want to do it properly and on the New York, London and Frankfort exchanges," said Mark von Lilliensklod, a member of Matáv's operating committee. "The Budapest Stock Exchange is too small."

Indeed it is. The BSE exchange has a market capitalization of \$1.2 billion compared to the Warsaw Stock Exchange's \$4 billion and the \$9 billion Prague Stock Exchange. Across the border is the \$27.3 billion Vienna Stock Exchange.

Matáv is not the first Hungarian company to go to other stock exchanges in search of capital. Fotex, the photo processor and retail holding company, went to New York to raise \$70 million, and holding company Konzum raised \$7.25 million on Western Europe markets.

The fact that many companies are searching for money outside of Hungary underscores some of BSE's long-term problems which could stunt its future growth. Analysts offer, among others, these major reasons:

- inadequate banking services
- limited liquidity
- small number of quality shares on the exchange

PLEASE SEE STOCKS PAGE 4

42

BSE is small, but its limitations can be corrected

CONTINUED FROM PAGE [illegible]

While these weaknesses are holding back potential investment, businesses are not waiting around for improvements. Many are tapping into both domestic and international exchanges.

Five companies – Richter Gedeon, Pharmavit, Graboplast, Garagent and Pick Szeged – are offering new shares on the Budapest exchange and foreign markets simultaneously.

"Low liquidity is why we're offering Pick and Pharmavit abroad," said Zsigmond Járai, managing director of Samuel Montagu's Budapest offices. The salami company expects international investors to purchase 70% to 80% of its current Ft 2.4 billion ($23 million) rights issue.

Vitamin and pharmaceutical company Pharmavit is selling 68% of its 620,000 share issue on international markets, which means an estimated Ft 211 million ($2 million) in stock is being offered internationally.

Richter Gedeon, one of Central Europe's largest pharmaceutical companies, is planning raise some $60 million in a domestic and international public issue. Analysts agree most of the money will not be raised on the BSE.

About 30% of the Ft 1.35 billion ($13.3 million) face-value issue of synthetics and vinyl company Graboplast shares will be sold to international investors in a private placement. Half of Garagent's most recent Ft 40 million ($400,000) issue was sold in German markets.

More debt than equity

Small new exchanges experience a variety of problems.

Gyorgy Jaksity, managing director of Concorde Securities, said the BSE is "characteristic of smaller exchanges, with underdeveloped investment bases."

The $1.25 billion capitalization in equities does not include another $6.25 billion in other securities primarily government bonds – the BSE first and primary investment product.

"The BSE market capitalization structure is really unhealthy," said Gábor Sitányi, an analyst for Creditanstalt Securities. Eight of the 30 registered companies on Hungary's exchange account for 77% of the entire equity capitalization of the BSE. Fotex and Pick combined account for one-third.

Most of BSE-listed companies are also listed in Vienna on the over-the-counter exchange, while another 10 are listed in Munich, one in Stuttgart and one in Frankfort. Fotex trades in New York, while several shares trade on the London and various German over-the-counter markets.

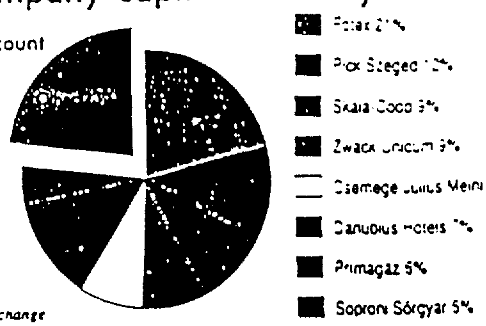
Marketing is the main reason for listing on these exchanges, according to brokers. Foreign investors are more familiar with more developed markets, said Gábor Tamás at Talentum Securities.

Pricing information is also more available in these markets. Market quotes for the Budapest, Prague or Warsaw exchanges are not published in major financial papers such as the London-based Financial Times or the European edition of the Wall Street Journal.

Many Hungarian stocks trade more actively abroad than on the Budapest exchange. Péter Has at Postabank Securities cites the example of Novotrade, a consulting and portfolio management company.

BSE Company Capitalization by %

Eight companies account for three-fourths of the $1.2 billion capitalization on the four-year-old Budapest Stock Exchange.



Source: Budapest Stock Exchange

"Novotrade is listed in Frankfort and Vienna, where the majority of its trading is done, which is why it is not liquid in Budapest," he said.

Analysts agree that foreign investors such as pension funds and emerging market funds, are interested in making multi-million stock purchases. Stock purchases of $10 million or more in a single company are not unusual, said Sitányi.

What could they buy or want to buy on the BSE at that amount?

In fact, $10 million would buy up all the shares offered on the BSE of the eight smallest companies. There are 13 companies with less than $10 million in capitalization available on the market.

In many cases, any multi-million dollar stock purchase would give the investor operational and legal control of most the businesses. Not something many institutional investors are interested in.

Two of these smaller companies, Terraholding and Müszi, are under liquidation, while others like Kontrax Irodatechnika and Kontrax Telekom are in dire financial straits.

"Larger blocks are difficult to execute on the BSE because of the lack of liquidity," said Attila Kovács, a broker at Credit Suisse First Boston.

Also major stock purchases result in major price fluctuations, especially lower-capitalized companies. Companies' share prices are easily changed by relatively small trades.

"It's very funny," said Zoltán Varga at CS First Boston. "Spend Ft 20,000 ($200) and you can push up the price by 5% to 10%." Kovács added, "The BSE is illiquid because its doesn't have the sizable companies."

Major state utilities, including Hungarian airlines Malév, electrical utilities holding company MVM Rt and oil company MOL Rt, are offering only a small percent of its shares to investors in exchange for compensation coupons. A secondhand market for the shares will develop on the over-the-counter market and part of the Ft 3.9 billion ($38 million) MOL issue will trade in Vienna.

"The exchange has the capacity to handle these shares – they're being kept off because of politics," said Victor Havassy, chief trader for Girocredit Securities. "The number of companies on the exchange after four years is very disappointing."

Offering large chunks of phone company Matáv and other utilities would "in one step change the whole liquidity picture on the BSE," said Sitányi of Creditanstalt.

Until major new issues hit the market, it will be plagued by stunted growth.

"The exchange definitely needs the shares in the top companies – Matáv and Richter Gedeon – the number one companies in their field," said Jaksity of Concorde Securities.

He said it is natural that these companies to be offered on various stock exchanges.

"None of the local Western Europe markets can handle big-scale privatization alone," he said.

Technical delays

The limited custodial services in Budapest also leads investors to buy shares in other markets. Commercial banks provide custodial services for investors, holding their shares and settling the transactions.

"Technical delays with banks [in Budapest] and difficult settlement is not acceptable to international shareholders," said Járai of Samuel Montagu.

Citibank and Budapest Bank are considered some of the leading custodian service providers for international investors on the Budapest exchange, but both admit the need for further development, particularly for foreign customers.

When buying shares, both banks will lend the foreign investor the money for two days until the foreign currency exchange can be completed through banking clearing houses. Most Hungarian banks require longer.

"At this time, there is no interest on the money and its not invested. Its just sitting there," Sitányi said.

Ágnes Kummer, head of custodial services at Citibank, said, "there is lower development of these services in Budapest, than Vienna" adding: "And investors need confidence in the bank's ability to carry out settlement."

Budapest's underdeveloped custodial services makes conducting business slower and more difficult for international investors – experienced financial hounds who are accustomed to minute-to-minute deals and wiring money easily around the world.

"If investors see the settlement structure working here, then there's no need to be in Vienna," said Kummer.

This summer's new BSE listings are not expected to radically change the situation. The new shares include plastics company Pannonplast, pharmaceutical firm Egis, vitamin company Pharmavit, frozen foods company Goldsun, Inter-Európa Bank, Graboplast and grocery store chain Global.

Investors also get a 30% tax break on initial public offerings if the stock is held for three years. The tax break was intended to attract investors to new issues, but has contributed to illiquidity according to analysts.

Although the upcoming IPOs may not solve all the exchange's liquidity problems, Sitányi said they "are a good step, though."

FUTURE DIRECTIONS

AUSTRIA USED TO BE THE WEST'S GATEWAY TO THE EAST. NOW THE FLOW GOES BOTH WAYS

For decades, Austria held a special niche in international political and business relations as a "gateway" to communist Central and Eastern Europe. Although the borders are now open and international business in the region is increasing, that image (with variations on a springboard or bridge theme) still adorns promotional literature and trips easily off the lips of officials and businessmen alike.

But behind the rhetoric, some are wondering what exactly that role is going to become now that the Cold War is over, and business partners can fly back and forth without the help of springboards and bridges.

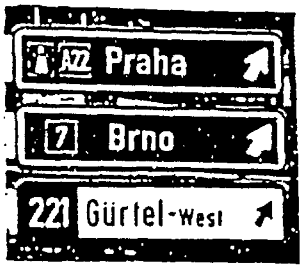
Will last month's decision to join the EU turn Austria into a vital link in the process of European integration, or just knock a final nail in the coffin of non-alignment? Will the flurry of Austrian business activity in the region become a staple for both sides, or a drop in the bucket in the region's total activity?

The answers are no longer quite as simple as in pre-1989 days, when Austria's role was to mediate and calm down East-West tensions, while conducting whatever business was possible under the circumstances. The key to its success in the region then was its neutral status on the edge of the Western world – a geographical and political position that gave Vienna more East European embassies, barter deals, spies and high-level East-West meetings per square mile than anywhere else in the West.

Now that the ideological tensions are gone, that particular niche has disappeared. What remains – and what is redefining Austria's relations with the region – is a combination of two elements: the comparative advantages of geographical and cultural proximity that are turning Central and Eastern Europe into one of Austria's most important markets; and a growing sense among business and political leaders of the importance for Austria's future of integrating the region into the rest of Europe as quickly as possible.

Hannes Androsch, former deputy prime minister and now head of Androsch International Consulting, argues that the events of 1989 have re-established "the logic of geography" in Central Europe. Under normal circumstances, he says, the vast majority of business is conducted within a 500 km radius of the home base, but politics erected an artificial barrier to the east and forced Austria to reorient itself westwards – primarily to Germany, with which the country now conducts 40% of its trade.

Austrian companies are now starting to re-establish these normal regional economic ties. In the 1920s, following the break-up of the Habsburg Empire, Central and Eastern Europe accounted for almost half of Austria's exports. Despite a surge in the mid-1970s at the height of détente and the recession in the West, that share had dropped to a low of 9% by 1988 (see fig. 1). Since then, it has increased to 12.7%, largely due to a jump in trade with Austria's direct neighbours – the Czech Republic, Hungary, Slovakia and Slovenia – which account for 8.2% of total exports. Last year, Hungary overtook Great Britain to become Austria's fifth most important trade partner (Austrian imports from Hungary come second only to those from Germany), and the Czech Republic ranked ninth. First quarter statistics for this year show further export increases in the neighbouring countries, and for the first time since the mid-1980s, imports are increasing more quickly than exports.



The logic of geography

IMPORTANT PARTNER

- 26.1% of Austrian investment abroad goes to Central and Eastern Europe.
- Austria accounts for 10.2% of the total number of joint ventures and 8.9% of the total capital invested in the region.
- Central and East European companies make up only 2.1% of foreign investment in Austria.
- 12.7% of total Austrian exports go east – more than in any other Western country – giving Austria a share of around 7% of OECD exports.
- Imports from Central and Eastern Europe make up 7.5% of total Austrian imports, leaving a trade surplus for Austria last year of $1.4bn.

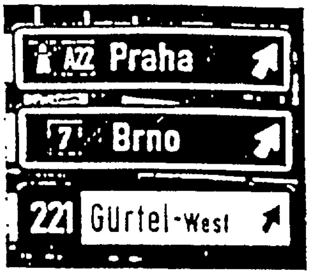
Figures for 1993 Source: WIFO

Opinions differ as to how far the upward trend will go. Stephen Barisitz of the Austrian Institute of East and South-East European Studies believes that joining the EU will strengthen Austria's Western orientation, limiting the share of exports to Central and Eastern Europe to around 15% over the next few years, and to no more than 20% in the long term. But Gerhard Fink of the Economics University of Vienna is far more optimistic. He believes that Central and East European trade could reach 35%, now that Austria is going to be on an equal competitive footing with the EU. Hungary and the Czech Republic, he suggests, could account for up to 10% each (more than either Switzerland or Italy today), assuming strong growth and closer integration with Western Europe.

Venturing abroad

Investment growth has been more startling. Last year, for the first time, Austria became a net exporter of capital – a situation that up until the late-1980s was unthinkable. Part of the push to get the country's overwhelmingly small and medium-sized companies to cross the border came from the beginnings of the Maastricht talks in 1986, but the opening of the eastern borders three years later brought a level of internationalisation in the economy that was entirely new

COVER & PHOTOS JARI KOBYLKA



"The road to Western Europe leads through Austria"

Austria now accounts for almost [illegible] of all investment in Central and Eastern Europe as a whole, and around one quarter of all investment in each of the neighbouring states. In Slovakia, it is the single largest investor with 23.4% at the end of March – the first time that has happened for Austria anywhere. Last year, just over one-third of all new investment flows were directed eastwards, bringing the stock of investment in the region to almost ATS20bn ($1.72bn) (see fig. 2). Around two-thirds of that – in some 4,500 companies – went to Hungary, followed by the Czech Republic, Slovakia and Slovenia. Countries outside the former imperial sphere of influence – Poland, Bulgaria, Romania and the former Soviet Union – are way down on the list, with no more than a few percentage points of total investment.

The capital transfer may sound quite large for a country the size of Austria, but the total amount nowhere near matches Austria's trade surplus with the region, which has been running at around $1bn per year since 1990 (see fig. 3). The shining macro-statistics are reflected at the micro-level in the success stories of sectors such as banking, construction, retail trade, consumer goods and machinery. But not everyone's been a winner. As Friedrich Makart of the Industrialists' Association puts it: "We've had the greatest advantages from the transformation, and the greatest disadvantages."

Finland, whose economy went into a tailspin after losing its Comecon markets, might beg to differ on the latter point. But those Austrian sectors that are feeling the pinch of cheap imports and new Eastern competition – steel, fertilisers, agricultural machinery, cement (see p. 45) and agriculture – would agree wholeheartedly. For the last few years, companies in these sectors have been insisting on state protection. They argue that the low-priced competition is unfair because it's based on subsidised energy and transport costs, and lower social and environmental standards – known in neo-protectionist speak as eco- and social dumping.

After a flurry of quotas and anti-dumping procedures last year answered in kind by [illegible] paper and fertiliser, the two sides [illegible] and agreed to replace explicit quantitative [illegible] what are innocuously termed "voluntary exp[illegible]" and "minimum price guarantees" – in reality [illegible] regulated quotas. The government's position on [illegible] protectionism is ambivalent. According to finance [illegible] Ferdinand Lacina, the dumping claims are "partly a [illegible] and partly an excuse. Companies have to get used [illegible] that there is more competition, but the decisive point [illegible] viving the transitional period. In the long run, nobody has [illegible] interest in maintaining the differences that are causing [illegible] problems."

Integration

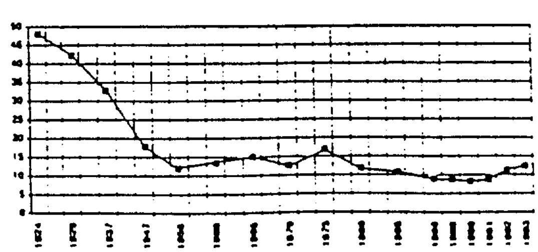
Although a lame excuse for protectionism, it is this fund[illegible] mental recognition – that the economic gulf between W[illegible] and East can only cause problems for Austria – that is driv[illegible] overall policy towards the region. Regardless of what aspe[illegible] of Austria's concerns you take, labour migration, import[illegible] environmental pollution, security issues or overall busine[illegible] development, a long-term solution requires that this que[illegible] tion on inequality be addressed. As Mr Lacina puts it: "[illegible] have very egotistical reasons to develop these countries."

Efforts in this direction are coming from all fronts. Au[illegible] tria's aid programme for the region is per capita the largest [illegible] the OECD, focusing largely on training managers, banke[illegible] and civil servants (over 20,000 have participated in trainin[illegible] programmes so far), and providing financing and investme[illegible] guarantees for small and medium-sized companies invest[illegible] or starting up in the region.

But the main focus of these efforts, now that Austria h[illegible] decided to join the EU next year, will be paving the way [illegible] membership of the Visegrád countries. Expectations are ve[illegible] high in the EU, which is still uncertain how to go about in[illegible] grating its post-communist fellow-Europeans, and in [illegible] region, especially in Hungary and Slovakia, which will n[illegible] have a border with the EU for the first time. Béla Kádár, Hu[illegible] gary's trade minister, oozes enthusiasm at the prospect: "T[illegible] future role of Austria is to link Central Europe economical[illegible] financially and politically to Europe – the road to Weste[illegible] Europe leads through Austria." Such sentiment is a little [illegible] strong even for the Austrians searching for their new nic[illegible] "These countries certainly don't need Austria as th[illegible] spokesman," says Mr Lacina, "but they can rely on us to pu[illegible] their case – especially for smaller countries such as Slove[illegible] and Slovakia."

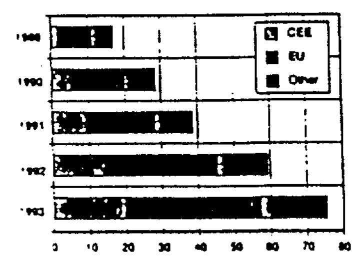
BACK TO THE FUTURE *fig. 1*

Austrian exports to Central Europe (% of total)



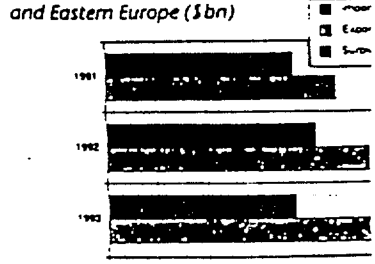
QUADRUPLING *fig. 2*

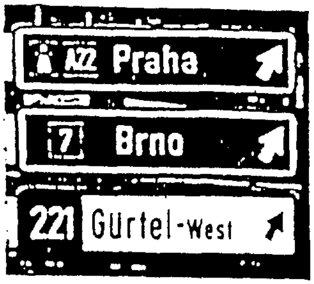
Austrian investments abroad (ATS bn)



IN SURPLUS

Austrian trade with Central and Eastern Europe ($bn)





Austria is now a two-way street

[illegible] the meaning of this new direction for Austria's business relations with Central and Eastern Europe, Wilhelm Ambichl of the Eisner trading house suggests that the gateway image will have to be revised. "It's ironic that Vienna is now having to do a 180° turn of sorts – it used to be a gateway for Western companies coming into the East, but now it's two-way. Austria will have to market itself to Central Europe: saying come here in order to penetrate the West."

Austrians expand eastwards

The near abroad

Whether returning to their old Central and East European commercial haunts or expanding abroad for the first time, modest (by international standards) Austrian concerns are fattening themselves quickly on the region's new opportunities. One outstanding example is Vienna-based food retailer and coffee roaster Julius Meinl. After losing its pre-Communist Czech, Slovak, Hungarian, Romanian, Slovene and Russian market-holds to history, the firm shrank to what Michael Pötscher, a specialist on Eastern Europe with the Austrian Federal Economic Chamber, calls "basically just an Austrian company" of the typical mid-sized, family-owned variety. For such firms, the opening of new markets to the east have been all the spark they needed to become budding multinationals.

When the iron curtain rose, Meinl's retail holdings comprised 260 stores in Austria and 20 in Italy, a West European presence which has changed little since then. But eastward it has exploded. From fledgling forays, like a modest export drive starting in 1980 to Hungary and what were then Yugoslavia and Czechoslovakia, and a few shops-within-shops set up in Budapest in the mid-1980s, Meinl today boasts 160 stores in the region. Their turnover by volume is now roughly 80% of Meinl's Austrian operations'. Its 600 sq m supermarket opened in Prague in April is the first of what Meinl says will be eight such Czech sites by the end of the year, and a total of 30 within five years. Meinl is also quickly expanding Jééé, a newly-launched chain of deep-discount stores in Hungary, following the success of its largest holding, the Csemege-Meinl chain.

Stumbling blocks

The going for Meinl's renewed eastward expansion has not always been smooth: in 1990, Meinl told the press that it was negotiating to open franchise shops in Poland and the then-USSR and to take a 50% stake in a café on Moscow's Gorky Street. But these projects never came to pass, for reasons the firm won't discuss: Meinl general manager Werner Ziegler explains that its failures make for less interesting conversation than its successes. [illegible] green light to speed into the region [illegible] investing was risk capital because [illegible] might really come up," he says. "This is [illegible] our success."

Of that, there is much to cite. A capital increase [illegible] ATS201m to ATS750m ($66m) to finance its eastern expansion and its habit of reinvesting earnings have fitted Meinl with the muscle to make its newest holdings pay off. While the 1993 turnover of Julius Meinl International, which consists of Meinl's Czech, Slovak and Hungarian holdings, was virtually unchanged from 1992's ATS2.8bn, post-tax profits soared from ATS22.9m in 1992 to ATS63.4m ($5.5m) last year.

The former east bloc markets have also been key to the dramatic resurgence of one of Austria's most aggressively expanding firms, building materials maker Wienerberger, which in 1980, says one of its executives, Tomas Winkler, was "just a loss-making East Austrian brick producer" with mere memories of its once-strong pre-World War I presence in Bohemia and Hungary. But since the trickles of a foreign acquisition spree in the mid-1980s started to gush in earnest in 1989, Wienerberger now boasts 88 production sites worldwide. Twenty-nine of these are in Central and Eastern Europe, more than in any other single region or country, including Mother Austria, which has 25. The ATS2.9bn ($254m) it has invested in the newly independent states is some 30% of its total expansion outlays, and the region accounted for approximately 20% of last year's ATS12.1bn sales revenues.

Bulldozer tactics

Wienerberger's aim in the region is as simple as its methods have been stark. "When we enter one of these [Central or East European] countries, our goal is to dominate the market," says Mr Winkler. They are off to a good start. To block competitors from importing cheap bricks – whose weight and bulk makes deliveries of over 250 km a money-loser – Wienerberger in 1986 and 1987 bought every foreign brick plant near its borders. Since its first Hungarian acquisition in 1986, Wienerberger claims to have cornered 40-50% of the brick market there.

It has also restructured its acquisitions methodically and radically. Mr Winkler cites the case of the South Bohemian Brick Works in the Czech Republic, whose 1,700 workers at 11 plants turned out an annual 100m bricks per year when Wienerberger bought it. Today 300 employees at the remaining five sites make some 350m bricks annually, thanks in part to heavy outlays for automation. Its first greenfield site, built at a cost of ATS250m, opened this May in the Slovak town of Zlaté Moravce.

That it chose to put the site in this particular, wildly oscillating construction market (Slovakia's construction industry shrank 31.6% in 1991, grew 7.8% in 1992 and shrank 28% last year) shows it willingness, despite its self-professed caution, to tackle risk head on. Wienerberger's restructurings "are never smooth," says Mr Winkler. "There's always problems." The Zlaté Moravce site, in what he deems a typical snag, consisted of some 25 newly restituted plots, each of whose owners haggled for the best price. "It takes a long time until you can finally say, 'The place is open'."

Bumps along the way are also familiar to Italtex and the other holding companies of Ivan Holler, a virtually unknown Vienna investor who launched into a flurry of Hungarian acquisitions in the late 1980s. One of these, for stakes in a textile factory in Györ, soured when the Hungarian firm went

Made in Hungary – financed in Austria

... chosen other ... carefully, and ... they are making mon- ... curtain-maker Gardenia, which already under the old regime had earned half its revenues in hard currency. After a Ft250m ($3.1m) investment over the last three years, it now exports 70% of its ISO 9001-certified wares, most of them to Germany, France and the UK. 1992's loss of Ft9.9m rebounded to last year's Ft32m pre-tax profit.

Mr Holler has also turned around Foenix, a 40-store retail chain in Hungary's depressed Hajdu-Bihari county. He has invested some $8m in the 1989 acquisition and hacked its workforce from 550 to 350 today, turning the firm's Ft86m loss in 1992 into last year's Ft24m pre-tax profit. Over the same period the results of another Holler buy, the Szaport Shoe Factory, moved from a Ft7.8m loss to a Ft2.9m pre-tax profit. Productivity there is up as well: when it was acquired, the plant's 500 workers turned out 700 pairs daily; today, 300 workers make 1,200, some 90% of which are sold to Rockport, an upscale US leisure shoe firm. Any "Made in Hungary" labels on these products – and on a burgeoning number of others coming from the new East – might as well add, "but financed in Austria".

Multinationals in Vienna

Hosting the most

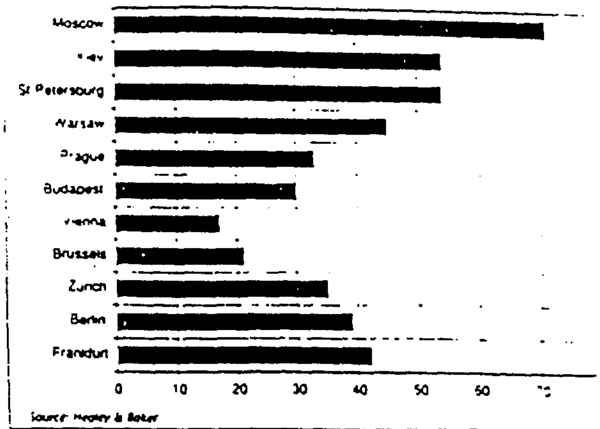
Vienna's status as host city to multinational firms longing for quiet, efficient headquarters for their Eastern operations seems to be continually reaffirmed. It happened most recently last month, when Agfa and chemicals producer Hoechst made the city the headquarters for what they hope to become galloping new levels of trade with Central and Eastern Europe.

With good reason, say Western executives already here. Vienna office rents are cheaper than any other potential base cities East or West (see chart), has basic support infrastructure (like reliable phones) and is close to most points in the Visegrád countries, which helps with transport and other logistics. Another attraction is a banking system considered business-friendly, whether the firm in question wants to finance operations in the East or is coming from there to bank in secret. Lastly, there is the much-touted Austrian "special appreciation" of Eastern neighbours' ways of thinking which, while commonly cited, is gaining its share of sceptics as well.

Asked why his firm coordinates regional operations from the city, IBM Eastern Europe president Dilip Chandra rattles off the travel schedule he knows all too well: Vienna is a 45 minute flight from Prague or Budapest, an hour in the air from Ljubljana and 45 minutes by car from Bratislava. Austrian Airlines, moreover, boasts a plethora of regular ... flights to these capitals; their relative paucity from the U... example, makes London "a non-starter" as a Central and ... European headquarters.

CHEAPER RENTS

Prime office space (sq m, month, in $, winter 1993-94)



Source: Healey & Baker

Others who have tried working from such a distant ... have soon enough found themselves succumbing to Vie... One example is Canon, whose masters in Tokyo insiste... using Marubeni, a Japanese trading company for se... the Visegrád countries, Romania and Bulgaria. Canon ... tria, however, defied Tokyo's orders to stay out of the re... deftly drubbing Marubeni in what became a fight for reg... turnover, and as a result in 1993 became Canon's new re... al centre, says Leo Häuer, CFO of the year-old Vienna-... Canon Eastern Europe.

Vienna's banks are also a draw. IBM's Mr Chandra ... they have shown a greater willingness than institutions ... where to finance "significantly" the company's Centra... East European suppliers, distributors and customers. A... that some executives are loathe to discuss – because they ... to do so divulges a competitive edge – is Austrian law's ... shore banking provisions, which allow tax free remittan... a firm's home country of net income on sales made ou... Austria. The country's banking secrecy laws, which ... Switzerland's, have attracted many a discreet Russian ... tomer and – reportedly – a compatriot who has made a ... ness of advising them how to do so. More out in the ... Hungarian travel agency Ibusz this winter moved its int... tional operations to Vienna, in part because it tired of wa... weeks for Budapest banks to clear simple payment trans...

That gateway thing

Another oft-cited reason to make Vienna a base for reg... operations – that history has given Austrians a unique un... standing of an "eastern mindset" – comes almost reflex... from most Western executives. A typical expression of ... comes from Daniele Marano, a manager with a Dow Ch... cal/Eli Lilly agrochemicals joint venture, which from V... has overseen activities in the Visegrád countries, Rom... Bulgaria, former Yugoslavia and most of the CIS sinc... venture began in 1989.

The Austrians, he says, serve as "a link to the ment... of the region; Vienna offers "a breath of the West with a

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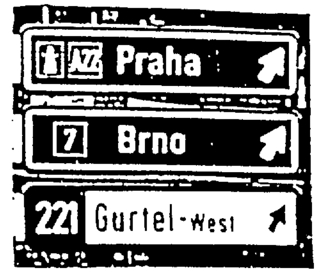
[illegible] Vienna [illegible] better [illegible] markets as a factor [illegible] for the Czech Republic [illegible] Vienna and Praha from Frankfurt to Vienna last month [illegible] that Austrians' relatively [illegible] at times somewhat [illegible] style meshes well with, for example, an Eastern [illegible] discursive speech which saves the point for the very last. "That takes many non-Austrian Westerners some getting used to," says one executive. "It's easy for an Austrian to understand when a Czech starts to babble in a way that would just annoy a Prussian or an Anglo-Saxon."

The empire strikes back

The imperial legacy has left more concrete benefits, such as the ample Eastern language capability which IBM Eastern Europe has tapped into by hiring second-generation Czechs and Hungarians.

But the bridge-to-the-east view has only so many adherents. One West European banker in Vienna responsible for operations in Central and Eastern Europe thinks that the heritage of the Habsburg years has bred a resentment among descendants of the monarchy's subjects. Maybe; but perhaps more significantly, the newly independent states are emerging too distinctly from one another for there to be a single "Eastern mentality" into which anyone – let alone the Austrians – can claim special insight. "I don't buy into this whole 'gateway to the East' thing," says American Anna Nerbovig of Vienna-based Pepsi International. "These countries are [illegible] themselves."

West Deutsche Landesbank's Austria general manager Hans Schwarz agrees. "Over some years, it's going to become impossible to service activities in Central and Eastern Europe from a third country," he says. "It's only a matter of time when the companies still using the Vienna base leave it to open their own units in those countries."



It's a question of mentality

Protectionism

Concrete measures

In recent months, Germany has appealed against cement dumping by Slovakia, Poland and the Czech Republic, and Spain has complained about cheap cement being shipped in from Romania. Both countries have filed anti-dumping protests with the European Commission. But Austrian producers – closer to the source of the imports – have been com-

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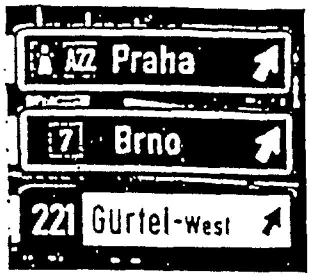

Introducing more subtle forms of protectionism

plaining about cheap cement for the last two years.

"Central and East Europeans can compete in Austria only because their cement industry is indirectly subsidised by the state", says Gerhard Raffel, who heads both the Austrian cement industry association and its largest cement producer, Perlmooser Zementwerke.

At first glance, the complaint has merit. Austrian producers argue that their competitors to the east and north, whose prices are 15%-20% less than domestic producers, are not saddled with stringent environmental regulations, and enjoy the benefits of low wages and devalued currencies. Worst of all, freight rates in the Visegrád countries are skewed by government subsidies, intended to prop up the national railways. On average, $6 will carry a tonne of cement 600 km in Hungary – an amount which would go no further than 50 km in Western Europe.

Mr Raffel reasons that these transport subsidies are particularly unfair since traditionally high shipping costs mean that cement is not an export item; domestic requirements are met by domestic producers. But statistics of the European cement industry association, Cembureau, show that the Benelux countries and Greece, for example, exported close to half of their production in 1993, primarily to nearby cross-border destinations. Which is exactly what the Czechs, Slovaks and Hungarians are doing exporting their cement to Austria.

Voluntary straitjackets

Nevertheless, on April 15 the Visegrád chambers of commerce agreed to implement "voluntary" export restraints, limiting the export of cement to Austria to 440,000 tonnes in 1994, a little under 10% of last year's national consumption. While double the anti-dumping quota imposed for a short while by Austria in 1993 (until Hungarians and Czechs slapped duties on Austrian exports of paper and fertilisers), the call for export restraints is short-sighted.

First of all, Austria is in a comfortable trade surplus situation with its Visegrád neighbours (see p. 40). Secondly, Austria's building sector could get a breather from easier access to cheaper cement and other construction materials from the east. Estimates suggest that the Czech Republic alone has the capacity to export up to 1.3m tonnes of cement annually to Austria.

Thirdly, the reasons cited for requiring protectionist support are increasingly irrelevant. Tougher environmental standards are being implemented – at great cost – by Visegrád producers as economic integration with the EU proceeds apace; the wage differential is shrinking; Central European currencies are on the verge of becoming fully convertible; and railway subsidies are gradually being reduced to levels found in the rest of Europe.

Austrian producers also suggest the imported cement is of low-quality. But cement plants in the Visegrad countries have been busily restructuring and re-investing in more up-to-date technology, with the help of foreign investors from Germany, Switzerland and [illegible] giant Maculan acquired a plant in [illegible] cement for its Austrian activities. And Perm[illegible] invested in the Hungarian cement industry [illegible] prefabricated elements) and in Slovenia, with the [illegible] boosting its share in those markets. But maybe some pressure for protectionism stems from sour grapes. [illegible] investors lost out to their German competitors while [illegible] to buy several other plants. Local rumours – dismiss[illegible] nonsense by Mr Raffel – suggest that privatisation [illegible] feared they were just trying to buy up and then close [illegible] future competition.

Austrian banks

Divergent tactics

You might get the impression that the larger Aus[illegible] banks – Bank Austria, Creditanstalt, GiroCredit Raiffeisen Zentralbank (RZB) – gained their sp[illegible] position in Central and Eastern Europe by joining hand[illegible] marching boldly in, with never a backward glance. The story is one of different strategies and varied success.

Creditanstalt – now being courted by Credit S[illegible] (among others) for its prowess in the region – has gon[illegible] the consistent approach of wholly owned commercial b[illegible]ing and securities subsidiaries side by side in all the Vis[illegible] countries, and now has 650 staff on the ground. RZB ha[illegible]ferred to take minority stakes in joint-venture or ex[illegible] banks, hoping to gain an eventual majority. It has a sta[illegible] Hungary's Unicbank, Slovakia's Tatra Bank and RCB in [illegible]saw, a joint venture with compatriot Centro Bank (alth[illegible] it has abandoned its step-by-step model with a wholly o[illegible] subsidiary in Prague). The bank has taken exposure to [illegible]kets the others have left, like Bulgaria. As for invest[illegible] banking, RZB plans to silence Creditanstalt's claim to [illegible] no real Austrian competitor in the region – a little unf[illegible] GiroCredit – by setting up full-fledged investment ba[illegible] operations in the four main capitals, perhaps later this [illegible] These will be joint ventures between RZB Vienna, its in[illegible]ment-banking arm and its local holdings.

Though less firmly entrenched, Bank Austria and [illegible] Credit (now in the process of merging operations) are making their mark, in commercial and investment ba[illegible] respectively. As well as its Russian presence, Bank Austr[illegible] profitable subsidiaries in Prague and Ljubljana and 5[illegible] EKB, a joint-venture Hungarian bank. The bank's early s[illegible]gy was to set up joint ventures with liquid local sa[illegible] banks, but it had to buy out its partners one by one as [illegible] failed to meet expectations.

GiroCredit has universal-banking and brokerage [illegible]sidiaries in Central Europe, as well as small stakes in com[illegible]cial and trade finance banks. But, aware of its limited siz[illegible] scope (it has a third of Creditanstalt's staff), the ban[illegible] evolved into a niche player, concentrating on capital-m[illegible] business and structured finance. For instance, it lead[illegible]aged financing for the Duna Intercontinental Ho[illegible] Budapest and for a Ukrainian offshore oil terminal. It [illegible] resigned to playing a marginal role in bread-and-butter [illegible]ing. "We learned the hard way that you can't do everyt[illegible] says Anton Burghardt, senior vice president at GiroC[illegible]

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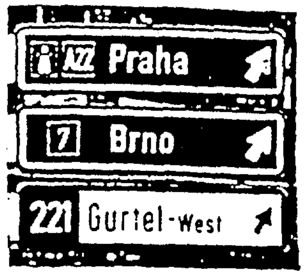
[illegible] Central European [illegible]

[illegible] varies on whether a bank needs to carry its own name in the region – Creditanstalt thinks it's important [illegible] – there is an industry-wide consensus that control of key holdings is necessary in order to see strategy through. Not that that solves all the problems. Creditanstalt, for instance, in 1992 bought a majority share in Nova Banka, a bright young Slovene bank, only to find that the general manager and some staff had very different ideas about its future. Many sackings and considerable stress later, Creditanstalt wrested real control, symbolised by the planned change of Nova Banka's name to Banka Creditanstalt.

No control, no deal

RZB has hit a similar wall, twice over. The bank recently withdrew from a 30% stake in Slovene bank Abanka (at no loss, it claims), a stake it originally planned to raise to over 50%. RZB sold the stake back to the Slovene state which, it says, hadn't honoured a commitment to cover loans to Serbian companies, while management hadn't declared all of the risks attached to the acquisition. With the minimum capital requirement at Slovene banks so high – around $30m – the bank feels it can't afford a replacement subsidiary. In Bulgaria, similarly, RZB will soon relinquish its minority stake in the Bank for Agricultural Credit, having tried and failed several times to get control of it. It will be a reluctant parting of [illegible] Western bank with a stake in a major Bulgarian bank, but [illegible] because Bulgarians voted BAC their bank of the year in 1992 and 1993. RZB won approval last month for a 100% subsidiary in Sofia.

One Vienna-based consultant's suggestion that the banks should throw their contacts and know-how into a central information pool draws derisive laughter from senior bankers. Beaming a smile, Creditanstalt's Manfred Wimmer explains why: "We're much too competitive for that."



Provincial branches are the new frontier

But despite the varied routes, the banks do have much in common: they have all developed a reputation for structuring tricky trade- and project-finance deals; most have well-established East-West trading subsidiaries (see next story); and they are strong on leasing, factoring and the like. Following the push into the stock-market and capital-markets business – all the banks have now set up funds for retail investors to invest in Central European equities – the latest frontier is opening up branches in the provinces, to win deposits from retail customers or to service local corporate clients. Between

60

[illegible] Austrian banks [illegible] Ceske Budejovice, Kosice [illegible] nan and Cracow.

This aggressive drive is based on the [illegible] region, especially the Visegrad countries and [illegible] kind of "near abroad" for Austrian banks, an extended [illegible] market. But the expansion has also required cash and a gr[eat] deal of commitment, especially since the biggest [illegible] banks, only medium-sized by international standards [illegible] already burnt their fingers once trying to expand into We[st]ern Europe in the 1980s.

However, their regional commitment only stretches [so] far. While all the banks profess interest in the CIS they won['t] throw many resources that far east. In Russia, where geo-poli[ti]tics – not the Austrians' forte – plays a leading role, they a[re] behind the French, Germans and Americans. Creditansta[lt] has a small stake in the up-and-coming Internation[al] Moscow Bank, and Bank Austria operates in Moscow with a[n] offshore licence, which limits its rouble business, but Alexan[der] Eduardoff, an assistant general manager at Bank Austr[ia] in Vienna, admits that the outfit is more for image than an[y]thing. "Its value is abstract, more on the goodwill than th[e] earnings side," he says. He describes the bank's strategy [in] "irrational" Russia as "very long-term".

Vienna's trading houses

Fighting back

Viennese trading houses, once the unchallenged ma[s]ters of countertrade with Central and Eastern Europ[e] have had to do almost as much restructuring to su[r]vive as the economies to their east. Good deals are harder [to] find, require more sweat, and yield shrinking margins [to] boot. Nor do the Austrians have a quasi-captive market an[y] more; competition has mushroomed, and Vienna now pla[ys] host to thousands of Central and East European-owned tra[d]ing outfits: "too many to count", reckons one trader.

So traders have had to learn to gamble on commerc[ial] risk, dealing directly with local producers and trying to d[is]cern which of them are reliable business partners. Alexand[er] Waldstein, managing director of AWT, a trading and trad[e] finance house owned by Creditanstalt, describes this scenar[io] as "the price we have paid for what we wanted politically" although he thinks firms like his now have a stronger ro[le] than ever in difficult transactions that commercial ban[ks] won't touch. "In a sense, we thrive on poor conditions," [he] says. "When a market hits trouble, the idea is the banks w[ill] pull out and our business will go up." But he accepts that t[he] gap is widening between, at one end, the former Sov[iet] Union, where countertrade is still the modus operandi, a[nd] Central Europe (especially the Czech Republic), where cas[h]-based trade is becoming the norm – although many lo[cal] banks are still slow at processing transactions – and t[he] emphasis has moved to marketing and distribution. Speci[al]ist traders are needed less and less for straight trade betwe[en] Western and Central Europe, as buyers and sellers increasin[g]ly link up unassisted.

For some, the new trading climate, while less secure, [is a] potential gold mine. Says László Hepp, director of Bank A[us]tria-owned Vienna Trade: "In the old days, if an FTO did

61

[illegible]

[illegible] its firm is [illegible] Vienna [illegible] ... [illegible] shopping market and distribute Western multinationals' products in Central Europe, especially Hungary. Clients include [illegible] and Ericsson, and its product specialities include [illegible] automation, auto body-shops and brewing goods. It's also doing some cross-border distribution for Central European firms, for example selling Czech malt to Hungarian breweries. Mr Hepp illustrates his firm's new role with a recent contract: a Japanese company set up a sales company in Vienna with about $2m. That wasn't enough to penetrate Central Europe, so it approached Vienna Trade, which agreed for a specified fee to take on the country and commercial risk, market its products, sort out logistics, arrange licensing and even conduct market research. In short, Vienna Trade agreed to buy a certain amount of the firm's products from it and sell them at a margin. If the Japanese company eventually wanted to take back control of its sales in the region, it would have to negotiate to buy the right to do so from Vienna Trade.

Slicing up the pie

Vienna Trade's new focus is part of a wider trend, with trading firms trying to concentrate on products, offer the kinds of service and penetrate markets where major competitors aren't willing to stick their necks out. Whereas they each used to have a nice slice of the same pie, "there isn't much overlap between us [the trading houses] anymore. It's become useless to complete," says Wilhelm Ambichl, head of FJ Elsner, the trading arm of RZB. Elsner specialises in agricultural products and is making a name in Asian-East European trade.

"Niche has become the buzzword," says Christian Sperk of Centrobank, a Vienna-based trade finance bank and trading house part-owned by Poland's Bank Handlowy. "Clients are only interested if you have a speciality," one of Centrobank's being raw materials and chemicals in Poland. Mr Sperk says the days of swapping sugar for machinery are over. Those that don't hone in on particular products and markets will drown in the choppy post-FTO waters.

Nowhere is it harder – or potentially more lucrative – to carve niches than Russia and the CIS. The problem is not so much finding goods to buy as getting them out. Train-loads disappear mid-transit and there's often no knowing when they'll reach port. If the ship's not there when the products are, there may be nowhere to store them. Conversely, the ship may be waiting weeks, which multiplies costs. Last year, Elsner had contracts for 150,000 tonnes of Russian seeds, but only managed to ship half that out. "How do you check up on a seller in Siberia?" asks Mr Ambichl.

Actually, he's already hit on a way. Aware that rock-solid local partners make all the difference, Elsner has formed a joint venture with a Russian entrepreneur who helps Mr Ambichl's sleep by taking care of the logistics quagmire: purchasing, local transportation, port arrangements and more. AWT has a similar arrangement in Russia. Both are very pleased with the results. Unfortunately, it doesn't seem to be a universal cure. Centrobank's Russian JV partners have proved disappointing, according to Mr Sperk. "It's as much mentality as logistics," he says. "They'll forget your contract if they see a better deal elsewhere."

This survey was written by Delia Meth-Cohn, Ken Kasriel, Béla Papp and Matthew Valencia.

52

Local heroes, to most

America's Enterprise Funds, especially the Polish one, have championed the local businessman. They've made lots of friends – and the odd enemy

A recent announcement by the Polish American Enterprise Fund (PAEF) that it has ploughed more than $200m into some 3,150 private Polish firms since 1990 might shake some sense into those critics still using bad publicity surrounding its Hungarian sister fund as proof that the Enterprise Funds – now operating in seven countries – were a bad idea.

They weren't. For starters, they were founded to fill a gap that most local banks still can't plug. With a venture capitalist slant, they lend to and take equity in small (some very small) and mid-sized local companies, joint ventures and sometimes US investors, always on commercial terms. They've helped many a start-up too. "Even their loans are tantamount to venture capitalist equity, because they're getting new firms moving," says one admirer. The Funds' stated mission is to help projects in the early stages, then to sow back their dollars "as early as is prudent" into other young risers. As only Americans can, they call this "planting and harvesting".

The beauty of the Funds is that, though financed by the US taxpayer, they have fairly free rein to act like private concerns on the ground, unhindered by politics. "We offer pure businessman-to-businessman finance," says PAEF vice president Frank Skrobiszewski.

His Polish fund is the shining star. It leads not only in terms of cash disbursed (after all, it's the biggest) but, more importantly, in terms of innovations. Three of these stand out:

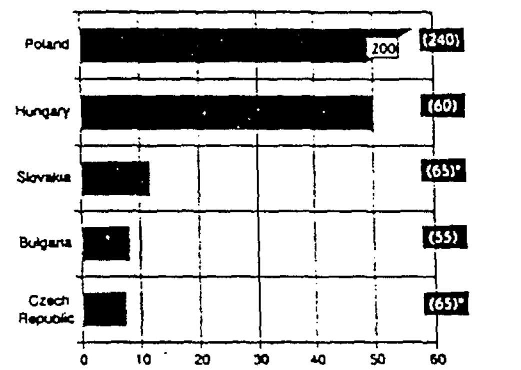
• True to its promise to attract "side-by-side money", the PAEF brought $101m of additional capital from the EBRD, banks and pension funds, into a $150m Polish Private Equity Fund, which has invested alongside its creator in 11 large projects.

• One of those was a $4.4m stake in rubber company Stomil Sanok, also the subject of a "capital management privatisation". This is a PAEF speciality, whereby the fund pushes capital (and sometimes advisers) into promising local firms to enable them to prosper without a foreign takeover.

• This caring stance to locals extends to small-time lending too. The PAEF small business loan subsidiary, Enterprise Credit Corporation, has surpassed all expectations, so far filtering down $58m in 11% dollar loans, averaging $25,000 apiece, to 3,100 small firms, and creating around 10,000 jobs, it claims, in the process. Amazingly, $32m has already been repaid and only 3% of the portfolio is non-performing. The PAEF has just started a scheme for micro-loans (in the $500-$7,500 range), and is reaching female entrepreneurs with similar-sized credits through a Women's Rural Lending Programme.

POLES APART

American Enterprise Fund disbursements, as of August 1994($m). Number in brackets is total fund size



* Joint Czech-Slovak fund

Source: Enterprise Funds

So admired is the PAEF that Eriberto Scocimara, the Hungarian fund's new top dog, plans to restructure his fund along the same lines, spinning off subsidiaries and new partnerships, and establishing a side-by-side investment fund.

But not all the PAEF's creations have been immediate hits. Mr Skrobiszewski admits that the foundation of Polish American Mortgage Bank was a touch premature. Though now operating, its start-up was painfully long. Initially, the PAEF just wanted to lend to home-building companies, but soon realised there was no mechanism to finance home buying, hence the bank. It then found developers in such poor shape that it had to help them too before anything else could happen. "We found as soon as you opened one door, you'd find another that needed opening," says Mr Skrobiszewski. The mortgage bank was "one thing we might have done differently".

Mixed bag

In fact, the overall story is one of much good work mingled with the odd glitch. David Scott, head of the Citizens Democracy Corps in Warsaw, has been loosely involved in several PAEF deals, one of which was a disaster and one a roaring success. In the disaster, the fund gave Tomasovia, a food processing company, "exactly what it asked for, but exactly *not* what was needed", says Mr Scott. The money was used to put summer-picked fruit and berries in cold storage for processing in wintertime. But that was illogical, as the cost of storing them so long ate away the eventual revenues.

The success was a $6m equity injection in the Polish-Swedish Hoste furniture company. According to Stanislaw Karczmarczyk, one of Hoste's top managers, the finance has allowed it to expand its core outdoor furniture business – it bought two former state factories – diversify into office equipment, and quadruple sales in three years, to $10m. "They probably couldn't have got the money from anywhere else," reckons Mr Scott.

Nevertheless, there will always be a degree of bitterness among those firms that apply for Enterprise Fund money and get turned down. One such reject

A FAR-OUT FUND

The foreign investment climate here is very good, and there are dynamite opportunities in certain sectors: inflation is lower than anywhere around; the local currency is internally convertible and in demand in less stable, neighbouring countries; and the president is utterly pro-market reform." Thus an American diplomat in...no, not the Czech Republic but, of all places, Kyrgyzstan. A recent surge in tributes like this have helped build a consensus that the small republic on the cutting edge of Central Asia is ripe fodder for privately managed investment funds to tuck into. One's on the way, in the shape of a $12-15m equity-investment fund that will be managed by Boston-based venture capitalists Schooner Capital Corp.

Half of the money for the Kyrgyz Investment Fund will come from multilaterals, including the IFC and EBRD, which are close to signing, and half from institutional investors. Uniquely, the fund will probably also be leveraged by a concessional debt package from the World Bank, which Schooner would also manage. Schooner has learnt from the experience of others how to drum up interest and get the locals on its side: in July, it sponsored a lavish dinner in honour of the Kyrgyz prime minister.

The fund's backers point to a number of "attractive" sectors, mainly mining and food-processing, but also tex-tiles and hydro-electricity (potentially one of Kyrgyzstan main exports). The country, they say, is also a handy ba... door to China, by far Kyrgyzstan's biggest trading partne: But everyone admits there's a problem with infrastructure making any deal a long-term proposition. The difficulty, says Burton Sheppard, Schooner's managing director, will be doing deals in a form understandable in Western terms and "turning centrally planned units into profit centres." And he cautions that Kyrgyzstan is "small, and not very developed."

Greg Kiez at Istanbul-based Global Securities, which : placing the fund's shares, says this one is for "pre-emergin market investors". He says he's happy to report the pool c institutional investors looking to place money in Centra Asia getting deeper lately, though it's still relatively small Global recently raised $13m for a vehicle to invest in Cen tral Asian holdings run by Turkish brewer Efes Pilsen.

Schooner's new baby won't be alone when it start making investments, probably early next year. Washing ton recently announced the formation of a $150m Centra Asian American Enterprise Fund. A fat slice of that cou end up jostling with Schooner's for projects in Kyrgyzstan

Matthew Valencia

is Stefalex, a young firm based in Košice, east Slovakia, which recycles beer crates into garden furniture. Its head, Jozef Šuchaň, calls the funds the "American trick" because "they look good but don't help".

But Enterprise Fund staff counter that sheer demand means disappointments are inevitable. "We've received many an application where the projected cash flow didn't even cover repayment," says Mr Skrobiszewki, although that's less common now. Mr Scocimara remembers hearing that the funds received 4,000 letters requesting help before any of them had even got started. With that level of demand and desperation, "you're bound to make enemies".

Matthew Valencia

shares. The law requires firms to pub a prospectus before going public: ever bother. "I've never seen a pros tus," says Diana Downing, an attor with Baker & McKenzie in Mosc "The law is not being enforced."

Lack of information about tra companies makes it impossible investors to assess risk and m informed decisions – as was the with MMM which, it emerged, ap ently had no assets on which to bas extravagant returns. Lack of tr parency also makes the market m vulnerable to manipulation, which major problem in Russia. "At moment, the market is a black b says Zoya Larkin, a stock market lyst with the consultancy AK&M.

No central plan

Also problematic is the issue of s registration, where there are violat on a mass scale, according to Mr lyev. Russia has no centralised de tory where stock transactions ca registered; instead, it is up to the ing companies themselves to re when their shares are bought and Unless a share is registered, its o cannot enjoy the privileges of ov ship. Frequently, companies demand a bribe before they agr register a share. Even then, becau archaic technology the process car up to a month.

EBRD credit lines

Middlemen

EBRD BANK-TO-BANK LOANS		
Country	**Intermediary bank(s)**	**Amount (Ecu m)**
Czech Republic	Komerční Banka	approx 30
Estonia	Estonian Investment Bank	3
Hungary	Magyar Hitel Bank, Kereskedelmi Bank, OTP Budapest Bank	87
Poland	Polish Development Bank	25
Poland	Wielkopolski Bank Kredytowy	41.5
Romania	Romanian Development Bank	41.7
Romania	Banca Agricola	53.3
Russia	Association Commercial Bank, Investment Commercial Bank Nizhegorodets, Nizhegorodsky Bankirsky Dom Bank, First Commercial Tula Bank, Mosbusiness Bank (Tula), Mosbusiness Bank (Tomsk)	16.9
Slovakia	VÚB	approx 50*
Slovenia	SKB Banka	25.8
Uzbekistan	National Bank for Foreign Economic Activity	49.8

** at documentation stage. Not yet signed* *Source: EBRD*

The EBRD has long been criticised for not pushing anywhere near enough finance out to the very firms most likely to set the region a-booming: those at the smaller end of the local private sector. Even the bank itself says it still wants to put more effort into delegating to financial intermediaries on the ground so as to get money quickly to projects too small – in the $500,000 to $5m range – to justify it throwing its own, limited human resources at.

That looks like modesty. In fact, the delegating started long ago. The bank now claims around 50 close buddies among the region's banks and funds: it has set up or ploughed equity into 11 regional and country-specific investment and venture capital funds; it is a shareholder in more than 10 investment and commercial banks (the latest being a mini-development bank in Lithuania, signed last month); and the number of co-financing agreements it's signed with Western and local banks – where the two parties share project risk – will soon hit double figures too. New concepts are emerging all the while. A recent one is the Trade Facilitation Programme, which sees the EBRD lending to commercial banks – so far in Prague and Skopje – which use the funds to finance local clients' exports.

Banking on banks

Perhaps the most efficient instrument has been "bank-to-bank loans", longish-term credit lines which are on-lent to investment projects. The EBRD has already signed off over Ecu400m ($490m) of these, to 16 banks from Prague to Tashkent (see table above). Another Ecu50m is about to fly out of the pipeline on to Slovak bank VÚB's lap. A bank with unrivalled knowledge of the Slovak business sector but little long-term money to throw its way, VÚB is the ideal candidate.

The concept is being pushed hard in response to towering demand. "When asked what the main problem was, most banks said a lack of longer term money to lend firms for investment," says Dragitsa Polipovic-Chaffey of the EBRD's Financial Institutions Group. She says the loans have the best track record of all the bank's tools: an estimated 80% of the money lent banks has already been matched with corporate borrowers. One reason for the speed is a commitment fee that effectively fines banks for lending too slowly.

Ms Polipovic-Chaffey says the approach is two-pronged: to aid the vibrant private sector and to set banks up as reliable borrowers. The EBRD looks closely at prospective bank-partners for a mixture of business-climate savvy and sound credit policy. In a few cases, just to be sure, it has lent to banks it owns shares in, like the Estonian Investment Bank. Even with the most trustworthy banks, it monitors the destination of loans on a regular basis and has the right to insist on foreclosure if it doesn't like what it sees (though it hasn't had to yet). In hairier investment climates, like Russia, it sends in seasoned venture capitalists – often on a contract basis – to help banks pick worthy borrowers.

So what kind of company should apply? The only conditions, says the EBRD, are that it should be private or about to privatise and have a realistic (and profitable) business plan. No Western involvement is required. As for loan terms, maturities are refreshingly long – generally 4 to 8 years – but rates aren't dirt cheap. "We don't provide subsidised money," says Kurt Geiger, an EBRD Senior Banker. "We have to price at what the market will bear. But we can offer finance that's attractively structured" with grace periods, and a "flexible" attitude if problems crop up.

With so little long money out there, the EBRD says it's had to create its own pricing benchmarks. Enough banks are finding those attractive. For some, it has meant being able to lend more cheaply than normal. For others, it has just offered more access to a rare commodity. One of the latter is Magyar Hitel Bank, which will soon begin lending about Ecu25m of EBRD cash to the agri-sector as part of an Ecu87m line to four Hungarian banks. Maria Ban, a director of the bank's credit department, says even though the EBRD is barely cheaper than its normal loans, demand from clients is high. Projects worth Ft600m ($5.6m) are already lined up. "It's not money we have ourselves," she explains. "That's why we asked for it." She thinks these loans help banks like hers in numerous ways: they establish a working relationship with the EBRD, are good for image (with banks abroad and local business), boost track record, and provide modest profit without risk.

Magyar Hitel hopes to stretch the money as far as possible. It has until 2004 to repay the EBRD. If it makes some shorter term loans, it should have enough time to lend again once the first borrowers have paid up. Or rather *if* they have. That's an if the EBRD is hoping its choice of banks will keep very small.

Perhaps the EBRD's hardest task finding banks in good enough shape. So it's started to attack the problem on

EBRD CO-FINANCING AGREEMENTS WITH LOCAL BANKS			
Country	**Partner**	**Amount (Ecu m)**	**Destination**
Hungary	Inter Europa Bank	25	Private companies. Max. loan size: Ecu8m
Poland	Amerbank	16.7	Private SMEs
Poland	Kredyt Bank	8.3	Private SMEs
Russia	International Moscow Bank	6.3	Private SMEs. Loan range: $250,000-$4m

Source: EBRD

Destination
Financing Czech exports
Private/privatising SMEs in industrial, export and financial sectors. Average loan size: Ecu500 000
Private SMEs in agricultural and agribusiness sectors
Private SMEs. Loan range: $300,000-$5m
Heating companies
Private and commercially managed state companies. Max. loan size: $5m
Companies in horticulture, forestry, fisheries, agribusiness and related services
Companies with fewer than 50 employees. Max. loan size: $75,000
Financing Slovak exports
Private SMEs
Private/privatising export-oriented SMEs

step further back. If a bank is almost there, but shaky in one or two areas, the EBRD will grant a bank-to-bank loan alongside a separate loan to remedy the ailment. Hence the $58m lent to the Romanian Development Bank in May: a $50m credit line plus $8m for a computer system. Last month, it went further, finalising $100m in loans to a group of 30 or so commercial banks that it believes will form the core of Russia's future banking industry. The loans are for computers and to help the banks strengthen their balance sheets and business plans. Only once that's been accomplished will the EBRD and World Bank pump in a further $300m in credit lines for the by-then well-toned banks to pass on to the private sector. Chances are, when the time comes to repay, the figures will show it was worth the wait.

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