Foreign Direct Investment in Hungary: Lessons for Central and Eastern Europe

Joop de Kort
Leiden University, Institute of East European Law and Russia Studies

Abstract: When in 1989 the markets in Central and Eastern Europe opened, western firms were quick to move in. Hungary treated foreign firms equal to domestic ones in the privatisation process. It attracted most foreign direct investment in the region. Now, other countries are likely to follow the Hungarian path and allow foreign firms to take over domestic firms. This contribution discusses the experience of six Dutch Multinational Firms in Hungary and discusses whether these can be useful for expansion into other countries in the region. The results indicate that firms easily underestimate the cost of reconstructing acquired enterprises and that building a market position is more expensive than anticipated.

keywords: Hungary, internationalization

acknowledgements to Herman Hoen, Ron Kemp, participants of the 5th annual conference on marketing strategies for central and Eastern Europe (Vienna 1997) and students from the project Market Entry Decisions: Budapest.
Foreign Direct Investment in Hungary: Lessons for Central and Eastern Europe

1. Introduction

It is ten years now that the people of Central and Eastern Europe decided to pull up the Iron Curtain and end communist rule and its accompanying system of central planning and work hard to build a market economy. The changes in Central and Eastern Europe (CEE) opened up a market of around 400 million consumers that for a long period of time had been deprived of many kinds of consumer goods and of a choice between different brands and qualities. Many western firms ceased the opportunity to serve these markets), which resulted in a radically different trade pattern for the countries in CEE in a short period of time. Prior to 1989, the bulk of their trade had been strongly restricted within the communist countries and focused strongly on the Soviet Union. In 1993-1994, fifty to seventy per cent of imports and exports were with western (OECD) countries (WIIW, 1995).

Many companies have set up sales agencies to export their products, but thus far western companies did not invest directly on a large scale in the area. Foreign direct investment (FDI) in the area of CEE totals 44 billion US$ over the period 1989-1996 (Meyer, 1996, EBRD, 1997). This may have to do with the privatization policies that have been pursued in the countries of the area. Although most of GDP is now produced in the private sector, foreign companies were in general excluded from the privatization process. Only in Hungary there were no restrictions on foreign firms to acquire domestic firms. They were treated equal to domestic bidders on firms that were privatized. As a result, Hungary is the largest recipient of FDI in CEE. It attracts almost one-third, US$ 13 billion. Only in 1996, the larger countries Poland and Russia started to attract more FDI annually than Hungary did.
In most countries, the privatisation resulted in insiders acquiring the ownership of the firms, either directly or through investment funds (Frydman, Murphy and Rapaczynski, 1998). Furthermore, the state continued to hold ownership of a large number of firms. This resulted in old patterns of behavior to continue and in a slow process of reconstruction. However, the investment climate is changing. The economic crises in Russia and the Czech Republic and the halted process of privatisation in almost all countries have renewed the discussion of foreign ownership in CEE. If foreign firms are allowed to acquire companies in other countries that Hungary (on a large scale), this may result in a fresh flow of FDI into the area. But like CEE governments are rethinking their position towards FDI and the sale of their firms to foreigners, western firms should also be rethinking their strategy to enter the region with FDI. Ten years of transition has brought many changes to the area, but it also showed that some old habits never die, or die very slowly. In that respect, Hungary can provide some valuable learning experiences. Many western firms are present in that country now for almost 10 years and have valuable experience in doing business in a formerly planned economy. In this paper, the focus will be on the experiences of six Dutch firms that have invested in Hungary five to ten years ago. The set of cases is a small convenience sample and we use it for exploratory purposes only. We did, however, include both greenfields and acquisitions in the sample. The material for the cases come from annual reports, accounts in the business press and interviews with executives in Hungary. The interviewees were either marketing directors or managing directors of the Hungarian operation of the firm. The interviews were arranged through direct contacts from the Netherlands and were of a semi-structured nature, consisting of a series of questions particular to the operation environment of the firm. Information of previous interviews was utilized and respondents were allowed to expand on topics, they were knowledgeable about. The interviews were held early 1997.

The focus of the first section will be on the background of Hungarian business in a Central and Eastern European and on a discussion of the motivations to enter new countries.
2. Is Hungary a special case?

Similar to the other countries in CEE, the economic system of Hungary, prior to 1989, was characterised by central planning. Political (communist) authorities set the economic goals and the structure of the planning process ensured a continuous political control over productive processes. At the enterprise level, the director of the enterprise engaged in an elaborate system of bargaining with the planning authorities to get ample inputs and a modest output goal. To realise the politically set production goals, the enterprise director also misinformed the authorities and engaged in an array of informal activities to allow for some discretionary powers to run the enterprises (Berliner, 1957, Linz, 1988). Hungary, in this respect was no exception to the rule (Kornai, 1959, Laky, 1979, Swaan, 1993).

Unlike the other countries, Hungary in the years of the New Economic Mechanism (NEM), which started in 1968, had replaced the system of physical planning by a system of comprehensive formal and informal regulation (Swaan, 1993). In this system, enterprises could more easily change the structure of their output towards the structure of demand. It also allowed management more freedom in acquiring inputs and rewards. The enterprises, however, continued to operate under so-called soft budget constraints (Kornai, 1979). If they accumulated losses, the state would always bail them out; thereby they were not held accountable for their actions furthermore. They were not motivated to earn profits, because of high tax rates for profits. The NEM did not fundamentally change the state socialist framework. The enterprises continued to be a part of an encompassing hierarchy where party organs at all levels continued to intervene with enterprise decision making. The entry and exit of enterprises was still subject to bureaucratic approval and regulation. Markets remained highly monopolistic and there was no capital market (Swaan 1993). Although private firms became progressively more important, they posed no real threat to the state sector. The benefit of the reforms in the light of the transition to a market economy was that it generated a class of managers that had some experience in a system of regulation, which can be interpreted as a
useful learning experience for operating in a market environment. The reforms also encouraged economic debate on the methods of running a market economy.

Only in the later years of the NEM, between 1978 and 1988, producers increasingly became authorized to trade on their own. (Until then there existed a state monopoly on foreign trade.) This authorization, however, was restricted to world market trade and did not include domestic trade. Neither did it include the authority to settle accounts. The currency monopoly remained firmly with the state (Hoen, 1992). Although Hungarian foreign trade performance was not different from other countries in CEE, Hungarian companies had valuable learning experiences for operating in a world economy. From a western company’s perspective, the possibility to directly trade with Hungarian companies provided the westerners with the opportunity learn something about Hungarian firms.

When, in 1989, the socialist economic system collapsed, Hungary was more familiar with a market economy and better known to western firms than the other countries in CEE. It was also more open to FDI. Unlike other countries in CEE, it was not afraid to sell companies to foreigners. It relied on FDI to provide the means to restructure obsolete enterprises and to provide means to invest. Domestic savings were insufficient to provide these means and the state itself not only wanted to withdraw from its direct intervention in enterprises, but didn’t have the means either to restructure or invest. The State Privatization Agency (SPA), that prepared enterprises for privatization, allowed an even encouraged foreign bids on enterprises (PW, 1995, NTDB, 1997.
3. Investing in Hungary

Companies entering new markets have a wide choice of options, the selection of which depends on the evaluation of the underlying dimensions, control, dissemination risk, resource commitment and flexibility (Root, 1994, Driscoll and Paliwoda, 1997). It goes beyond the scope of this paper to discuss all the underlying dimensions of the choice extensively, but internationally experienced firms tend to prefer investment modes of entry (Johansen and Vahlne, 1977, Anderson and Gatignon, 1986, Hill et al, 1990, Barkema et al., 1996). These modes offer high control and have low dissemination risk. In case of acquisitions this is accompanied with a high resource commitment and little flexibility. Greenfields, on the other hand are more flexible and do not require the large resource commitment of an acquisition. This would explain why Hungary attracts so much FDI in comparison to other countries in CEE since it allows firms to enter with their preferred mode of entry.

Although Hungary is only a small market of 10 million people with low income, many firms rushed in to establish a presence. The pace was extraordinay, which raises the question why firms were so eager to enter Hungary. Many firms entered through an acquisition of an existing enterprise. Because traditionally in centrally planned economies enterprises were large, the purchase of an existing one provided western firms with large market shares instantly.

In management, there is a strong belief that ‘first movers’ in a market will be able to establish market leadership. (Robinson and Fornell, 1985, Lieberman and Montgomery, 1988). They can set the standard and create entry barriers for others. Although most studies on ‘first movers’ concern product markets, studies by Wesnitzer (1993) and Becker and Baker (1996) indicate that managers extend the ‘first movers advantages’ to regional markets as well. In Hungary, they preferred the role of pioneer, even if the market may be difficult to enter because of low consumer purchasing power, political instability, unfamiliarity with these markets, lack of knowledge and experience in doing things the western way, inadequate
distribution networks and transport facilities and limited advertising media (Karakaya, 1993).

Perceived pioneering advantages in Hungary include building important contacts, getting attention in the media, easier distribution because shelf space is still available, an open-mindedness by consumers for new brands, the absence of competitor’s noise in advertising, the possibility to make mistakes in a less competitive and less expensive environment, acquiring a deeper knowledge of the market by going in the rough way (Becker and Baker (1997). Some of these advantages are only temporarily. For example, if other firms enter the advertising noise will increase. Others, such as having good contacts, may be defensible. Because the control that can be exercised over the pioneering effects is limited, and a considerable degree of commitment and expertise are necessary to succeed, Becker and Baker (1997) conclude that pioneering is less likely to be successful than most people seem to assume.

4. Dutch investment in Hungary

The sample in this paper utilizes 6 Dutch multinational firms that are active in Hungary. The material was collected for a study on motives to enter the Hungarian market and on the preferred way to enter (acquisition versus greenfield). The results, however, provided information too on the experiences in the Hungarian market. This information is presented here in a format using three basic categories, the entry process in Hungary, the internal organization and the marketing strategy.

*Aegon* is a large Dutch insurance company. The internationalization of the insurance market is of a fairly recent date, but is developing rapidly and Aegon intends to become a global player in its main activities, life insurance and securities. The company is also interested in the emerging markets in CEE and according to Aegon, Hungary combined economic success and a legal structure for foreign ownership and, therefore, was one of the most interesting countries in CEE. In 1992, it was possible for Aegon to bid on AB; a Hungarian company that
specialized in life and household insurance. Aegon won the bid. Aegon believed that AB would fit in their organization and bring a large customer base. With the state withdrawing from economic interventions and the deterioration of state pensions and social security, the customer base would be a valuable asset to sell insurance products.

With the purchase of AB, Aegon gained a large customer base. It had a network of 20 county directorates and 150 branch offices. The operating costs, however, were very high. The administration-sales person ratio was 3 to 1, and the distribution network was inefficient. A restructuring process was initiated: turn around the administration-sales person ratio to 1 to 5; train sales persons to get more out of their customer base; reorganize the branch offices into 50 branch offices and 100 representative offices under 6 county directorates and centralize the administration. This process was time consuming and not completed when the company was visited.

Aegon used its network to market newly developed products, especially life insurance, which would supplement the decreasing social service benefits. Other insurers, however, entered the market with greenfield operations and concentrated on the niches with high margin products like life insurance. Therefore, Aegon faced serious competition in those niches.

Although Aegon is still market leader in its markets in Hungary, it had to invest more than it intended in the restructuring of the organization. The market proved much more competitive than expected.

Another service providing company and focus of this study is KPN, a Dutch telecommunications company. Similar to insurance, telecommunications is a rapidly globalizing sector. KPN, with its small home base, strongly believes in international expansion. Internationally, it co-operates with Swedish, Swiss and US telecommunication companies in a joint venture, Unisource. In 1992-1993, the Hungarian government prepared legislation and regulation to privatize and liberalize the telecommunications market (NTDB, 1997, PW, 1995). MATAV, the national telephone company, was privatized and local telephone concessions in 18 out of 54 regions were issued. KPN bid for MATAV, because that would buy a large market share, but lost to a joint venture of Ameritech and Deutsche
Telekom. Together with Unisource partner Swiss Telecom, it was able to win a concession for Jaszbereny, one of the 18 regions. This is a relative small operation in which KPN wants to learn about the telecommunications market in CEE.

The terms for the acquisition included the new owners having to install 19,000 new lines by the end of 1995 (and 30,000 lines by the year 2003). The concession is for 25 years (of which 8 of exclusivity). The capacity was quickly increased to 25,000 lines by replacing the analogue network by a new digital network. Subscriptions did increase, but only to 15,000 lines. It turned out that the people in the area could not afford the entrance fee (which equaled half a month’s income) or the monthly bill (which required 5-10% of a monthly income). Rather than pick up the receiver, the people in this rural area would cross the street to deliver messages. The social structure in the area is still very much family based.

With another Unisource partner, Telia from Sweden, KPN formed Pannon GSM to enter the market for mobile phones. Mobile phones is a new market in Hungary and only US based Westel 900 was operating in this market. Pannon GSM hoped to establish a presence in the market before it fully develops, but was taken by surprise by a booming market. Sales targets continuously had to be adapted upward. KPN explains this success by the high number of entrepreneurs in Hungary (the interviewee mentions a number of 800,000) and the high share of the informal economy, which is officially estimated to be around one third of GDP.

The major difficulty for Pannon GSM lies in staffing. The sales force is young and enthusiastic, but focuses very much on selling, rather than marketing. The organization therefore intends in the near future to set up a hierarchical organization to work on its marketing strategy.

*Sara Lee/DE* is an American-Dutch company marketing consumer goods. It operates in two divisions, households and body care on the one hand, food and stimulants on the other. It is well established in many markets and also wants to build a position in emerging markets. As a general strategy, it acquires a firm in a new country in any of its activities to learn and builds a position from there. In Hungary, Sara Lee/DE acquired Compack, a coffee and tea company.
that also packed spices and had a salt division. This acquisition bought Sara Lee/DE market
dominance in both coffee and tea and Sara Lee/DE intended to build from here.

In the tea market, Sara Lee/DE continued to market Sir Morton, Compack’s
successful tea brand. It used the distribution channels to introduce its own brand Pickwick.
Not to damage Sir Morton’s market position, Pickwick was marketed in fruit-tea varieties, a
product-innovation for the Hungarian market. Competition, however, is fierce. Unilever, with
its Lipton brand is aggressively working the market. In the coffee market, Sara Lee/DE
decided to position its own brand Douwe Egberts as the main brand next to the local brands.
Although initially successful, Douwe Egberts, in 1996-1997, started to feel the pressure from
the competition, especially from Tschibo, a German coffee brand. To defend its market share,
the company invested in a new package design. The market in itself was threatened by the rise
of a black market in coffee and tea as a consequence of the luxury tax the government
imposed in these products.

A large effort has been made to reorganize Compack. Production facilities had to be
shut down and investment in new machinery was needed in other ones. To install the new
machinery, and to teach local operators, Dutch maintenance personnel had to be brought in.
Many people had to leave the company. The salt division was a burden on Sara Lee/DE’s
investment. It did not make any profit and would be very expensive to reorganize. The terms
of sale, however, did not allow Sara Lee/DE to close it and the company has been unable to
find others to buy the division.

Unilever, an Anglo-Dutch multinational operates in many of the markets that Sara Lee/DE is
active in. It also has a wide international presence and wants to be present in all countries in
CEE. It prefers to be close to its markets and to produce locally. In Hungary, the acquisitions
of a number of production companies bought it market dominance in ice cream, detergents,
margarine and quick frozen foods. It was hoping to capitalize on an early entry.

Unilever intended to restyle the local brands and put their acclaimed brands next to
these existing lines. Its own brands were targeted at the high-income segment. In Hungary,
however, this still is a small market. Unilever found the consumers to be very price sensitive.
It also found that traditional, rural patterns of food preparation and consumption persisted in Hungary, even in Budapest. The economic crisis even induced people to increase their time spent on home cooking. It was impossible to capitalize on early entry since competitors entered Hungary very quickly too. Furthermore, consumers were not very brand loyal and became very critical, very quickly. They grazed the market. Unilever ran into difficulties marketing its own, more expensive, brands successfully. Another problem Unilever encountered was the inadequate retail infrastructure in Hungary. Stores had insufficient in-store cooling and freezing facilities and it took Unilever more means and effort than expected to establish the appropriate warehousing. On the other hand, the acquisitions and the restyling of the existing product-line had given Unilever a good portfolio in the cheaper ends of the market. These turned out to be very successful.

Another Anglo-Dutch firm, Shell, is active in petrochemicals. It is present in most countries of the world. It was one of the few western firms that already were present in Hungary before 1989, where it operated a range of petrol stations. It would like to establish a presence in all countries in CEE. In Hungary, an interesting market for Shell was the filling and distribution of Liquefied Petroleum Gas (LPG). When LPG supply was privatized, Shell tried to acquire companies that were filling and distributing LPG cylinders and tanks. However, SHV/Primagaz and Total Gaz won these bids. Because Shell still wanted to be in this market it started a greenfield. It built a gas-filling station and started to serve the area in Hungary with a low penetration of LPG, close to its home base. This home base was carefully chosen to be an area where the two competitors were not omnipresent. Shell copied its French strategy, which focused on distribution of gas cylinders through the village hardware stores. These stores were closer to the customers than the usual outlets outside the villages and had much longer opening hours. Shell would avoid head on competition with its competitors, expanding to other villages continuously. Next to the proximity and longer opening hours, Shell could also offer a better product. Its new filling plant operated with strict security systems and high reliability and could therefore deliver full cylinders. The competitors were operating on older equipment and were unable to do that. The project was very successful and
Shell realized its target (2-5 percent market share in 1995) ahead of time. The major difficulties Shell experienced in its sales staff. It recruited young people from universities and trained them in selling techniques. The young staff did not have a settled way of doing things. This required a lot of coaching from head office, but also brought in new ideas continuously. *The Press Company* (TPC, an alias) is a large Dutch publisher of newspapers, magazines and educational material. Publishing is turning into a global industry too and a few large firms dominate the global market. TPC is active in several countries and intends to further internationalize its operations. Since TPC is not a large publisher internationally, it also turned to CEE, because these were not very mature markets in publishing. However, in Hungary it could not compete with the large publishers from Germany that acquired most publishers with a broad portfolio. To establish itself in the market, it bought a small publisher, Theseus (an alias) that had a strong position in crosswords magazines.

The most difficult issue for TPC was to establish its distribution system. Before the change, magazines were distributed through the post offices, but this system collapsed. The large publishers have now set up their own distribution network. Another difficulty is to determine the number of copies of each issue that had to be distributed to each point of sale. In publishing, unsold copies are returned to the publisher. For small publishers, mistakes in this field are more harming than for large publishers. The economic crisis also hit publishing. People did not have a lot of money to spend on magazines, whereas prices of magazines rose with the increase in the cost of production. The paper industry had modernized and produced high quality, high priced paper. Being a capital-intensive industry, the low Hungarian wages did not provide any compensation. Being a small company within Hungary, Theseus did not have a large promotion fund, and limited sales negatively influenced the advertising income.
5. Discussion

Although only small sample, it affirms the Becker and Baker (1997) conclusion that firms have a strong belief that it offers advantages to enter a new market quickly and to acquire market leadership. All our respondents preferred acquisitions and the market leadership that came with that. The ones that started a greenfield had to, because they lost a bid for the market leader (Shell) or because there was no market for the product previously (KPN in mobiles). KPN in fixed lines and TPC also lost bids for large Hungarian firms, but were able to acquire smaller partners. The sample was too small to firmly conclude that an early entry, especially through an acquisition, was an erroneous strategy, but the findings provide some indications that it was a questionable one. The firms in the sample faced great challenges. Acquisitions did not create entry barriers for followers and competitors either attacked the same markets (especially in consumer goods industries) or targeted niche markets with smaller investments. Shell followed a similar strategy in the LPG market.

The respondents in the acquired firms all mentioned the large costs of reconstruction exceeding expectations. Additional investments were required to operate the firms more efficiently and to set up distribution systems; additional time was needed to allow people to change over to the new circumstances. Staff was much more production oriented than market oriented. Obviously, greenfields avoided the high costs of reorganizations, but they shared the experiences in the human factor.

The common denominator with respect to the marketing strategy was that the firms encountered competitive markets and critical consumers. Since in fact there existed no barriers of entry in Hungary (with the exception of telephone operations, which were given concessions for longer periods of time) and many western firms were attracted to Hungary, market shares were difficult to attain or to hold. Furthermore, the distribution infrastructure proved to be very poor, which made it difficult to market products on a national scale.
rural consumption pattern and the economic crisis, which reduced incomes, made the marketing of more expensive western products very difficult. The experience of Unilever is characteristic in this respect. The existing, cheaper brands were the most successful ones. After a period in which consumers tested several western brands, they were not brand loyal, they often returned to the improved local ones that were cheaper.

What can firms learn from experiences in Hungary? With respect to developments in the market other countries in CEE are similar to the Hungarian one. An initial shopping spree, particularly focused on Western products, is followed by a very difficult economic situation in which consumers see their income erode. They are unable to buy the expensive western product and become highly critical, price sensitive consumers. The individual markets are too small to support large sales of expensive products and firms have to concentrate on the lower priced segments of the market, which very often will be the (improved) local products. With respect to the internal organization western firms may find surprisingly similar developments as in Hungary in the past years. The discussions on privatization and reports in the business press point to a slow pace of reconstruction of firms. This will result in a repetition of the slow and expensive process of reconstructing firms included some unexpected elements. A comprehensive study into the types and magnitude of unexpected costs may be useful to evaluate the reconstruction costs. One of the important benefits of ten years of reform is that it is much easier to value assets nowadays. They certainly should not expect quick returns. Doing business in CEE is a long-term commitment.
References


Kornai, Janosz, 1980, *Economics of Shortage*, Amsterdam, North Holland Publishing Company


Comments to referees of manuscript 74

The manuscript has been seriously shortened. The cases have been rewritten and more strictly structured. Material that had no direct relevance to the study has been dropped and they follow a descriptive format. The introduction has been rewritten and includes a clearer research question: what can firms learn from the Hungarian experience of the companies in this sample when they consider investing in Central and Eastern Europe? To understand the Hungarian situation vis-à-vis the situation in other countries, a section has been added on the Hungarian environment. The discussion on internationalization is rewritten to eliminate unsubstantiated assertions or assumptions. A paragraph has been added on the methodology and the limitations of the study. These are taken into account when writing the discussion.