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ADVISORY
TRANSACTIONS & RESTRUCTURING

Developing a Market Entry Strategy for Central & Eastern Europe

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Introduction

Central and Eastern Europe (CEE) is one of the most dynamic regions in the world. The region's nations continue to solidify their transition to democratic market economies and many countries have become respected members of the European Union (EU) and the OECD. We define Central and Eastern Europe as the formerly communist states between Germany, Austria and Italy in the west and the pre-1939 Soviet Union territory in the east, stretching from Estonia in the north to Albania in the south. The region as a whole has over 130 million inhabitants, which is more than the UK and France combined. Its growing number of middle-income consumers and the anticipation of strong infrastructure investment supported by European Union funds are enticing propositions, **attracting strong interest from investors across the globe.**

While the investment prospects are attractive, **decisions made now can have enduring consequences.** Inadequate market understanding or insufficient forward planning can greatly inhibit a venture's chances of success. Commercial and operational issues, taxation, intellectual property, employee remuneration and regulation all bring challenges in new markets and jurisdictions. Meanwhile, pricing, innovation, supply chains and routes to market in one country or sector may turn out to be quite different in another.

KPMG can help fill the gaps in knowledge, provide a better understanding of the market and assist with strategy development activities, as well as anticipating and preparing for the opportunities and risks involved in entering a new market. We provide in-depth know-how across a wide span of service lines. Our multidisciplinary approach, combined with our global experience and on-the-ground presence, enables us **to cut through the complexity of local markets** for the benefit of our clients.

This publication presents a basic overview of the CEE markets and highlights ways in which KPMG can assist investors with market entry. While this publication addresses relevant areas, it does not provide the in-depth information needed to make investment decisions. As matters in the region are still subject to frequent and rapid change, we recommend that you obtain comprehensive advice before taking any action.

Central & Eastern Europe's common opportunities and challenges

The countries in Central & Eastern Europe have undergone **tremendous change** over the last couple of decades. The vast majority of them are now established market economies that have seen strong growth since EU entry or in preparation for it. Another common thread is continuous reform of the economy, improving governance and convergence to European standards.

The impact of the financial crisis has also been profound on many of the region's economies, especially in the Baltics, although others such as Poland have weathered the storm relatively well. Overall, the regional economy contracted by 5 percent in 2009. A remarkable sign of confidence in the region has been the commitment shown by corporate and financial sector investors to their assets in the region.

While the region is facing an uneven recovery, **prospects for resumed growth** are good in most countries. In its November 2010 EU10 Regular Economic Report, the World Bank suggests that market confidence in the region has returned and gross capital inflows have picked up, at least in the new EU member states, *"aided by close trade and production linkages within the EU, competitive production costs, a skilled workforce, and nimble entrepreneurs"*.

Furthermore, the region stands to benefit from the expected **inflow of European Union structural and cohesion funds** into its transport and energy infrastructure. EU funds allocated to the ten CEE members amount to €177 billion for 2007-2013. The surge in infrastructure investment presents appealing opportunities to civil engineering and construction companies. For instance, according to PMI, capital expenditure on road infrastructure alone is poised to increase considerably at a nominal rate of 5% in the coming years, with its value exceeding €15 billion annually in 2012 and 2013.

Moreover, most of the region couples high levels of education and **technical skills** with relatively low labour costs and increasingly flexible labour markets.

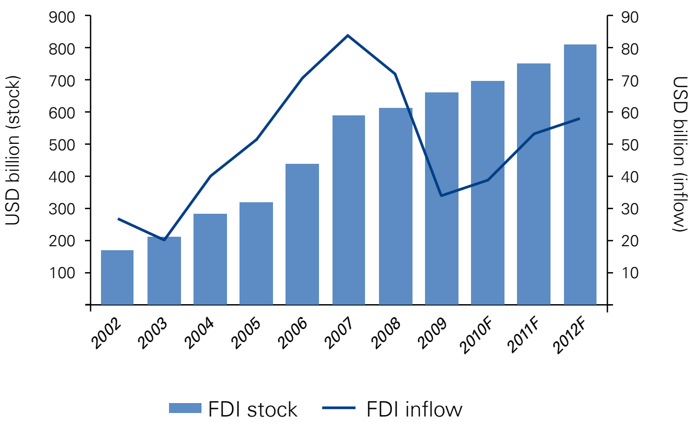
The region does share a number of **common issues** affecting investors. Institutional risks still exist, albeit mostly at a local level. Legislation changes rapidly, may at times be self-contradictory and can be inconsistently applied, while legal procedures are often inefficient.

While progress is being made, property rights in several countries are still not entirely transparent. Company ownership structures are often complex and unconsolidated and cross-company liabilities may exist. Minority interests can have a disproportionate amount of power and related-party relationships may prove to be on non-commercial terms.

The accessibility, timeliness and robustness of financial and commercial information are not always up to international standards, and the technical condition of plant and equipment needs to be carefully considered.

Despite these challenges, Central & Eastern Europe is increasingly popular as a destination for foreign investment. In effect, currently investment is moving beyond natural resources and manufacturing to include areas such as luxury retailing and shared service centres. Foreign Direct investment (FDI) inflows rose strongly across the region in the years leading up to the financial crisis. The recent downturn in inward investment is likely to be followed by renewed interest in the CEE region.

FDI in CEE region



Source: Economist Intelligence Unit

Central & Eastern Europe's diverse cultures and economies

The grouping together of more than a dozen nations under the label of 'Central & Eastern Europe' ignores the fundamental **diversity in the region**. While these countries share a geographic position and have common areas of recent history, in a cultural and economic sense such a grouping seems to be merely a temporal phenomenon. Investors should be aware that Central & Eastern Europe covers five major language groups and all of Europe's main religious tendencies.

Economic development varies widely from around the European Union average in Slovenia to less than a quarter of the EU average in Albania and Bosnia & Herzegovina. In addition to the Euro, more than ten currencies still feature. Moreover, countries' sovereign debt ratings diverge, for example including AA in Slovenia, but also BB- in Serbia (according to Fitch.com).

Furthermore, the quality of the infrastructure differs significantly and local supply chain limitations can be a challenge to foreign investors. Moreover, the distribution landscape is often radically different in each country.

In all, the World Bank concluded already in 2008 that in the region "*many countries that started the reform process early, such as the new member states of the European Union, have come to resemble advanced market economies and face challenges in competing successfully in the global economy that are similar to the challenges faced by other European countries… but for other countries that started the reform process later, such as the countries of south-eastern Europe and the former Soviet Union, there is still a need to address the legacy of transition*".

Market entry

Given Central & Eastern Europe's attractive opportunities, it is no surprise that **many companies are considering expanding into the region**. Although the region's appeal is justified by many factors, any entry does require research and planning. Whether you are considering an acquisition, a greenfield investment or a restructuring, you **need to understand the strategic and financial impact** of your decisions **as well as the implementation risks**. Understanding where the opportunities and risks lie, the size of each opportunity and what competitors are doing will arm you with the confidence to make a sound investment decision.

The commercial arena is changing rapidly due to the region's increasingly competitive markets as well as government reforms and initiatives. Many economic sectors prove to be a minefield of complexity. Moreover, potential target companies may lack reliable and timely financial, tax, commercial and operational information. Market information and competitive intelligence may be irregular, inconsistent, inaccurate or simply non-existent. Investors often underestimate the cost of entry and the strain on management resources.

Our approach to market entry

KPMG aims to assist international and regional investors in developing an understanding of **what it takes to succeed in a market**. We help define your expansion strategy and we study – in-depth – the market size and growth potential, key demand drivers and relevant trends, the regulatory and competitive environment, as well as the tax, legal and labour aspects which could be critical in the evaluation of an industry. **Using a structured, quantitative and practical approach**, we assess the attractiveness of the industry and evaluate whether the opportunity is realistic, as the client builds a strategy to enter or expand into the market.

Market entry process

When executed well, a new market entry is often the most controllable way for managers to drive corporate growth.

Whether choosing a location, selecting a company form, devising a market entry strategy or identifying specific risks, the decisions you make at the beginning can have a decisive impact on your future success. At KPMG, we have witnessed that successful companies use a methodical, fact-driven process for market entry

Market selection and determination of mode of entry

Market assessment

- Demand forecasting
- Value chain analysis
- Customer needs/behavior surveys
- Competitor profiling
- Channel analysis
- Risk analysis
- Institutional and regulatory environment mapping
- Entry barrier analysis
- Resources availability
- Cost driver analysis

Internal capability assessment

- Vision and objectives
- Internal core competencies
- Internal SWOT

Market selection and positioning

- Mapping internal capabilities to market opportunities
- Agree investment criteria
- Prioritization of potential market opportunities

Assessment of entry options

- Evaluation and prioritization of potential entry modes (e.g. acquisition, joint venture) based on market and internal capability assessment

Preparation for market entry

Implementation

Acquisition

- Target identification and profiling
- Target prioritization
  - Long-listing
  - Short-listing & ranking
- Target approach
- Preliminary due diligence
- Detailed due diligence
- Valuation, Deal negotiation, Tax structuring
- Closing / Integration

Alliance / Joint venture

- Business case development
  - Partner identification and selection
  - Evaluation of growth and synergy potential
  - Operational planning
- Partner approach
- Evaluation and planning
- Closing and implementation

Greenfield

- Business case development
  - Business plan development
  - Selection of location, product, etc.
  - Financial model build
  - Operational planning
- Tax structuring and incentives
- Roadmap preparation
- Business plan implementation
  - Operations planning and design
  - Sourcing
  - Real estate purchase and/or construction
  - Personnel recruitment
  - Roll-out planning and control
- Location assessment, Site identification

In considering the first steps into a new market, organisations have many issues to consider. Our team helps investors identify **which steps are the most critical**, where the most significant risks could be and how to implement a plan to both take advantage of market opportunities while mitigating potential risks:

1. Identify and assess the market: Which markets, which segments, how to position, how to manage and implement marketing efforts, how to enter (through intermediaries or directly), and using which information? What is the scale of the opportunity?

2. Develop sourcing opportunities: Whether to make products or buy them? Where can key inputs be sourced?

3. Decide on the form of investment and control: Joint venture, local partner, or acquisition?

4. Determine how to operate in the region from a tax perspective: What are the most efficient legal structures, the key potential taxes, the risks and opportunities involved, and the existing benefits and incentives?

5. Identify and approach local partners: Which companies can be approached, how attractive and dependable are these partners, how to reach a deal with them?

6. Build or validate a business plan: How the business is likely to perform in the upcoming years? How the key commercial and operational drivers, external and internal factors will impact the business?

7. Evaluate where to establish the business (location assessment, site identification): Which locations (countries, regions, cities) are the most attractive? Within the selected locations, what are the sites (properties, land, buildings) that best fit the business needs?

To answer these questions, our team leverages **a high level of local expertise and networking capabilities** across the region, and has **access to a broad range of external information resources** to develop a comprehensive market entry plan.

Our multidisciplinary team

Our talent pool of highly qualified professionals has always been our greatest strength. As a **multidisciplinary advisory firm**, instead of just being specialists in one discipline, we encourage our people to cross into other functions to bring a more rounded and comprehensive approach to every assignment. This means, for instance, that our Market Entry teams not only think about strategy and deal resolution, but also about the post-integration of systems and cultures, tax, legal and labour aspects; they consider how an internal audit will operate across a wider group; how risk can be effectively managed and reputations maintained and enhanced.

Our teams have the know-how and experience to consider the big picture and, where appropriate, to call in more specialist expertise. KPMG has **industry specialists** across all industries and sectors. We gather hard-to-find information from primary and secondary sources to present a fact-based and independent view. Nothing is considered in isolation but in terms of how it will promote overall corporate well-being. For clients, this means that **KPMG staff give you the whole story**, not the abridged version. They take time to truly understand your business and are plugged into the issues that make it tick.

Multidisciplinary by essence, in the context of a market entry exercise, KPMG can provide market intelligence, feasibility studies, due diligence assistance, tax structuring, integration and separation advice, M&A advisory, business modelling, valuation services, debt advisory and accounting advisory services.

Clients using our **full range of advisory services** benefit from improved efficiency of data gathering and communication as well as cross-fertilisation between the teams, which allows us to offer you a better deal in relation to cost.

Your best first step in considering market entry in the CEE region is to contact your trusted local KPMG advisor, or to reach out to our CEE team, whose details are on the back page of this brochure.

Central & Eastern Europe Factsheet

Geography and infrastructure

Central and Eastern Europe (CEE) can be defined in geo-political terms as the formerly communist states between Germany, Austria and Italy in the west and the pre-1939 Soviet Union territory in the east. This range of countries stretches from Estonia in the north to Albania in the south. Most of the northern part of the region covers the European plain, while in the southern half more mountainous areas are prevalent, with the Carpathian mountain chain, the Dinaric Alps and the Balkans surrounding the Pannonian plain. The region also has strong maritime links, bordering the Baltic Sea in the north, as well as the Adriatic and the Black Seas in the south. The most important rivers that flow through the region are the Danube and its many large tributaries, the Vistula and the Daugava. The region falls mostly in the temperate continental (Dfb) and Mediterranean (Csa, Cfa) climate zones.

The region is rich in certain natural resources, including coal and lignite, as well as various metal ores including (among others) copper, zinc and lead. Petroleum is most notably present in Romania. The region and its bordering seas are also crossed by a number of major oil and gas pipelines connecting the EU to energy sources in Russia and beyond.

The quality of public infrastructure is variable throughout the region. Whereas Estonia, Slovenia and the Czech Republic rank among the top 40 worldwide, according to the World Economic Forum (WEF), Poland, Serbia and Romania do not make the top 100. Historical underinvestment in infrastructure is currently being addressed, and EU funding is enabling major projects to modernise and expand road and rail networks, but also to renew water supply and treatment infrastructure, as well as to upgrade energy generation and transmission capacity. EU structural and cohesion funds allocated to the ten CEE members amount to €177 billion for the period 2007-2013. The current surge in infrastructure investment presents significant opportunities to civil engineering and construction companies.

Largest metropolitan areas

Core city	Country	Population (mln)
Katowice	Poland	2.7
Warsaw	Poland	2.7
Budapest	Hungary	2.4
Bucharest	Romania	2.1
Prague	Czech Republic	2.0
Belgrade	Serbia	1.5
Cracow	Poland	1.3
Sofia	Bulgaria	1.3
Zagreb	Croatia	1.2
Lodz	Poland	1.2

Sources: Eurostat Urban Audit, Wikipedia

Population, languages and labour

The CEE region has a combined population of over 130 million people, with the most populous countries being Poland (38.2 million inhabitants, according to Eurostat) and Romania (21.5 million). The most densely populated country is the Czech Republic (133 inhabitants per km2), followed by Poland (122 inhabitants per km2), while Estonia is the least densely populated (29 inhabitants per km2). The largest urban areas in the region are centred around Katowice, Warsaw, Budapest, Bucharest and Prague.

The region covers at least five major language groups. Slavic languages (e.g. Polish, Czech, Bulgarian) are the most prominent and belong to the Indo-European language family, as do the Baltic, Romance (Romanian) and Albanian branches. Hungarian and Estonian belong to the Finno-Ugric language family. Besides their national languages, an increasing number of people speak English, while German and Russian are widely spoken in parts of the region.

The workforce is considered highly educated and technically skilled. For instance, tertiary education enrolment rates lie above 50% in all major CEE countries, which is ahead of not only Brazil, India and China, but also Germany.

Tertiary education enrollment rate

Example countries	Score	Global Rank
Slovenia	86.7	4
Lithuania	77.3	11
Latvia	69.2	18
Poland	66.9	21
Romania	65.6	22
Hungary	65.0	23
Estonia	63.7	25
Czech Republic	58.6	32
Slovakia	53.6	40
Bulgaria	51.0	46
Switzerland	49.4	48
Germany	46.3	52

Sources: UNESCO Institute for Statistics
The Global Competetiveness Report 2010-2011 prepared by World Economic Forum

Flexibility of wage determination

Example countries	Score	Global Rank
Estonia	6.0	5
Macedonia	6.0	6
Lithuania	5.9	9
Latvia	5.7	21
Hungary	5.5	35
Moldova	5.5	39
Bosnia & Herzegovina	5.4	40
Poland	5.4	47
Slovakia	5.3	49
mean	*4.9*	

Source: The Global Competetiveness Report 2010-2011 prepared by World Economic Forum

In the CEE region labour costs remain very competitive versus western European levels. Typically, wages are flexibly determined, in contrast to practices in many western European countries. For example, on flexibility of wage determination, the WEF ranks nine CEE countries in its top 50, led by Estonia, Macedonia and Lithuania, but also including Poland, Slovakia and Hungary. It is interesting to note that twelve western EU members feature in the bottom 20. Moreover, redundancy costs are considered relatively low in key CEE countries, according to the same study.

As labour is highly skilled, competitively priced and flexible, a substantial number of captive shared service and business process outsourcing centres have been established in the region. Companies such as Accenture, Barclays, BP, Dell, DHL, Diageo, ExxonMobil, Genpact, HP, Huawei, IBM, Johnson Controls, Philip Morris, Vodafone and Western Union have set up operations in CEE.

Transition and governance

A key feature of Central & Eastern Europe is its shared history of Communism since World War II, ended by the collapse of the Iron Curtain in 1989 and the subsequent dissolutions of the Soviet Union and Yugoslavia. The countries in CEE embarked on a journey of socio-political reform and economic transition, from different development levels, with different approaches and at different speeds, but all moving towards free market oriented economies and a reunited Europe.

Ten CEE nations have already achieved EU membership, while Croatia, Macedonia and Montenegro have become official candidates. Most of these new members have also joined the Schengen border-free area, while three (Estonia, Slovakia and Slovenia) have joined the Euro zone. In addition, all CEE countries are IMF members, 14 have joined the WTO and six are part of the OECD.

Property rights protection and governance standards have been raised strongly, especially in those countries that have joined the EU or are negotiating entry. For instance, according to the WEF, when it comes to the protection of property rights Estonia, Slovenia and Poland all rank ahead of countries such as Italy, India and Brazil.

Property rights

Example countries	Score	Global Rank
Estonia	5.3	33
Montenegro	4.8	48
Slovenia	4.6	58
Poland	4.6	59
India	4.5	61
mean	*4.4*	
Italy	4.3	69
Brazil	4.3	72

Source: The Global Competetiveness Report 2010-2011 prepared by World Economic Forum

Furthermore, financial auditing and reporting standards are high in leading CEE countries. The WEF places six of these nations ahead of developed nations such as Spain and even the United States.

On the other hand, the burden of government regulation on businesses still varies widely in the region, with Estonia in seventh place between global leaders, according to the WEF, whereas Hungary, Croatia and Serbia languish among the bottom ten countries studied.

Strength of auditing and reporting standards

Example countries	Score	Global Rank
Estonia	5.6	26
Hungary	5.4	31
Lithuania	5.1	43
Poland	5.1	46
Czech Republic	5.1	47
Slovenia	5.1	48
United States	5.0	55
Spain	4.9	57
mean	*4.7*	

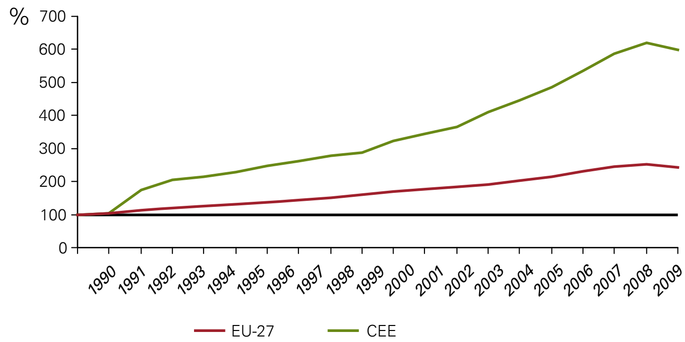
Source: The Global Competetiveness Report 2010-2011 prepared by World Economic Forum

Economy and ratings

Over the past twenty years the CEE region has made strong gains towards western European economic development levels.

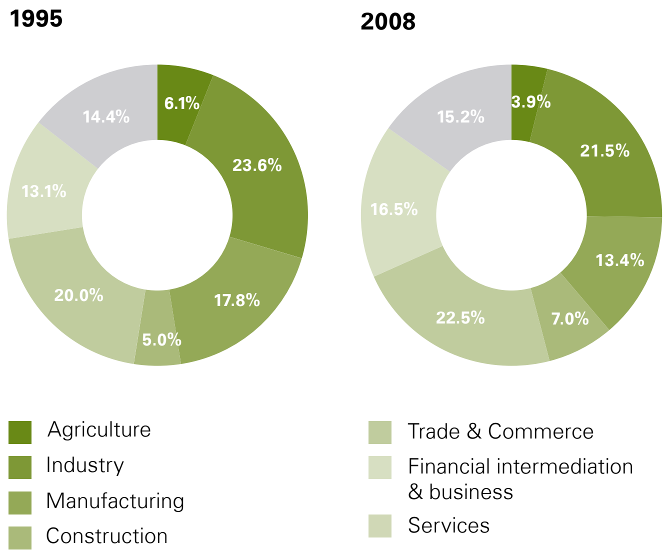
Liberalisation, mass-privatisation and massive inflow of funds from abroad, combined with a burst of entrepreneurialism have created established and competitive market economies. In addition, there has been a major shift from agriculture and industry towards commerce and services.
However, the process of economic convergence is far from complete, and many CEE countries have experienced set-backs during the last two years, as the global financial crisis affected economies with high levels of debt and other imbalances. Overall, the regional economy contracted by 5% in 2009, according to IMF estimates, although Poland merely experienced a slow-down in growth and was the only economy to show GDP growth (+1.7%) in the EU that year.

GDP in EU-27 and CEE (1990–2008), 1990=100%



Source: International Monetary Fund, World Economic Outlook Database, April 2009

Distribution of GDP by sectors in the CEE region



Source: EUROSTAT

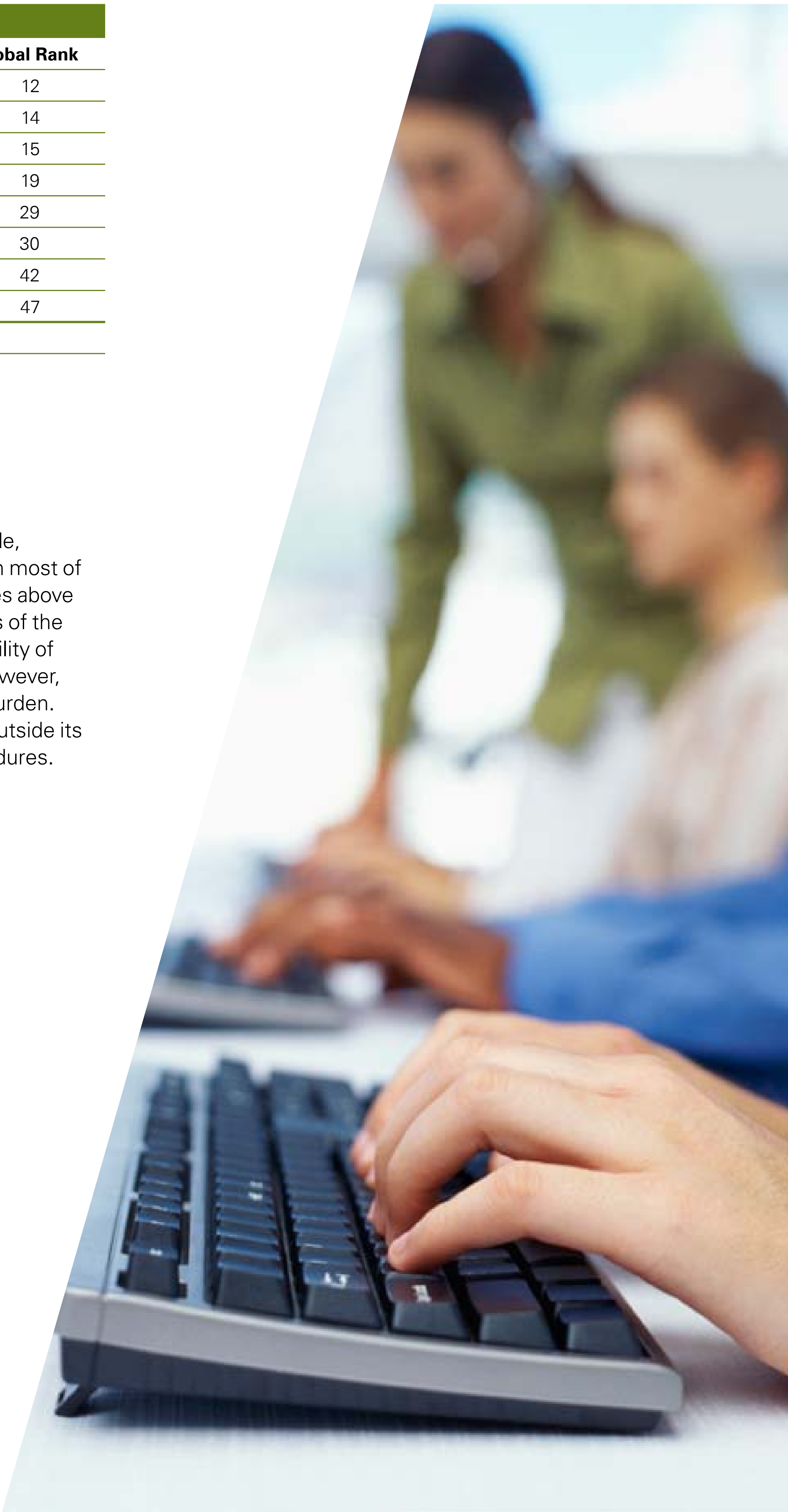
While much of CEE is again on the path towards growth, the recovery remains fragile and seems to be a two-speed recovery. The European Bank for Reconstruction and Development (EBRD) foresees growth rates of 2.2% in 2010 and 3.0% in 2011 for the northern half of the region, led by Poland, Slovakia and Estonia (although Latvia was still declining in 2010). However, the EBRD expects continued negative growth (-0.6%) for south-eastern Europe in 2010, followed by just 1.6% growth in 2011, with Romania performing the worst. In the mid- to long term, the prospects for economic growth appear good.

Economic development levels also diverge widely from roughly the European Union average in Slovenia to less than a quarter of the average in Albania and Bosnia & Herzegovina, with Moldova even lower. Inflation rates have come down and in 2009 only Romania (5.6%) and Serbia (8.1%) had inflation rates above 5%, according to the EBRD. EBRD data for 2009 further indicates that current account deficits were particularly high in Bulgaria (24% of GDP) and Montenegro (51% of GDP), fiscal balances ranged from a positive 2.9% of GDP in Bulgaria to a negative 5.5% in Albania, and government debt levels stood between 7% of GDP in Estonia and 78% of GDP in Hungary. Furthermore, sovereign debt ratings vary. For example, Fitch ratings range from AA in Slovenia and A+ in the Czech Republic and Slovakia to BB- in Serbia, B+ in Bosnia and B in Moldova.

Prevalence of trade barriers		
Example countries	**Score**	**Global Rank**
Czech Republic	5.7	12
Estonia	5.6	14
Hungary	5.6	15
Slovakia	5.5	19
Latvia	5.2	29
Slovenia	5.1	30
Romania	4.9	42
Poland	4.8	47
mean	*4.6*	

Source: The Global Competetiveness Report 2010-2011 prepared by World Economic Forum

The CEE economies are relatively open. For example, the prevalence of trade barriers is considered low in most of the larger nations. The WEF ranks ten CEE countries above the mean and ahead of the United States – in terms of the extent of tariff and non-tariff barriers limiting the ability of imported goods to compete in the local market. However, in some countries, customs procedures can be a burden. For instance, the WEF places Bulgaria and Serbia outside its top 100 on the level of efficiency of customs procedures.

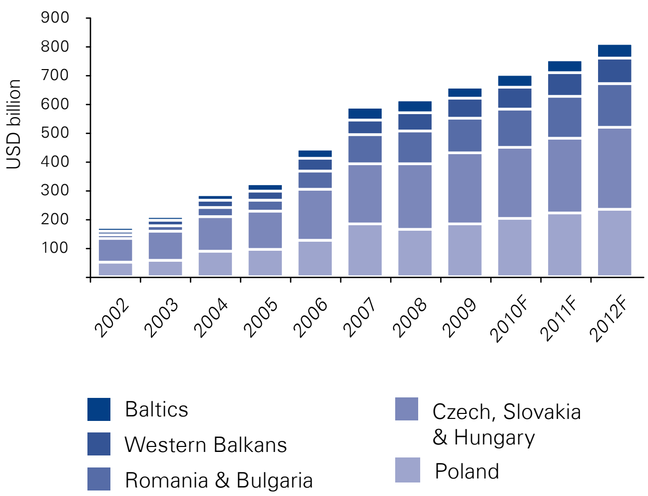


Foreign Direct Investment

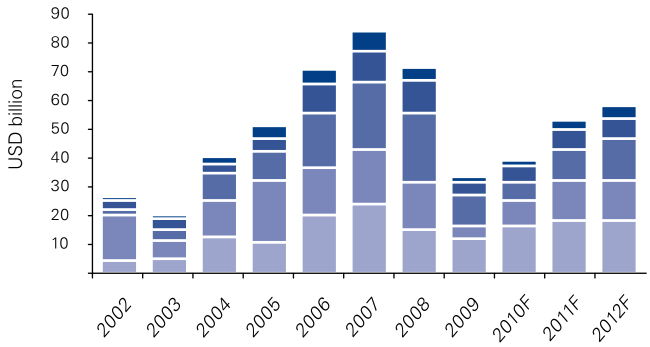
While foreign investment in the CEE region was initially mostly concentrated in the 'Visegrad Four' countries (Poland, the Czech Republic, Hungary and Slovakia), FDI inflows across the region rose rapidly from 2003 to 2008. Nevertheless, FDI stock per capita is still relatively high in the Czech Republic and Hungary.

This FDI expansion was followed by a collapse in 2009 as the impact from the global financial crisis was felt, sometimes aggravated by local economic imbalances. However, in some of the more resilient economies, FDI is clearly picking up again and institutes such as the EIU are projecting further gains throughout the region.

FDI stock by countries



FDI inflow by countries



Source: The Economist Intelligence Unit (2010)

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