

Briefing paper

The right fit

Corporate structures in the new Europe



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March 2004

Economist Corporate Network

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Economist Corporate Network

Schwarzenbergplatz 8/7
1030 Vienna, Austria
Telephone: (43 1) 712 41 61 0
Fax: (43 1) 712 41 65

www.economistcorporatenetwork.com

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Author

Delia Meth-Cohn
Senior Consultant
Economist Corporate Network, Vienna

Cover Illustration

sigrid.bartl@tonik.at

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Foreword

Eight Central European countries will join the EU club on May 1, 2004, erasing the remnants of the Iron Curtain that has divided Europe since the second world war. The international business community was quick to embrace the former communist markets, leaving Brussels to follow its lead. But while a few companies have abandoned their east-west division in recent months, most are hesitating to take the final step and match their corporate structures to Europe's new geopolitical reality. The old Central and East European region will live on, combining new EU member states with Russia, Albania and even Kazakhstan. Why?

This report explores the logic of the CEE region. It looks at why companies fear they will lose out on growth opportunities if they absorb the new member states into a wider EU region, and how companies are creating clusters to form an efficient platform for growth across the diverse CEE region. It also looks at how corporate structures will change as pan-European reality sets in.

Acknowledgements

This report is the second in a series sponsored by Ernst & Young and Oracle. Its findings will be presented at meetings of Economist Corporate Network's East European Group and at Economist Conferences across the region in spring 2004.

The report was based on a survey of the members of the East European Group and in-depth interviews with 28 regional directors of leading companies active in Central and Eastern Europe. We would like to thank them for their generosity in sharing their thoughts and plans with us.

We would also like to thank Karl Johansson, Nick Prentice and Christopher Hinze at Ernst & Young and Alfonso di Ianni, Sue Locke, Janusz Naklicki and Hans Jarnik at Oracle for supporting this work.

If you would like any further information on the Economist Corporate Network, please contact Andrea Stark by phone (+43 1) 712 41 61 40 or by e-mail andreastark@economist.com.



Daniel Thorniley

Senior Vice-president
Economist Corporate Network, Vienna

Executive summary

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Corporate structures in the new Europe

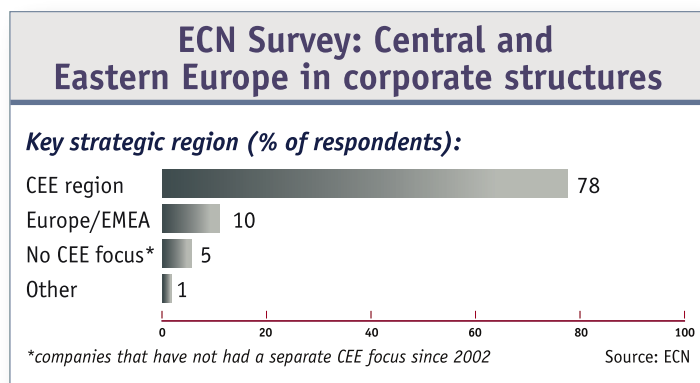
- Very few companies are radically altering their corporate structures to integrate Western and Eastern Europe at the time of EU enlargement on May 1, 2004. Only five companies in our survey of 61 multinationals are shifting responsibility for the new EU member states to a Western Europe or EU region.
- Most companies expect to integrate the new EU member states into a wider EU region in the next three years or at the time of Euro adoption, which we expect to be around 2009-10. The likelihood is that Central Europe would be handled as a separate cluster or combined with Austria/Switzerland. The vast majority of companies are wary of grouping the new member states with Germany.
- Two companies in our survey have even recreated a Central and East European region in recent months, after seeing sales development hit by the lack of local autonomy.
- Although delaying full integration, many companies are trying to find more appropriate structures within the Central and Eastern Europe region, using a variety of clusters or groupings to cope with the greater diversity and size of the region and to keep costs down.
- In the Central European markets, some companies are experimenting with halfway-house structures to allow for growth, while preparing the region to be integrated into Western Europe, where there is usually more centralisation, more pressure on profit margins and more onerous corporate standards.
- These attempts reflect the broad consensus that the Central Europe region has become something of a hybrid. In most sectors, the countries can no longer be regarded as emerging markets, with high growth rates and changing market shares, which require strong investment to reach their potential. On the other hand, they are not yet mature markets, since there is still considerable potential for growth and market development requires different strategies than in Western Europe.
- The transformation of the new EU member states is particularly advanced for consumer goods companies. The markets are extremely competitive, with strong pressure on prices and tiny shifts in market shares. As in Western Europe, the large retail chains are the main customers; their global rivals are their main competitors and consumer behaviour is rapidly becoming identical to that in Germany. This explains why several companies in this sector have opted to integrate the new member states into Western Europe before enlargement.
- But even in the consumer goods sector, the majority of companies argue that treating Central Europe as a mature market would jeopardise their ability to grow and put them at a disadvantage to their competitors. The consumer base is very narrow. And while the market for Western-style consumers is saturated, there is enormous growth potential among the rest of the population—particularly in rural areas. But competing for these consumers means going up against cheap local brands, which requires something different than a mature-market strategy.
- Regardless of sector, companies are increasingly creating separate management teams for Central Europe and Russia/CIS and many expect Russia to become more autonomous, reporting directly to the Europe/EMEA HQ in the next few years.
- Around half of companies treat South-Eastern Europe as a cluster in some form, but increasingly Romania is overshadowing the other markets. Romania, Bulgaria and Croatia could shift into a Central European cluster within Western Europe after joining the EU in 2007-08. Alternatively, several companies already run the South-East European markets from Italy or Greece.

Section 1

What does EU enlargement mean for corporate structures?

There will be no major reshuffling on May 1, 2004 to match corporate structures with Europe's new geopolitical reality. A handful of multinational companies have already integrated the new EU member states into West European structures in advance of enlargement. But the majority tossed the idea around briefly before deciding to stay with the status quo—for now.

That doesn't mean EU enlargement is irrelevant to the way in which companies organise themselves. Rather, most see a transition period of several years before business reality on the ground catches up with politics. Instead of enlargement itself being the trigger for abandoning the division between east and west, most are now talking about euro adoption as the right time to merge the new member states with Western Europe. Asked for a date, most regional managers come up with something like 2007, although the Eurozone is unlikely to see much expansion until 2009-10.



Beyond the defence mechanisms and power plays that make most CEE regional managers wary of giving up their biggest markets, there are also plenty of solid business reasons to delay the decision. As one regional director for a chemicals company puts it: "We operate differently in the two areas and our penetration rate is different. It's still a different business—we need more development." In other words, Central European markets are still about growth, development and building market share.

But in some sectors it's getting more and more difficult to make such a clear distinction between east and west as markets like Hungary and the Czech Republic mature and costs rise. The situation is most extreme in the consumer goods sectors, both FMCG and durable.

For many of these companies, their main customers are the same retail chains they deal with in Western Europe. Their competitors are old rivals in the rest of Europe too. And Czech, Hungarian and Polish consumers are increasingly behaving like discount-hungry Germans. The key business challenges in these markets are no longer those common to emerging markets, but prosaic European ones, like cutting costs, being more efficient and encouraging consumers to upgrade to premium products. All in all, the consensus is emerging that business in the new EU members states has more in common with western Europe than with Russia or Serbia.

Nevertheless, most companies—even in the consumer sector—say they need a few more years of different treatment to ensure that the growth potential of the Central European markets doesn't end up being realised only by their competitors. "It's so competitive, we feel like we are in a mature market—but we're not," says the regional director of an FMCG company. "We're fighting to set market share for the next ten years."

But integration will come sooner or later. While Russia's potential is starting to demand the attention of senior management, the new EU member states of Central Europe are coming under scrutiny for the opposite reason. The money-crunchers are asking whether it really makes any sense to have, for example, a full-blown subsidiary in Hungary when neighbouring Austria is treated as little more than a suburb of Germany. Does it make sense to put pressure on profits in Belgium, while the Czech Republic can look for increasingly elusive growth?

Few regional managers have avoided this discussion entirely as EU accession looms. The majority have managed to persuade the powers that be that corporate interests require a continued focus on Central Europe. Five companies in our survey have accepted the

ECN survey of corporate structures

In December 2003, we received 61 responses from clients of the Economist Corporate Network's East European Group to a detailed questionnaire on corporate structures and the impact of EU enlargement. Although the answers were a good starting point, it soon became clear that the details behind each company's organisation are vitally important to understanding how they work in practice. So we conducted 28 in-depth interviews with respondents, which form the basis of this report.

integration logic and are handing over the new EU members to Western Europe. However, two respondents have even managed to reverse centralisation and create a new niche for Central and Eastern Europe. Whatever the temporary solution, the question of which structure is appropriate for Central and Eastern Europe will remain a burning one. “The discussion comes in phases,” says one regional manager. “There were talks on this 18 months ago. We’ll be getting another knock on the door soon.”

The arguments for integration

The arguments for bringing Central Europe into the EU fold fall into two categories: that it would be good for the company as a whole and that it’s right for business in the region. A third of respondents in our Economist Corporate Network survey agreed that integration was good for the company as a whole, even though some of these and the majority of respondents felt it would be bad for their specific CEE business. There are two reasons why.

The first is cost-saving in a region where costs are growing and cost discipline has often been on the lax side. “Pressure from international competition is so intense that margins are down and we can’t support the cost structures we have,” says a regional manager who is shifting the Central European markets into Western Europe before enlargement. “We need to find a way to allow them to develop but with lower costs.” The problem for him, and for many other companies, is that the Central European markets are still too small to justify large overheads and they’re not growing quickly enough to classify rising costs as long-term investment.

That points to the second reason why the company might benefit from integration: improved visibility. The division into east and west can make comparisons difficult. Is it better to put more resources into market development in Hungary or to focus on sorting out Germany or launching a new product in the Netherlands? While the Central European markets were growing like wildfire, the question was irrelevant. Now that they are looking more like the rest of Europe, it’s a valid point. In volume or value terms, five or even ten percent growth in the Czech Republic is still an awful lot smaller than a fraction of a percent in the UK.

But while the key driver for integration is cost-saving and resource allocation, there is a second category of arguments that claim it would be good for business if Central Europe is seen as part of Western Europe. In particular, proponents of integration say that Central European markets are starting to suffer by being thrown in the same boat as the booming and/or difficult East European markets. Not only are they being overshadowed by Russia (see Section 2), which is demanding the lion’s share of investment and attention, but the challenges managers face on Central European markets now require the skill-sets of developed markets, not of emerging ones.

That’s the position of one regional manager in a consumer goods industry. “In the early development stages, like in Russia, it’s a question of growing or getting out. In Central Europe the challenges

now are salary inflation, pressure to sell more, to cut costs, to be more efficient,” he says. “Western Europe has tackled these issues successfully in the past year or two, so they’re better able to cope.”

Pro and contra	
<ol style="list-style-type: none"> 1. Central European operations need a bout of cost discipline. 2. Companies need good visibility across Europe to better allocate resources. 3. Management challenges are like those in the EU. 4. Customers, competitors and consumers are like those in the EU. 	<ol style="list-style-type: none"> 1. The key management challenge is the growth potential, which is greatest where customers, competitors and consumers are not the same as in Western Europe. 2. Central Europe would be suffocated by the big EU markets; it would get too little attention and would suffer under stringent corporate norms. 3. Corporate structures in Western Europe have become extremely centralised in many companies, involving degrees of standardisation and homogenisation that are inappropriate for Central Europe.

Not only have their management challenges converged with those in the existing EU member states, say some companies, but so have their customers, competitors and consumers. The Central Europe manager of one consumer electronics company on the verge of integrating with Western Europe says there is no point in delaying the obvious, because business with purely local entities is dwindling. “The local accounts are not standing up. The European accounts are taking a bigger share of business and they want the same conditions as in Germany.”

In FMCGs, it’s the same story. “Our competitors are all multinationals, as the last locals get bought up, and our trade partners are all European,” says a regional manager at one large multinational.

The arguments against integration

But experienced regional managers argue that the similarities are still quite superficial. Take the idea that consumers, competitors and competitors are all the same as in Western Europe. For most companies, it’s only the partial truth. And it is precisely where the similarities end that the real growth potential now exists.

Imagine this. The vice president for EMEA pops in for a one-day fact-finding visit, accompanied by the regional director for Western Europe. They fly into Budapest or Prague and see nothing that reminds them of Eastern Europe. The cars are Western, the clothes

are Western, the restaurants are good, the shopping centres are full of Ikeas, Tescos and Carrefours, and these shops are full of Pampers, Mars Bars and Persil. Even the vegetables look good. "Remind me again why you think Central Europe isn't ready to join Western Europe," the EMEA director says, while his West European sidekick rubs his hands gleefully.

Where do you start? There are plenty of arguments against integration—but most are not as simple as the arguments for. In fact, they are generally a more differentiated version of the same arguments.

Consumers— more like Russians or Germans?

In late 2004, one FMCG company reinstated its CEE division, reversing a three-year trend towards European integration. The main motivation for re-dividing the two regions was that the consumers required different approaches. "The integration was threatening to move too fast for the Central European consumer," a CEE director from the company says. "Europe is trying to standardise and harmonise—all countries are executing the same market strategy. You lose competitive edge if you transfer that market segmentation to Central Europe."

For many companies, the difficult issue is local brands. But this company only has global brands, so the problems were focused on areas like packaging sizes to get the right price point on the shelf or in specific marketing to build a category that was still new. "As part of Western Europe, we had to spend two months arguing about why we needed to do it differently," he says.

For companies that want to do more than scratch the surface, consumer behaviour in Central Europe is not the same as in Western Europe. There are islands of wealth in these markets, especially concentrated in the major urban areas, where consumption per capita is high and consumers behave like Westerners, buying in big retail chains and looking for value for money rather than brand status. But this consumer base is very narrow and already fully exploited. Penetration among the rest of the population, where disposable income is low and the consumer profile is completely different, is miserable.

The regional director of a healthcare company sums up the problem. "Is the Polish consumer more like the German one or the Russian one?" he asks. "The question is which Polish consumer? In the cities, they're like Germans, but in the rural areas they're more like in Russia."

This is the paradox of Central Europe. Growth in consumer markets is slowing because the developed market segment is saturated. But there are whole swathes of the population still to be reached and their incomes will rise steadily over the next decade or two. As the regional finance director of a drinks company puts it: "We're not

Why corporate structures matter

You can blame poor corporate performance on all sorts of external factors—recessions, new competitors, trade consolidation, national regulations. But there is one factor that a company controls: its own organisational structure. Get it right, and the structure can be a source of competitive advantage. Get it wrong and it becomes a serious obstacle to change.

The reason is simple: a company's structure channels limited management attention and corporate resources into specific places. If the structure hides key growth markets under a mass of large complicated mature markets, they will never get the focus they need to show potential. By the time they show up on the management board's radar screen, competitors will have stolen the show. On the other hand, if growth markets swallow resources beyond their potential, they cut into the development of larger or more profitable markets.

Getting the right balance depends on the type of business, the maturity of the markets, the maturity of the company in specific markets and the nature of the competition. But most companies find themselves changing their structures every few years, trying to square the circle of maximising synergies, cutting costs and improving market focus.

Generally, the major realignments are a result of new strategic objectives—a greater focus on growth or on cost-saving, for example, or a new emphasis on globalising the company or breaking into emerging markets. But structural changes are also often driven or blocked by internal power politics and encouraged by corporate fashion.

The trend for the past few years has been for greater centralisation, with companies focusing on cost-savings and global synergies. US companies, in particular, have often taken a radical approach, taking power away from country managers and shifting it to global business units and powerful regional headquarters. That allows for cost-cutting through shared services at both back-office and functional levels, while also enabling efficient tax-planning through commissionaire structures (where country offices become fee-paid agents of central office, which is based in a low-tax location like Ireland or Switzerland) and the like.

Central Europe has also seen a tangible swing of the pendulum—but nothing like in Western Europe. The local fiefdoms that emerged in-country in CEE during the expansive 1990s have generally been cut down to size through the introduction of clusters of markets or stricter cost-cutting measures. But the standardisation and harmonisation drives that have prevailed in Western Europe, wiping out country identity in many markets and centralising decision-making, are still to come in the CEE region. That explains why integrating the new Central European member states into Western Europe implies much more for many companies than just a reporting shift.

bailing out. There are very few people drinking our products. There should be more. There will be growth, but it will be hard.”

Reaching these consumers requires different mechanisms than in a mature market. The company which recreated a CEE region argues that their marketing had become too Western. “Our consumers are not as sophisticated as we sometimes think,” says the finance director. “We think we can get away with Hollywood movie lifestyle ads, but we need to get back to benefit communication—why should they buy this product. We had possibly forgotten this.”

Some companies will decide that it’s not worth the trouble of cracking this market and will instead focus on key accounts and premium consumers, waiting for the rural consumer profile to change as retail chains expand into smaller towns and incomes grow. But, by then, those companies that have continued to focus on growing Central European business will have staked out the best market positions.

The competitive arena

Competition is very intense in Central Europe, largely because all the major global players are there and the consolidation process is still underway, weeding out the weaklings on the market. But it’s also particularly intense because the local producers that have survived are as clever as the big boys, but much cheaper. The power of local brands varies from sector to sector and category to category and not all will survive the next few years as consolidation revs up. But for now, if multinationals want to expand their market share substantially, they need to face the locals head-on.

“Business would suffer if we became part of Western Europe because there is lots of entrenched local competition around,” argues the regional manager of an FMCG company that is still growing strongly by developing local brands to complement its global ones. “The synergies you could create by joining Western Europe would not outweigh the importance of being local. If we shifted, it would give a big competitive advantage to the locals.”

Not every company has the stomach for competing head-on. The price battle is bad enough already without targeting the bottom of the market and many companies are more interested in reducing or regionalising local brands than in expanding them. But even companies with global brands and premium prices need to take the competition into account. The company that recently abandoned its attempt to handle Europe as a single unit and recreated a Central and Eastern Europe region recognised that it was falling behind the competition. “Our execution in the market was too limited,” explains the finance director. “It wasn’t necessarily that we lost sales, but the local competition had got its act together and started executing well and the international competition was buying local brands or adapting things for the market. Our sales performance suffered.”

Are key accounts enough?

One of the major drivers of transformation in Central Europe over the past five years has been the arrival of organised trade. Hypermarkets and supermarkets have sprung up all over, revolutionising the entire distribution chain. In sectors where distribution and supply are still highly fragmented, the markets feel less mature. Business is more complicated in many ways, but the pressure is lower. In sectors like consumer electronics, where consolidation is well-advanced, the markets are as competitive as anywhere in Europe.

But the dramatic retail development obscures a basic fact—that the penetration of international retailers is still very low compared to Western Europe. The intense competition and vicious price wars are a result of too many players focusing on too few areas. There’s still room for growth and there are still numerous distribution channels outside of the trade. The difference to key EU markets is enormous. For an FMCG company in Western Europe, there are maybe three key accounts for 65% of total revenue and the top 20 customers account for 80-90% of revenue. In Central Europe, the top 20 customers still only account for around 30%.

The retailers, too, face a fragmented supplier market. That’s why chains like Tesco have, for now, abandoned attempts to create a continent-wide supply chain with pan-European accounts and have opted instead for a Central European solution. The retailers have created Central European clusters and are trying to persuade their key suppliers to do the same, using a common account for the region. Although this is a driving force behind some manufacturers’ attempts to create CEE clusters, this shouldn’t be the deciding factor in determining future corporate structures. Several companies have created regional key account managers to co-ordinate sales rather than change structures that were working in other respects.

For some multinationals, the costs associated with servicing fragmented local accounts is too high for the volume of business they generate—especially as Central European consumers shift noticeably towards the discounting German retail model. With the expectation of margins collapsing and growth slowing, a number of companies have started to rationalise, taking their own marketing people off the ground and replacing them with local distributors.

It’s a calculation many companies will be making across Europe. Do we need production facilities, R&D centres and competence centres in both Western Europe and CEE? Can we regionalise Central European local brands or does it make more sense to replace them with global ones? Does it make more sense to write off short-term growth potential in the CEE region by cutting costs dramatically and boosting profit growth?

These questions will form the background to an intensified consolidation battle over the next few years. Some companies will be knocked out and some will just focus on key accounts. What’s clear is that other companies will boost their CEE business significantly by focusing on growth rather than profits. “We need an attractive price point, lots of advertising and feet on the street to get wide distribution,” says the regional director of the FMCG

company that is focusing again on CEE. “Our objective is to grow without taking cash out of the company.”

Germany’s icy hand

While some companies are keeping Central Europe out of a wider European sphere of influence to make sure they can exploit the region’s additional growth potential, others are more worried about being squashed and suffocated by the size and norms of Western Europe.

For most CEE regional managers, the biggest danger of integrating their region with Western Europe is the destructive impact of German influence. For most companies, clustering a market like the Czech Republic with Germany would mean the end of market growth. “The example of Austria and Switzerland is important,” says the regional manager of a healthcare company. “Since they’ve been together with Germany, we never hear from them.”

A Germanic cluster can be disastrous for Central European markets for two reasons. First, it is one of the biggest markets in Europe for many companies and that means any manager responsible for Germany will have to focus the bulk of his time on business there. Getting management attention for the peculiarities of tiny Central European markets becomes impossible. Secondly, Germany is going through a hard time, squeezed by lack of consumer confidence, strapped government authorities and struggling local companies. As the regional director of an FMCG company puts: “German managers are taken up with trying to figure out how to stabilise the market and how to run a business with prices collapsing.” That focus would wipe out any attempt to exploit growth opportunities in Central Europe.

Nevertheless, one clothing company that recently created a cluster with Germany, Poland and the Czech Republic, claims it is a good way of helping Central European subsidiaries to become fully integrated into their highly centralised Europe structure. “We coach them to become part of the company structure,” says the business development manager for Europe. “The focus should not be on retaining ownership but on knowledge transfer.”

The German option is certainly not the only way of integrating the CEE region into Europe—and only two respondents in our survey report to Germany. Most companies that have integrated east and west have gone for one of two options: lumping the markets with Austria and Switzerland (thus freeing these markets too from Germany’s icy hand) or keeping a dedicated Central Europe cluster under a broader European region (with the Baltics under a Nordic cluster). Both solutions have the advantage of keeping the focus and interest on Central Europe and will probably become the norm as companies integrate over the coming years.

But even the soft option of a CEE cluster, with a dedicated management team, would imply a significant change in approach for many companies. That’s a result of different norms and standards and a strong shift towards centralisation and standardisation in Western Europe, often driven by tax structures. The Central Europe manager of a company that has recently shifted to a European-wide business unit structure bemoans the change. “Our local management has the sense that they are competing with one arm tied behind their backs,” he says. “Lots of their time is taken up with form-filling, sending things out in English, meeting worthies from HQ. These are pretty unbearable burdens for an immature business.”

Section 2

Finding appropriate structures for Central and Eastern Europe

The Central and Eastern Europe region is still the basic strategic unit for most companies doing business from Prague to Vladivostok. But the classic CEE headquarters, based in Vienna, Geneva or Budapest, and co-ordinating operations across the entire region is on the way out.

“Instead, over half the companies we surveyed are transferring power to sub-groupings or clusters, reflecting the growing diversity across the region (see box on clusters, next page). “The regional HQ is no longer big and centralised; it’s lean and mean,” says the regional director of an IT company. “It can be virtual. It’s located where the top man has his domicile.

Coping with diversity

The transformation is not surprising. When companies group together markets under a single management team it implies that they have something significant in common. A decade ago, the CEE region shared its communist legacy. Despite their differences, all the markets were facing similar challenges and opportunities—a business sector on its knees, a population hungry for Western consumer goods, companies looking for quality suppliers, and a complete lack of Western business infrastructure.

But the markets have developed at phenomenally different speeds. Those countries about to join the EU have moved rapidly in the direction of Western Europe, due to both government reform policies and the impact of Western business practice. In most sectors, the booming sales of the 1990s have given way to slower growth as competition heated up, the markets matured and costs rose. Now, for most companies, Central Europe is something of a hybrid—it’s no longer an emerging market, but it’s not yet a mature one.

Russia is quite definitely an emerging market. The collapse of the Soviet Union, the crisis of 1998 and the emergence of the powerful Russian oligarchs all slowed down the development of multinational business in the country. But now the country is booming. Most of Russia’s regions are still virgin territory for multinationals and foreign investors are starting to move in. Russia has become an insistent beep on corporate radar screens—a key growth market for the next decade.

Does it make sense to lump the two sub-regions, CEE and CIS, together? Are there any synergies to be had or learnings to be transferred? An increasing number of companies are making a clear distinction between Central Europe and CIS. At the most radical end, one IT company recently abandoned its CEE umbrella in favour of merging Central Europe and the Balkans with Austria and Switzerland, while shifting Russia into an emerging markets grouping. (see Example 1) “Markets like Hungary and Romania are more similar to Austria than to Russia,” says one manager from this company. “Before they were being overshadowed by booming Russia. Now we have more visibility. We can see where resources should go.”

Example 1: US IT company, with sales across the region and very strong position in Russia.

Global HQ ► EMEA ►

1. CEE/Austria/Switzerland
2. Russia/MEA (*Russia will soon be separated from MEA*)
3. Baltics, Benelux, Nordics,

*Vertical managers at EMEA level.
Each cluster run by a senior VP, supported by functional managers.
Country managers execute strategy.*

For now, this approach of cutting the CEE region into separate pieces under the Europe, Middle East and Africa (EMEA) umbrella is relatively rare. Only five of the 28 companies we interviewed in detail had already made or were planning this shift in 2004-5. But almost all of the companies remarked on the increasing lack of synergy within the broader CEE group. The regional manager of a consumer durables company, one of those which made the split last year, sums up their concerns. “I’m uncomfortable with the CEE model, so we took off the eastern part and left Central Europe to report directly to Europe,” he says. “The complexities of Eastern Europe were choking Central Europe, but these countries are not ready yet to be teamed up with the EU. They won’t be for years.”

What is a cluster?

In the 1990s, everybody was talking about regions and hubs. Now they're talking about clusters. Why? The main reason is that CEE markets are growing and maturing; this changes the kind of attention a market needs. At first, most companies did their business in the region out of a hub somewhere, like Vienna or Geneva. Once business started growing, those hubs were transformed into full-blown regional headquarters—legal entities, running a variety of subsidiaries and distributors, with a number of support staff.

Regional headquarters still exist in many companies, but they're changing. CEE business is becoming too big and too diverse to be run successfully from one place. At the same time, for most companies, the CEE markets are too small and overhead costs too high to have dozens of independent subsidiaries.

Enter the cluster. Clusters are not legal entities like a regional headquarters, but flexible market groupings that are designed to get the highest level of business development at the lowest cost. They are a halfway house between centralisation and decentralisation, reducing the power of country managers without shifting it to HQ. For region managers they can provide a clearer overview of business development. "It's all down to scale," says one regional director. "There's no point in having lots of tiny markets reporting in."

Some theorists use the term regionalisation, since most clusters are geographical (like South-Eastern Europe, CIS or Nordics). But clustering should be based primarily on business synergies not on geography—and the process of setting them up should be dynamic, changing as business realities change.

Clusters in the CEE region have tended to emerge in three different ways:

1. In companies established in a region for several years, clustering is often a way of cutting burgeoning costs that are no longer matched by booming top-line growth. In Central and Eastern Europe many companies have opted in recent years to group together, say the Czech Republic, Slovakia and Hungary.
2. New markets are frequently developed by established ones, creating a natural cluster in the early stages of development. This explains why Poland is often clustered with the Baltics, Slovenia with Croatia and Serbia and Greece with the Balkans.
3. New market entrants, forced by existing competition to keep overheads low, often choose to group smaller markets, like South-Eastern Europe or even Central Europe, from the start, avoiding a big regional headquarters and numerous independent local operations.

The difficulty of finding an appropriate solution for Central Europe—one that combines focus with efficiency—explains why most companies are still holding on to the concept of Central and Eastern Europe as a region. The ideal for many companies would be a halfway-house, where the Central European markets have their own management team, are viewed as a unit and not

If clusters function well, they have the advantage of creating useful synergies between markets, ensuring strategic market focus on small markets and keeping overhead costs low by sharing back-office and strategic resources. They can also function badly, though. Often small markets are lumped together with a giant one, eliminating management focus on the smaller ones. Austria with Germany is a classic example, but for some companies it can already be a problem to group Ukraine together with Russia or the Czech Republic with Poland. Clusters can also end up increasing costs by adding a new management layer, if not introduced as part of a broader restructuring to reduce the power of local management and/or the regional HQ.

The criteria that make clusters relevant to a specific company vary. The following are the most common, with companies looking to maximise as many criteria as are relevant to their business:

- ▶ efficient reporting lines
- ▶ geographical proximity
- ▶ linguistic or cultural similarities
- ▶ size of business
- ▶ size of market
- ▶ market maturity
- ▶ cross-border sales
- ▶ ways of doing business
- ▶ knowledge transfer
- ▶ consumer profiles
- ▶ customer structures

Whatever the principle, the key to successful clustering is to ensure that the groupings reflect business realities for the specific company. Take the former Yugoslav markets as an example. Some companies are delighted by their decision to group them together in one cluster. Managers in the more advanced markets like Slovenia can train up the others; language is no problem and logistical connections are still good. For other companies, there are just no synergies between the mature Slovene or Croatian markets and the chaotic Serbian and Bosnian ones.

Finding a functioning cluster structure is particularly important now for two reasons. First, EU enlargement means that companies are looking at the Central European markets in a different way. For those companies that are trying to squeeze more growth out of these markets before integrating them into Europe, it's vital to streamline resources and find a platform that focuses intensively on market development without requiring additional investment. Equally, finding a good cluster structure can facilitate the process of integration. Secondly, since Russia has become a key growth market for many companies, it is also crucial to find a structure that encourages the Russian sales boom, without allowing the market to squash development elsewhere.

as an afterthought to Germany, and are not forced to adapt to all West European norms and standards. Creating that halfway house in some form or another is sometimes possible within the CEE category, where the markets are big and important. But matched next to a Germany or France, it's hard to justify special treatment to a group of tiddlers.

“It’s best to take a two-tiered approach in the CEE region,” says the regional manager of a consumer health company. “Let some develop at one pace and some at another.” Several companies have recently created special transitional structures to cope with the differences. Two IT firms, for example, have ringed off the Central European markets to focus on a final growth push before market shares become set in stone. Then the new member states can join the corporate EU category.

Example 2: US consumer goods/industry, all markets growing much faster than in EU; EEMEA VP on management board

Global HQ ▶ EEMEA ▶

1. Poland
2. CEE
 - ▶ Czech, Slovak, Hungary
 - ▶ Romania, Bulgaria, Moldova
 - ▶ Ukraine
3. Slovenia/former Yugoslav Republics
4. Russia

Active managing director and several functional managers at EEMEA level; plus functional managers at cluster level.

Another company, which sells across both the consumer goods and industry sectors, is in the process of rethinking its CEE clusters (see Example 2). Like many larger players, it has subsidiaries in big markets like Russia and Poland reporting in directly. Now it wants to break down its CEE sub-region, which currently combines everything from Hungary to Ukraine and Bulgaria, into three clusters: 1) the new EU member states, 2) Romania, Bulgaria and Moldova, and 3) Ukraine.

“It makes sense to divide out the new EUs, because of the pace of their development, the maturity of the markets, the structure of the distribution channels and our own organisation,” says the regional manager. “We can get synergies and efficiency gains and improve our approach to customers. We can also prep them to be in the EU group later.”

Example 3: US FMCG company, with big and growing business across the entire region

Global HQ ▶ CEEMEA

- Central Europe North (Poland/Baltics)
- Central Europe South (Hungary, Czech/Slovakia, Croatia, Slovenia)
- Balkans (Romania, Bulgaria, Serbia, Macedonia, Bosnia)
- Eastern Europe (Russia, Ukraine, Belarus)
- Turkey (plus Stans/Caucasus)

100 functional managers at CEEMEA level, strategy at cluster level. plus active country managers.

A major US FMCG company has a similar structure, with CEEMEA represented on the board and very focused clusters (see Example 3). “Some clusters emerged as larger markets developed smaller ones,” says a regional director. “Others were an opportunity for synergies and cost-saving.”

But some companies argue that dividing up markets by maturity removes the chance to transfer valuable experience from one place to another. A company in the agri-food sector, for example, decided that the CEE region had become much too big for one manager to run. But instead of taking the usual route of creating smaller clusters based on maturity or cultural similarities, it went for two fairly arbitrary groups, run by two equal managers, deliberately mixing big markets with small ones and mature markets with developing ones (see Example 4). “The decision to have two managers on exactly the same level was due to capacity and as a back-up,” says one of the two. “The businesses were getting too big in a number of markets for one person to deal with.”

Example 4: Agri-food company with larger sales volume and growth in CEE than in Western Europe

Europe ▶ CEE ▶

1. Austria, Czech Rep, Poland, Slovenia, Croatia, Serbia
2. Hungary, Slovakia, Bulgaria, Ukraine, Romania, Russia

No CEE manager. Two equal cluster managers responsible for strategy; co-ordinating country managers responsible for several markets. Europe-wide functional support

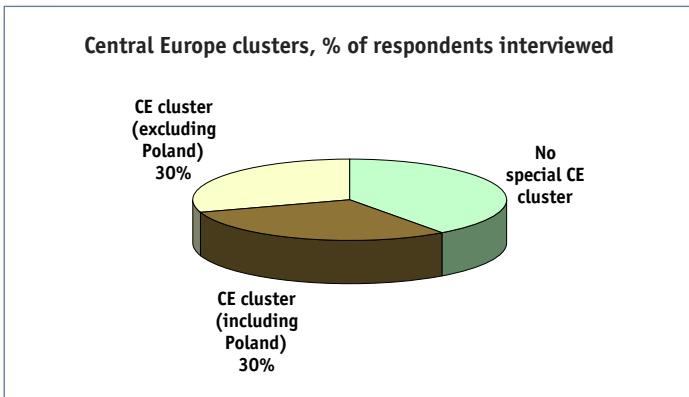
Pooling resources is the reasoning behind other companies going against the clustering trend. One luxury consumer goods company recently re-merged its Central Europe and Russia sub-groups, arguing that the division wasted resources that could be used more effectively. Now each of the country markets is a legal entity, with a number of shared managers across the broad CEE region. “We streamlined resources this way in anticipation of growth to service a much bigger business,” says the regional director. “The idea is not strictly cost-saving. We need to invest and grow—not cut costs.”

An FMCG company, with well-established operations in Central Europe, is also bucking the trend. Its CEE manager is taking over Russia, which used to be run from Germany, hoping to use its experience in developing business in places like Poland and the Czech Republic to boost development in Russia.

A healthcare company, currently focusing on how to cluster its regional operations, is also worried about losing synergies. “Does it make sense to spin off Russia from Romania or Ukraine?” he asks. “We have lots of learnings that could help, in everything from managing distribution to marketing through fragmented trade.”

Does Central Europe work as a cluster?

Does it make sense to combine the mature Central European markets (Poland, Hungary, the Czech Republic, Slovakia and Slovenia) into one cluster? Less than one third of the companies we interviewed group most of these countries in one cluster. Around 40% of companies have broader regional groupings, while 30% isolate Poland from the other markets.



Why? For many established companies Poland is too important and business too difficult to work well in a cluster—and it's noticeable that many of the companies that keep a separate focus on Poland are the ones that have particularly strong and growing businesses there. In many cases, companies still have subsidiaries in most main markets, seeing little point in creating a cluster until the sub-region is integrated with Western Europe. But even then, the Czech Republic and Slovakia are often thrown into one pot. Although growing as an investment location, the Slovak consumer market is still small. One consumer goods company claimed that Slovakia was too quiet and too tiny to attract any attention at the regional level; by lumping it together with the Czech Republic, it created a sizeable unit.

But size is relative. Once companies start integrating the Central European markets into pan-European structures over the next few years, Poland will return to the fold. Polish sales are big for the region but are still smaller than Austria's for most companies.

Defining South-Eastern Europe

The south-east European markets have become much more interesting as Central Europe matures. About half of the companies in the survey group these markets together. Many companies have developed them as satellites out of Slovenia or Hungary; others treat them as a cluster or just part of the CEE region. Several companies, though, have used their subsidiaries in Greece or Italy to develop the markets.

But what exactly is the SEE region and does it work as a cluster? For some companies, the best-functioning unit is actually former Yugoslavia,

run out of Slovenia, and responsible for Croatia, Bosnia, Serbia, Montenegro and Macedonia. The cluster is usually dubbed Adriatic to distance it from unwanted Yugoslav connotations. But recent wars and conflicts have not wiped out cultural and linguistic affinities—and a long history of close business relations. Slovenia was always more advanced and many Slovenes speak Serbo-Croat fluently, enabling them to help launch operations in the less advanced markets.

Questions for clusterers

There is no such thing as a typical or right corporate structure—only one that is appropriate for achieving your business goals or one that is not. Does a company have production locations across the region? Does it only have global brands, or local ones too? Is the business mature or still being created? All of these questions shape what a company needs in terms of structure.

What are you trying to achieve by forming clusters?

- ▶ Is business too small to have offices in each country but too big to manage regionally?
- ▶ Are you trying to create management focus teams to develop specific markets?
- ▶ Do you want to save costs by grouping markets and sharing resources?
- ▶ Are you trying to increase corporate attention and resources by clustering markets?
- ▶ Is the reorganisation part of a broader corporate shift, for example to an agency structure for tax reasons?
- ▶ Do you want to reduce the autonomy and status of country managers?
- ▶ Do you want to eliminate regional HQ and create clusters that can report to EMEA?
- ▶ Do you want to match your customers' structures?
- ▶ How far do you have to break down units to ensure effective management?
- ▶ What constitutes synergy most in your business—form of business, similar consumer profiles, similar business partners and customers, similar language and culture, natural trading areas?
- ▶ Do the typical geographical clusters (Central Europe, SEE/ Former Yugoslavia, CIS) work for your business?
- ▶ Are there larger markets in clusters (like Poland, Russia and Romania) that will hog all the attention to the detriment of other markets? Are these markets important enough to be handled separately?
- ▶ Will clusters create problems with the tax authorities if business becomes too big (for example, if Ukraine's books are handled by Russia)?
- ▶ Which country management teams would be capable of developing new markets as satellites (eg Poland for the Baltics, Hungary or Slovenia for the South-East European markets, Russia for Ukraine)?
- ▶ How do you create synergies and share learnings between the different clusters? Is it important to transfer learnings from more advanced markets to less developed ones? What mechanisms would achieve this?
- ▶ How do you provide leadership across the clusters? At what level does regional strategy make sense—CEE, CEEMEA, EMEA?

That's fine for many sectors, but a number of consumer goods companies argue that the fit is totally wrong. While Slovenia and Croatia are wealthy and soon to be part of the EU, the other states are relatively poor, politically unstable and economically backwards and will require years to join the EU. As a result, the average Serb and Croatian consumer have little in common—disposable income levels are different and consumer behaviour is different. As a result, these companies are more like to cluster Croatia and Slovenia with Central Europe.

The other popular definition of the SEE region centres around Romania and Bulgaria, sometimes clustered with Greece or Turkey and often including the former Yugoslav republics, plus Albania and Moldova. There are dozens of different name variations for this cluster: Balkans, Southern Region, South Danube and CEE South. In this variant, Croatia and Slovenia might be clustered with Central Europe, or together with the former Yugoslav republics in a separate Adriatic region.

Whether or not this cluster functions well depends on the sector and size of business. Several companies mentioned that Romania was getting too dominant in their cluster; and a number already have the market reporting directly to a regional director. Others feel that the synergies between the markets were small—especially where trading barriers reduced economies of scale.

Is Russia too big to cluster?

Over two-thirds of the companies we interviewed had a separate Russia/CIS cluster, usually covering Ukraine and Belarus, plus Central Asia and the Caucasus. Many have set up the cluster recently, making the split with Central Europe; other regional managers are planning to do so soon. Although a quarter of companies still handle Central Europe and CIS as one region without separate strategic clusters, few see significant synergies in the relationship.

But the Russia/CIS cluster is a peculiar beast. Russia is so much larger than the other markets, usually accounting for 85% of revenues, that the cluster is really more a hub with satellite offices in Ukraine and Kazakhstan. Such a cluster is problematic for all parties. Already, where the Russian market is becoming big enough, a country manager will sometimes report directly to regional HQ, rather than through the CIS manager. And increasingly, regional managers talk about the need to spin Russia off separately, and give the market more senior management reporting in at a higher level, to take full advantage of growth. Companies are also starting to look at setting up full subsidiaries in Ukraine to ensure it gets sufficient attention too.

Corporate structures in 2010

How will corporate structures look by the end of the decade? By then, the ten new Central European member states will be full players in the internal market. The last border controls will have disappeared (around 2007), local currencies will have been recently replaced by the Euro (2009-10) and most transition periods will be over. Stronger trade and investment flows, plus EU funds, will be translated into a tangible increase in prosperity—but also into higher costs.

The EU-28, including newcomers Romania, Bulgaria and Croatia, will be in the midst of difficult accession negotiations with Turkey and with the other Balkan states. It will be weighing up Ukraine's future status with the EU—and all eyes will be on the growing economic and political clout of Russia in Europe.

How will corporate structures change to take advantage of business opportunities in this new Europe? By then, multinational companies will have abandoned the east-west distinction. The EMEA region will still make sense, but the Central European markets will be in clusters, competing for attention and resources in Europe with others like France/Benelux, the Nordics, Iberian and UK/Ireland. Some companies will bundle all the accession countries together, on the grounds that the more advanced markets would provide learnings for the newcomers—certainly the case, for any business that sees substantial growth potential in accessing EU funds.

Other companies will break up the accession countries into regional clusters.

- ▶ Central Europe: Hungary, the Czech Republic, Slovakia, Slovenia and Poland, with Austria and Switzerland (and Germany?).

- ▶ Adriatic: Slovenia, Croatia (and possibly other former Yugoslav markets) with Italy.
- ▶ Balkan: Romania, Bulgaria with Greece and, possibly, Turkey, which will shift more decisively into Europe rather than the Middle East, once accession negotiations start in 2005.

By 2010, Russia will have joined that category of corporate misfits—like China, India and Japan—that distort any geographical category they belong to. For some companies, Russia will remain the core of a growing CIS region. But if Ukraine starts to normalise politically, its growth potential will be too big to develop under Russia's wing, and companies will increasingly handle the two big markets separately. Russia—a key global growth market—is more likely to have a senior management team reporting directly to EMEA. Ukraine could then become the core of a new CIS region or even cluster with Poland, if relations develop well.

Although the EMEA structure is likely to persist, some companies might rejuvenate an emerging markets region, now out of favour in most companies, focusing on what are being dubbed the BRIC countries, Brazil, Russia, India, China. These countries, if they continue to grow, will increasingly dominate the world economy in the next few decades and become the major development focus for global business.

Whatever solution companies will have found, by 2010, to channel resources and management attention into the right markets, one thing is clear: the CEE region will finally have disappeared.



Ernst & Young has established a cross-border strategic tax task force to advise clients on issues arising from the EU Accession. The task force includes specialists from the 10 accession countries and the 15 existing EU member states who cover a broad range of areas including Value Added Tax (VAT), customs and international trade, corporate and international tax, Human Capital issues and the grants and incentives available for companies and organizations.

Clients are also able to draw on the expertise of Ernst & Young's associated law practices in the Accession states. They can advise on a range of legal issues including corporate law, mergers and acquisitions and employment law.

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Economist Corporate Network
Schwarzenbergplatz 8/7
A-1030 Vienna
Austria
Tel: (43 1) 712 41 61-40
Fax: (43 1) 714 67 69
www.economistcorporatenetwork.com

An Economist Group business