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## The impact of EU accession on Hungarian SMEs

### Abstract

The enlargement of the European Union on May 1, 2004 has presented many opportunities and challenges for SMEs in the newly admitted countries. This paper examines the history of five Hungarian companies, and what the enlargement has meant for them. They are Wizz Air, Artis Restaurant, Lidl/CBA, Kaposplast and Subway Sandwich.

The impact of heightened competition, increased market opportunities and environmental differences are examined.

**Keywords:** SMEs, Hungary, competition, market opportunities, performance.

### Introduction

Accession into the European Union has created a number of opportunities and challenges for small- and medium-sized enterprises (SME's) in the newly admitted countries. In this paper, I will examine a number of such entities, and describe their success, or lack thereof, in coping with the realities of the New Europe.

May 1, 2004 is a unique milepost for the newly admitted countries, and for companies operating within them. However, it would be a mistake to assume that all changes occurred on that date. For some firms, knowing that the likelihood of admittance was high, steps were taken prior to this date, while for others, reaction started well after this date.

I will not be too specific in defining what an SME is. In today's global marketplace, even an enterprise that could be considered large in its home country, would only rank as small- or medium-sized on a global scale.

Being resident in Hungary, my examples are based on Hungarian firms. It is my opinion, however, that similar companies and experiences can be found in the other newly admitted countries.

#### 1. Wizz Air<sup>1</sup>

In 2003, Jozsef Varadi, in anticipation of changes in regulations, was on the verge of establishing Wizz Air, a new low-fare airline. He was successful in wooing Europe's financial centers for financing, ahead of Hungary's admission into the EU. Wizz Air was founded by Varadi and 6 colleagues, and was registered in London with subsidiaries in Hungary and Poland. Headquarters are in Budapest. Operations started in May, 2004, with the first flight scheduled on May 19th.

The concept of the airline was to operate as a point-to-point network between secondary airports, and thereby to minimize costs and be able to offer a cheap alternative for regular air travel. This is not an original business model, but is based on that of Southwest Airlines (USA), Ryan Air (Ireland), and others.

The funding process for the airline was completed in January 2005 with 34 million Euros provided by an international investor group led by Indigo Partners. This made Wizz Air the best capitalized start-up airline in Europe.

Wizz Air started with two base airports, Katowice and Budapest. The base airports are important initial network points (hubs) and offer a good basis for future expansion. Today there are eight operating bases, serving 50 destinations – and that number continues to grow. The company's ultimate goal is to provide unrivalled low-cost air transport for millions from Central and Eastern Europe to the most popular leisure and business destinations in Europe. The secondary goal is to achieve it through being a value oriented airline that focuses on innovation all along the way of the customer's experience in terms of money and value for money.

**1.1. The competition.** The main competitors in Hungary were Malev (the national airline) and Easyjet. Malev has kept its leading position among the companies operating from Ferihegy. In 2005 Easyjet and WizzAir gained the second and third position – displacing Lufthansa from the top three. Today, Wizz Air is easily number two, having carried more than 10 million passengers, and having driven SkyEurope (another competitor) out of Hungary. Ryan Air attempted to enter the Hungarian market in late October 2007 with little success – announcing recently (March 17, 2008) that it would decrease all but one of its flights from Hungary.

**1.2. Performance figures.** Wizz Air follows a "simple service model" based on ticketless travel, use of cost and time-efficient airports, single-class, no-assignment seating, and a modern, young, standard fleet of aircraft. Quick turn-around time is also a key factor for capacity utilization.

On its fourth anniversary announcement, in 2007, Wizz Air reported flying 4.2 million passengers, which was 40% over the passenger count in the previous year. It expects to fly 10 million passengers in the next 18 months. With such numbers, it is the largest low-cost airline in the CEE.

**1.3. Epilogue.** Although starting small, Wizz Air has shown that a local company, initially consisting of

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<sup>1</sup> Mayer, C.S. and V. Csozik (2005). Wizz Air, CEU Business School Case.

only seven people, can challenge internationally successful competitors, and win. As the saying goes, “the sky is the limit”.

Wizz Air was made possible by the changes in air traffic regulations instituted upon entering the EU. Accordingly, accession was the enabling force behind the founding of Wizz Air.

## 2. Artis restaurant<sup>1</sup>

Artis was founded by majority-owner, Gabor Feheri. He was also a stakeholder in Trofea Café and Grill, a mid-quality, all-you-can-eat, buffet restaurant. Since the initial opening, six years ago, Trofea had successfully opened additional locations in Budapest. Feheri wished to extend his all-you-can-eat buffet concept, which was largely a novelty in Hungary, to the high-quality restaurant market.

The decision to open was made in early 2005. A building was leased, with rent payments at 1,000,000 HUF<sup>2</sup>/month. Rent was set to increase linearly to 1,500,000 HUF/month over 5 years. Taxes were paid only on revenue, not on real estate. The sunk cost for opening the restaurant (interior/exterior improvements, equipment, and furniture) was 250,000,000 HUF. Artis opened in September 2005, after a 6-7 months delay required to obtain various permits.

Minimal market research was conducted. Rather, the owners relied on some internet statistics, but, mainly intuition. The target group was to be up-scale tourists from the West, who were increasingly coming to Budapest after Hungary's entry into the EU. Rich Hungarians formed a secondary target.

Trofea and Artis purchased their food from some common suppliers, but never the same grade or quality. Hence, quantity discounts could not be obtained by Artis. The Artis buffet was to be world-class – food quality, arrangement, and presentation, as well as the most modern technology for keeping food. For example, most hotel buffets use candles to keep the food warm in the buffet. Artis purchased auto-regulated, boiling water thermostats. This equipment is much more expensive.

**2.1. Location.** Transportation and parking was arguably a problem, as Artis was right at the foot of the Margit Bridge, on the Buda side, on an intersection obstructed in the middle by a streetcar stop. 15 parking spots were informally shared with an adjacent computer store. However, one had to drive up from behind the restaurant to access them. Further, if none were available on the first pass, one

had no choice but merge onto the Margit bridge, cross the river to Pest, and tediously return to Buda again.

Despite some of these locational problems, the present location was the only choice considered as Feheri wanted to start his new restaurant there.

**2.2. Opening day.** The September 2005 offering was a set menu of various appetizers, entrees, and desserts, in which customers would choose one item from each category to make a complete meal.

The price per person was 6,000 HUF for lunch and 10,000 HUF for dinner. This package included all beverages (soft drinks, beer/wine), an elaborate buffet on the side, and gratuity. Liquor drinks could be purchased at an additional charge.

The first week after opening day witnessed a terrible turnout. The shock of the poor market response was so great that Feheri wanted to rename Artis to “Trofea Buda”. Everyone else (management, chef, staff) promised to leave if the new name was adopted.

Feheri then decided to make a drastic move. He decided to drop the prices and offer the buffet not only with the menu but also as a separate option. The new buffet was 2,399/3,499 HUF (lunch/dinner buffet, soft drinks, but excluding beer/wine). The new menu was 3,999/3,999 HUF (menu, soft drinks, no beer/wine, buffet). The reaction could be seen almost immediately. Overall, about 80% of customers ordered the buffet.

The price drop was initially intended for just one month, but remained indefinitely at 2,399 HUF for the lunch buffet. The buffet price for dinner was raised to 3,999 HUF within 2 months.

The new prices created very slim margins, and thus Artis hoped to sell plenty of add-ons to their customers. Lunch customers bought close to nothing extra. Dinner customers (buffet and menu) bought on average 1 bottle per every 2 people.

The price drop intuitively targeted a new group – locals who enjoy a bargain. It was planned for just one month, but was then extended indefinitely.

Costs were very high. They included high rent, large staff, sophisticated buffet equipment, full-time operating grill (adjacent to the buffet), and of course very high quality food purchases.

**2.3. Final developments.** April, 2006 – a special lunch offering was introduced, consisting of just an appetizer/soup and entree, for 1,250 HUF. The buffet option remained at the same price of 2,399 HUF/3999 HUF, but no longer included drinks of any kind.

October, 2006 – the decision was made to close Artis, and to turn the facility into another Trofea Grill. In doing so, the expensive leasehold improvements were sacrificed, as the Trofea chain did not require such an

<sup>1</sup> Mayer, C.S. and D. Kaali (2005). Artis Restaurant, CEU Business School Case.

<sup>2</sup> At the time of writing (07/2008) 1 EUR = 234 HUF; 1 USD = 148 HUF.

elaborate setting. The reopened facility is somewhat profitable, but it is unlikely that the “sunk costs” can be recovered in the near future.

**2.4. Epilogue.** It is relatively easy to open new ventures in Hungary. Also, there seems to be a belief that as long as you own your own business, you will be successful.

The Artis example shows that despite significant financial backing, a venture that is not based on a solid business model, and in which basic strategies are abandoned in an effort to create traffic, will fail. In the New Europe, a much better understanding of business principles and planning are becoming essential for success.

The Artis venture demonstrates the euphoria that many Hungarians felt upon entering the EU. As a member of EU, new opportunities, including a swelling in the ranks of tourists would follow. To benefit, all one had to do was “be there”. Unfortunately, this was not the case.

### 3. Lidl/CBA<sup>1,2</sup>

Lidl is a European discount supermarket chain of German origin that operates 5,000 stores. In Germany it is the most important competitor of Aldi, and initially copied the Aldi business model. Lidl is the fifth largest supermarket chain in Germany (2004), and has established itself in over 17 countries around the world. The stores commonly carry about 800 different items, mostly under Lidl’s own brand.

Lidl is following a strategy of regional expansion, as it opens new branches in Denmark, Hungary, Norway, and Slovenia. It entered Hungary in 2004.

As soon as Lidl entered the Hungarian market, it opened 21 stores, which were serviced by a 30,000 square meter distribution centre in Szekesfehervar.

Lidl’s retail prices are around 20% lower than the EU average. This is one of the major reasons behind its success in the new EU member countries, where consumer disposable incomes are generally lower than in the older EU states.

In Hungary Lidl during the first six months of its operation reached nearly 29% of the households through its 29 shops (8.2% in the first month). During the first months Lidl obtained a bigger market share than some of its competitors and has maintained that level since. The demand is high for the private label products and because of this the Lidl private label became one of the strongest brands.

**3.1. Discount stores in Hungary.** Hungary itself has become one of the most important expansion markets for Western retail groups (including Metro, Cora, Auchan, Tesco, and Spar). In most of the measures by GRDI (Global Retail Development Index), the hottest spots are moving eastward, and most of the “to be considered” countries are in Eastern Europe. Hungary continues its descent on the GRDI as the market fills up and consolidates. Most of the large grocery retailers are non-Hungarian, and they control more than 60% of the market.

Prime retail locations are also increasingly hard to come by, underscoring that the time to enter is limited.

**3.2. Performance of Lidl.** To say that Lidl has been successful in Hungary would be an over-statement. It is more popular in smaller towns than larger cities. It has had major problems with health regulations, resulting in temporary store closures. And, there is a building resistance to its policies of stocking mostly foreign products. Competition has become fierce as well.

In 2008, Aldi, Lidl’s major competitor in Germany, finally entered the Hungarian market. Aldi did it on a large scale, opening 9 stores simultaneously.

**3.3. Impact on smaller retailers.** Lidl’s entrance into the Hungarian market was only the tip of the “iceberg” of what was happening to smaller retailers. The other mass merchandisers, also with lower prices, and with broader product ranges were hurting local retail.

According to a recent survey by Nielsen, “the number of small shops have plummeted by a third during the last decade. These outlets, defined as shops of less than 50 sqm – now are responsible for less than 11.8% of food sales turnover”.

**3.4. Formation of CBA.** It was indeed difficult, but not impossible for smaller retailers to respond. They too had to lower their prices to remain competitive. This was accomplished by the formation of CBA – a cooperative founded in Hungary. Founded in 1992, CBA was established by a consortium of ten private businessmen who previously managed to privatize 17 Hungarian state-owned food stores. The driving principle behind the establishment of CBA was to unify, supply, and strengthen the food distribution network in Hungary, while simultaneously satisfying their core customers by offering lower prices with more variety. In 1995, CBA established its own warehouse with the aim to increase storage capacity and also broaden the scope of their customer service department. 1998 was a banner year as CBA stepped out of their local Budapest presence and began to expand to other cities in the countryside. This set the path for CBA to become the main presence in the grocery store sector in Hungary and in 2000, they began a joint partnership with German EDEKA, Europe’s largest trading association. This strategic

<sup>1</sup> Mayer, C.S. and V. Csozik (2005), Lidl in Szentendre, CEU Business School Case.

<sup>2</sup> Mayer, C.S. et al., Marketing in Magyarorszag, a chapter in Marin Marinov, ed. Marketing in the CEE, to be published in 2009.

move, helped to drive the Hungarian chain's international expansion a year later. In 2005 CBA built a state-of-the-art logistics center, which changed the character of its store franchise system.

**3.5. Performance.** Today CBA has remained solely in Hungarian hands. The chain has managed to build a good reputation and win a leading position both in the domestic retail market and on a regional basis. It operates through more than 2400 store outlets, partners with numerous SMEs and has created considerable employment opportunities. The regional distribution centers of the company total 22 and the stores they service are continuously expanding with new franchised stores. The foreign affiliates of CBA exist in such countries, as Bulgaria, Czech Republic, Croatia, Poland, Lithuania, Romania, Serbia, Slovakia, Slovenia.

**3.6. Epilogue.** The entry of large multinational retailers has created major problems for the small, local operators. For some, the competition is so severe that they go out of business. For others, solutions can be found that will negate the advantage of the foreigners. CBA, by forming a buying association which has common purchasing, warehousing, and logistics can offer lower prices. Having local market knowledge, and connections, is also a major contributor to continued success.

The push toward Eastern Europe by Western multinationals was in full-swing by the time the new members gained entrance to the EU. Accession probably accelerated market entry by the "laggards".

Due to the entry of Western multinationals (some even before the change in regimes), the need for an entity like CBA already existed prior to accession. CBA was founded in 1992. However, its existence raised the bar for late entrants, who responded to the opportunities presented by the accession.

#### 4. Kaposplast Plastic Industrial Co. Ltd.<sup>1</sup>

Kaposplast is located in Kaposvar, a small south-western town in Hungary. Its facilities and buildings are old, but functional. Kaposplast produces plastic fibres and straps for industrial use.

Kaposplast was founded in 1949. Initially, it was processing natural hair for the brush industry. In 1967 it acquired the first plastic extrusion machine in Hungary. By the 1980's, natural hair was eliminated, and the company focused on plastic products only.

In 1996, Kaposplast was purchased by Pannonplast Plc, which, at its prime, held 19 plastic industrial companies. Pannonplast, due to managerial problems, experienced financial difficulties, which led to a decision to sell off its still profitable

companies. One of them was Kaposplast, which by 2004 became a privately owned, 100% Hungarian company. The ownership was acquired by a management buy-out.

The company was certified by ISO 9001 in combination with ISO 14001. The total capacity ranges around 2,000 tons a year with turnover of 1.1 billion HUF. This company is a significant player on the domestic market as well as in several European countries. As the options for growth in Hungary reached their limitations, and as Kaposplast's capacity is much higher than the need in Hungary, the company's main interest is to focus on export options, preferably to Western Europe.

Kaposplast's main product range is plastic strapping tapes, plastic threads for the brush and broom industries, monofilaments for industrial and agricultural use and a concrete additive plastic fibre. The company has spent time and money on Research and Development, and as an outcome a number of new products were developed and patented.

In general, the purchasers and users of these products are factories making finished goods, such as brushes, or for use in packing. Fibres are the main drivers of this business. In Central Europe, Kaposplast produces a unique cross-section of plastic fibres shaped in the form of a star, a cross or a Y. Kaposplast is ready to meet any demands with special requirements with regard to color, size, and quality. User satisfaction and quality can be demonstrated through having such customers as GE, Electrolux or Sony.

The company has a few major customers that enjoy priority. Other minor customers have a longer lead time. Transportation is another significant issue as Kaposplast does not have its own transportation capacity. The company relies heavily on external companies for this.

**4.1. Market analysis.** The biggest competitors on the European market producing fibre products are the German Haal, the Italian Fili & Forme, Larsetta and Favagrossa and Polish York and Paterski.

Kaposplast's main focus area is Germany. In 2004 2/3 of its export (355 tons) went to Germany. The advantage of this market is the large quantity that can be sold annually, however the prices are low and the profit is substantially lower per unit.

On the other hand, the Serbian market has an advantage in price establishment. High prices can be charged, due to the limited supply. However, the unstable economical and political circumstances do not provide a constant business flow; the payments are late and the ordering consists of small and slowly producible fibres.

The Polish market gives an opportunity for the Hungarian products, as the size of this market is

<sup>1</sup> Mayer, C.S. et al. (2005). Kaposplast, CEU Business School Case.

large enough to give business opportunities for many suppliers. Additionally, the quality of the equivalent Polish fibre product is poor due to the usage of secondary and recycled material. The weakness of the Polish product allows Kaposplast to charge a higher price than the local producers.

**4.2. Epilogue.** Kaposplast is showing good growth in a specialty niche market, not only in Hungary, but in other European countries as well. By being a low-cost producer, it is able to compete effectively in markets that are not transportation-dependent. By using its cash flow, it is gradually expanding, and up-dating its facilities. It is also providing employment opportunities for locals.

Kaposplast was already active in member countries of the EU (both old and new). Official entry only ratified what Kaposplast was already doing.

## 5. Subway Sandwiches<sup>1</sup>

Subway Sandwiches opened its doors in Budapest, Hungary on July 26, 2004. Unlike other QSR (Quick Service Restaurants) chains, Subway operates strictly through its franchisees. There are no company owned stores and all the risk is put on the franchisee: from the investment, to finding a location, to construction. The only help offered is the Subway brand equity, and a Subway field consultant who offers some help in the process of operations. In return, the franchisee pays Subway 8% royalty on net sales and an additional 3.5% for common advertising.

Subway currently operates over 29,000 stores globally, in 86 countries. If you are the first to open in a country and it is successful, you have the right to become a development agent or DA for Subway. For this right, you accept 33% liability for any franchise in default, and have to open the territory to comparatively the same level as McDonalds. In the case of Subway, that meant 46 stores in a 7-year period. In return, the DA would receive 3% of the 8% royalty.

When John Holm, an American living in Hungary, opened the first store, his goal was to become the DA. He knew he had to find a location that could depend on tourists and expats to populate the store, while waiting for the Hungarians to accept the Subway taste. His first location was right next to the Jewish Synagogue, in downtown Budapest, which is the second biggest tourist attraction there.

**5.1. Market challenges.** Having joined the EU, Hungary adopted regulations and standards required by EU, which can be unfamiliar for American companies. There are many taxes, such as corporate tax, Value Added Tax, and taxes applied locally on different activities and at different rates.

The language issue can be a difficulty as well. Hungarian is one of the hardest languages in the world to speak, and even though there is an improving percentage of locals who speaks English, a large proportion still lacks this knowledge. Translation is required for manuals, labels, meetings or dealing with government, and usually requires the services of an interpreter.

Competitors from all over the world are operating in Hungary. Additionally, local firms are also starting to play key roles. Therefore, low prices, excellent quality and superior services are necessary components to success.

**5.2. Franchising in Hungary.** Currently there are around 400 franchise operations in Hungary and half of these are foreign owned. In the fast food sector, McDonalds is the biggest chain. It follows a successful transnational strategy, as do Pizza Hut, Kentucky Fried Chicken (KFC), Burger King and Subway. Nonetheless some other franchises have to be mentioned that did not work out on this market due to different tastes, and business practices. Examples are: Dunkin' Donuts, Wendy's and New York Bagel – all of whom had withdrew after an unsuccessful entry attempt.

There are different business models to follow. McDonalds uses multiple franchising techniques such as real estate development, purchasing land and building, assigning a partner to run and manage its restaurants. The other techniques implemented by Burger King, Pizza Hut and Kentucky Fried Chicken involve the purchase of a master franchise by a company or group of private investors, who become owners and operators of most, if not all of the outlets.

Some of the key elements for success are providing financing, getting a lower master franchisee fee and/or using foreign master franchisees. However, franchising is still underdeveloped compared to American or Western European standards. Current inefficiencies in the delivery of goods and services and a developing middle class, suggest that there are significant opportunities in franchising.

Fortunately for the franchisee, the initial Subway restaurant was a hit. With the help of the US Ambassador opening the store and a grass roots PR campaign, it became a great success. In order to facilitate growth and show how strong the Subway brand could be to potential franchisees, Holm then decided to open the 2nd outlet in a non-traditional location, only targeting Hungarians. This was a much higher risk than placing it in downtown, but if successful would show how powerful the brand could be to locals.

The second location opened in December, 2004 at the brand new Premier Outlet Center located in Biatorbagy, a suburb outside of Budapest.

<sup>1</sup> Mayer, C.S., J. Holm and V. Csozik (2005). Subway Sandwich (A, B, C), CEU Business School Case.

After opening two stores, one in Budapest and one in Biatorbagy, the plan paid off for Subway – but not for Holm. Holm at this point was developing the territory in good faith and had not yet signed any agreement with Subway. Once Subway headquarters saw the growth potential in Hungary, they immediately started developing it as fast as they could themselves, before any contracts could be signed.

Holm did not become the DA, and did not participate in the opening of additional Subway locations. His two stores are operating profitably, but do not generate enough profit to attract the full-time attention of a professional, such as Holm.

**5.3. Epilogue.** One of the benefits of operating within a franchise is that it reduces the risk of failure. In new markets, such as Hungary, it is not clear that being a franchisee is a benefit. The systems and processes that the franchisor brings to the operation may not be suitable for that market. However, there is always a cost to being a

franchisee. A new franchisee must weigh the benefits against the costs.

McDonalds, as well as other multinational franchisors, including the one that had to withdraw from the Hungarian market, saw the opportunities in the CEE substantially before the accession of the newly admitted countries. Accession made these opportunities more visible to the others on the sidelines. Also, a “champion”, such a Holm was more likely to be listened to after accession.

### Observations and conclusions

In this paper, five different Hungarian company histories were detailed, with their implications for SMEs in the new Europe. It is not easy for new or restructured firms in the newly admitted countries into the EU to find their way in this new environment. Competition is more global and hence, more fierce. It will test the mettle of the would-be player. However, the opportunities and rewards are also greater – making the attempt worthwhile.

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