

Business Advice Series Part Six: Ten typical mistakes investors make in Hungary

How investors are typically taken advantage of

Up to this point this series has dealt with the classic problems that arise in Hungary when structuring an investment, purchasing a company, setting up a new company, and finally with topics related to the everyday operation of a business. This instalment and the two to follow will analyse a typical crisis situation that could lead to a total loss of one's invested capital - if handled unskillfully, that is. What we are about to look at are the conspicuously frequent cases in which the local management intentionally takes advantage of a foreign stakeholder. Let's look at a short case study of a situation which is so common one could almost call it a pattern.

The case study

At the beginning of the 1990s, a foreign investor bought a stake in a Hungarian company with a good reputation and a strong position on the market. At the time the aim was to gain a foothold in Hungary or the region and to exploit the relative advantages of the local market, especially its low wages and taxes. At first the company's products were to be sold by the Hungarian company itself and to its parent company abroad, which would then sell the products on its home market. The original stakeholder took on an outside foreign investor because the only way he could see to modernise his enterprise to the necessary standards was through foreign capital and expertise. He remained the chief executive of the company after the foreign investor bought into the company because there was a need for his considerable expertise in "his own" company and on the local market. Because of his key role, he was granted extensive authority. For the most part, this type of "joint venture" got started without a hitch.

Then the foreign entrepreneur continued to expand his business by taking advantage of the transformation process going on in other countries in the region. Often the expansion into particular countries (for example Russia) turned out to be more difficult than it had been in Hungary, both in terms of legal considerations and of simply doing business. This caused the investor to focus all his attention on this new project.

Drop in earnings

The earnings of the Hungarian company kept shrinking, but there still did not seem to be reason for concern. The company was not paying out any dividends in Hungary and the invested capital was intended to remain in the Hungarian subsidiary anyway. Besides, there was not really any time to follow up on certain problems concerning prices and quality, since the controller in charge of the Hungarian project was up to his ears in work dealing with the projects in more difficult countries. In the process nobody noticed that the monthly report was usually late, frequently got revised and did not always paint a plausible picture.

Out of the blue an employee of the Hungarian company, who had just been sacked by the CEO, spilled the beans about serious irregularities in company operations. (Or another thing that frequently happens is that the Hungarian CEO inquires whether he can buy back the foreign investor's stake.) At this point the foreign investor finally sends his proxy to Hungary to look into matters. What he finds is the following:

Rampant nepotism

The Hungarian CEO really has everything “under control.” By now he has managed to employ half of his relatives. The books are being kept internally by particularly loyal colleagues, or if he can manage it, by relatives. These bookkeepers are far from generous with access to company data, possibly only allowing access to the general ledger if the CEO grants permission.

There is a reason for this policy of tight information control. The company has contracted to buy materials and services from third-party companies at exorbitant prices that bear no relation to the usual market prices. And the CEO stuck with his suppliers, even when the quality of deliveries was substandard. One contractor has done a variety of diverse services for the company and also happens to be another of the CEO’s relatives. Comparative offers have rarely been explored, if ever. A portion of the orders evidently never made it into the books, since there is a scandalous discrepancy between raw material and component usage and the quantity of products made and sold. Perhaps there has not been any monitoring of stock at all. At this point the only clue to what the company has been doing is energy and water consumption records. In especially blatant cases, the CEO has, without obtaining the formal approval of the stakeholders, sold real estate belonging to the company. The investigator only has one more thing to do: once he goes to take a look at the CEO’s home, he will understand where the invested capital or the business loan ended up.

Mistakes made

Later, when the corrupted organisation of the company is analysed, it quickly becomes obvious that some inexcusable mistakes had been made. The CEO was given too much autonomy, having the sole power of representation. The monthly report - an important information and supervision instrument - was neglected and no proper method of control was ever established. The marginal returns earned by the company, which were well below the returns earned by competing companies, should have triggered a thorough investigation much earlier than eventually happened. Some part of the above scenario is already familiar to the investors, but they all know that even more, and different facts could yet be uncovered. The damage has already been done. The only choice now is to take decisive action. One either sells one’s stake as quickly as possible, or one resolves to “clean house.” How one goes about such “housecleaning” is the topic of the next installment.

The ‘Business Advice Series’ points out the recurrent pitfalls of doing business in Hungary and gives advice aimed at making your business more successful.