

Eastern Influx

Automotive manufacturing in Central and Eastern Europe*

Part 2:

How should an automotive manufacturer that has decided to move to Central and Eastern Europe go about choosing the right location for its needs?



*connectedthinking

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Choosing the right location

A growing number of automotive manufacturers and suppliers are migrating to Central and Eastern Europe. In our first paper we discussed the drivers of this eastward drift, and the questions any carmaker or components supplier should consider before making the move. But what if it decides to take the plunge? Where, precisely, should it go? Our second paper covers the issues involved in choosing the right location.

The decision is a complex one, not least because understanding of the region is still quite limited, despite the 16 years that have elapsed since the end of Communism. Moreover, finding the right location for a manufacturer's needs is not just a matter of selecting the right country, it is also a matter of selecting the right place within the right country. Differences in nationwide features such as the employment laws and tax regime are relatively easy to identify, but differences in local characteristics like the availability of skilled labour, planning regulations and quality of the utilities are much harder to determine – and it is these that can make or break a move.

Dispelling the myths

It is important to start by dispelling several myths. Many people who have little, or no, experience of doing business in Central and Eastern Europe believe that the level of

Table 1: Perceptions of corruption in the Central and Eastern European member states of the EU

Country	Ranking
Estonia	24
Slovenia	28
Hungary	41
Czech Republic	46
Lithuania	46
Latvia	49
Slovakia	49
Bulgaria	57
Poland	61
Romania	84

Source: Transparency International, Corruption Perceptions Index 2006
 Note: The higher the ranking a country enjoys (1 being the highest), the lower the perceived degree of corruption

political corruption, fraud and intellectual theft is much higher than it is in more developed regions, and that union activism is a major problem. In fact, the political, economic and commercial climate is far more attractive than it is in many other parts of the world, although there are some significant national variations.

The new Central and Eastern European member states of the European Union (EU) have made huge strides since putting aside their centrally planned economic models. All 10 countries have established stable democracies and made considerable progress in becoming industrialised market economies, in compliance with the conditions for joining the EU. The transition process is more advanced in the eight Central and Eastern European states that joined the EU in May 2004 than it is in Bulgaria or Romania. But though the two newest recruits have yet to catch up with their northern neighbours, their economic growth is three times that of the Eurozone as a whole.

Seven of the eight states that acceded in 2004 also scored higher in Transparency International's 2006 Corruptions Perceptions Index than they have in previous years – yet another sign of the progress they have made since joining the EU. Estonia and Slovenia lead the pack, with a performance that puts them alongside Spain and Portugal, although Bulgaria, Poland and Romania still have some way to go (see Table 1).

Corruption and economic crime

The picture when it comes to economic crime (including the misappropriation of assets, financial misrepresentation, insider trading, money laundering and the like) is also quite positive. In the PricewaterhouseCoopers Global Economic Crime Survey 2005, 45% of companies worldwide reported that they had been victims of economic crime during the previous two years. The percentage of companies that reported experiencing such problems was marginally higher – at 47% – in Central and Eastern Europe, suggesting that the prevalence of fraud is little more than the global average.

Closer inspection of the figures shows that there were some substantial national differences; the percentage of companies reporting that they had suffered from economic crime ranged from 25% in Hungary to 54% in Poland and 63% in the Czech Republic. But these variations may be somewhat misleading. There was a dramatic surge in the number of economic crimes reported in some countries

in 2005, compared with the number reported in 2003 – a fact that reflects the extent to which greater awareness of fraud, the lessening of the stigma associated with reporting such problems and the introduction of more stringent risk management systems have helped to expose crimes that would formerly have gone undetected or undisclosed.

The privatisation process, influx of foreign capital and increasing affluence have all played a part in improving the situation. Most of the major companies are now properly owned and managed; contact with Western institutions has raised the standards of corporate governance; and wages are higher than they were a decade ago, so employees have less incentive to pilfer. Nevertheless, the Communist attitude towards property, encapsulated in the saying “A man who doesn’t steal from his employer steals from his family”, has left its legacy – and although the economic risks of operating in Central and Eastern Europe are often exaggerated, it would be wrong to imply that doing business there is exactly like doing business in Western Europe or North America.

Intellectual piracy

Yet neither economic crime nor intellectual theft is as widespread as it is in many other regions of the world.

Table 2: The degree of difficulty in hiring and firing workers

Country	Difficulty of Hiring Index	Rigidity of Hours Index	Difficulty of Firing Index	Rigidity of Employment Index	Firing Costs (Weeks of Wages)
Bulgaria	50	80	10	47	9
Czech Republic	33	20	30	28	22
Estonia	33	80	60	58	34.7
Hungary	11	80	10	34	35
Latvia	67	40	70	59	17.3
Lithuania	33	80	30	48	30
Poland	0	60	40	33	13
Romania	33	80	40	51	3
Slovakia	17	60	40	39	13
Slovenia	61	60	50	57	40
Germany	33	60	40	44	69

Source: World Bank, “Doing Business 2007”

Note: The first three indices measure how difficult it is to hire a new worker, how rigid the regulations on working hours are and how difficult it is to dismiss a redundant worker. Each index assigns values between 0 and 100, with higher values representing more rigid regulations. The overall Rigidity of Employment Index is an average of the three indices

All 10 member states have implemented the relevant EU directives on the protection of intellectual property rights (IPR), and Estonia had robust copyright laws long before some of the older EU states. The policing and enforcement of these laws is still quite weak; the judiciary is generally inexperienced in dealing with commercial claims, court proceedings are slow and it can take many years to settle a case. However, the protection of intellectual assets is an old and deep-rooted concept in much of the area; Bulgaria, Estonia, Hungary and Poland joined the Berne Convention in the 1920s, for example, and though socialism did much to erode these cultural roots, respect for IPR is much stronger in Central and Eastern Europe than it is in Asia or Latin America.

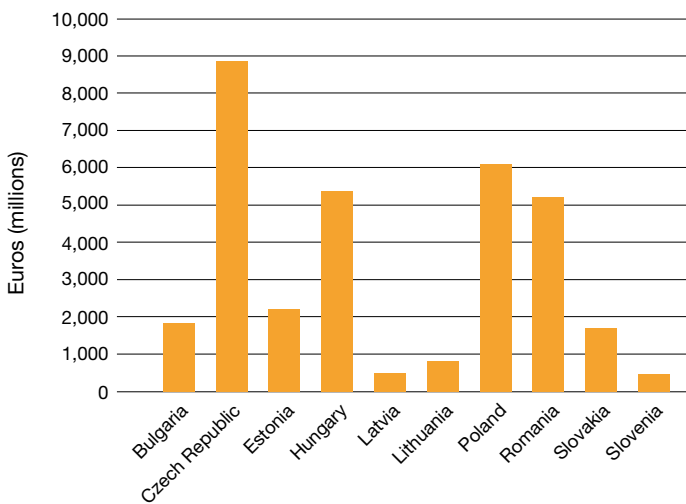
Labour laws

The labour laws are also far more benign, and the unions far more fragmented, than many people realise. In all but three states, it is as easy to hire and fire staff as it is in Germany; indeed, it is often much easier and always cheaper (see Table 2). And though the unions must be consulted when 10% or more of the workforce is to be made redundant, the maximum notice period is generally three months. Working hours are also fairly flexible outside the Baltic States. The working week is typically 40 hours

and overtime is limited to 416 hours a year, except in Hungary where the limit is 200 hours.

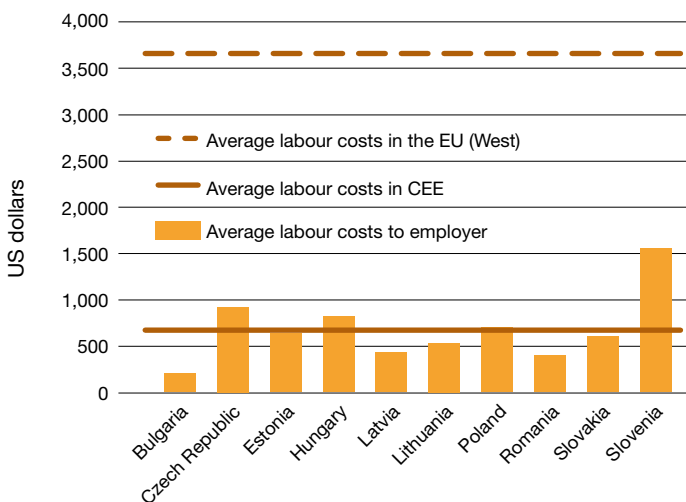
In short, some of what passes for common knowledge about Central and Eastern Europe is either incorrect or overstated. The eight states that joined the EU in 2004 are politically and economically stable, and offer a favourable

Figure 1: Foreign direct investment in the Central and Eastern European accession states (2005)



Source: The Vienna Institute for International Economic Studies Database on FDI in Central, East and Southeast Europe, 2006

Figure 2: Average monthly labour costs in the Central and Eastern European accession states (US\$)



Source: PricewaterhouseCoopers

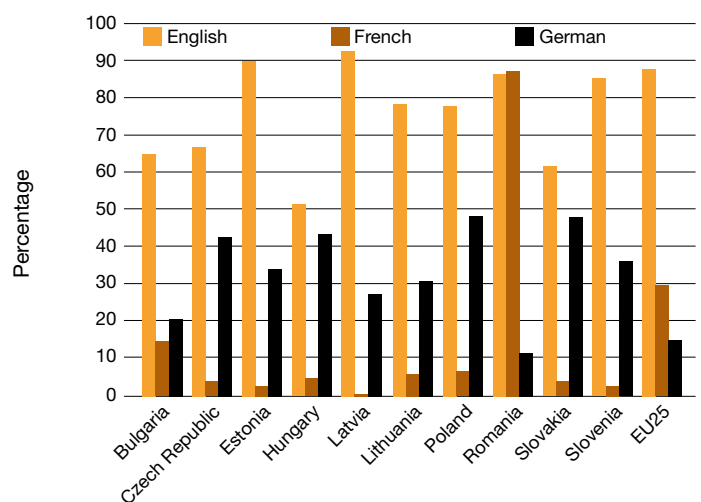
business environment – as shown by the high inflows of foreign direct investment they have already attracted. They are certainly not hotbeds of political corruption, economic crime, intellectual piracy or union activism. Bulgaria and Romania are more difficult countries in which to operate, but they are making rapid economic progress and attracting increasing interest from foreign firms (see Figure 1).

Regional and national characteristics

The labour force

So much for the myths, but what about the reality? As we indicated in our previous paper, the single biggest reason for migrating to Central and Eastern Europe is the potential for labour savings, with wages currently a fraction of those in the West. In the EU15, the average monthly labour cost is \$3,658. In Bulgaria it is just 6%, and in Romania just 11%, of this sum. Even in Slovenia, which has the highest wages in the region, the average is still only 42.7% of the level in the older member states (see Figure 2). The introduction of the euro is likely to push earnings up faster than the rate of inflation. Nevertheless, the World Bank predicts that labour will remain cheaper in the new Central and Eastern European member states than in the EU15 for at least the next 20 years.

Figure 3: The percentage of pupils learning a language in secondary school



Source: Eurostat Education Statistics

The quality of the workforce is also very high, with a large pool of factory operatives skilled in metal cutting, bending, welding, plastics, tooling, assembly and finishing, many of whom can speak a second language. A substantial number of people under the age of 35 can speak English, for example, although German, French, Italian, Spanish and Russian are quite widely spoken, too. This linguistic proficiency is a reflection of the educational advances the new member states have made over the past few years. More than half of all secondary-school children in the region now study English, and more than one-quarter study German (see [Figure 3](#)).

The graduate population is likewise increasing rapidly, especially in the fields of science and engineering, although it is still much smaller in most of the Central and Eastern European accession countries than it is in very industrialised countries like Germany (see [Table 3](#)). Between 1998 and 2003, the number of people graduating from universities or other institutes of higher education virtually doubled in Poland, Latvia and Slovakia. And, measured as a proportion of the college-age population, the average number of students gaining degrees is now higher than it is in the older member states; about 60 students in every 1,000 inhabitants aged between 20 and 29 gain degrees, compared with 51 in the EU15.

The hunt for human capital

Several of our largest automotive manufacturing clients have reported that they are experiencing difficulties in recruiting factory-floor workers, according to Branislav Hunčík, PricewaterhouseCoopers' Central and Eastern European adviser on human resource issues. Since the workforce in most of the region is not very mobile, some companies have tried to solve their staffing shortages by joining forces with local agencies to provide temporary housing for new recruits. Many firms employ a significant number of temporary workers. But smaller companies often lack the resources to adopt such measures, and are likely to find recruiting skilled personnel very tough. The competition for local talent has also seen some staff change employers once they have received their induction training. So any firm hiring new workers should ensure that its employment contracts include a penalty clause for those who leave within a specified timeframe.

Table 3: The graduate pool in the Central and Eastern European accession countries

Country	Number of Graduates (2003)	Number of Graduates in Science, Mathematics & Computing (2003)	No. of Graduates in Engineering, Manufacturing & Construction (2003)
Bulgaria	47,277	2,132	7,432
Czech Republic	47,178	3,467	7,244
Estonia	9,877	776	914
Hungary	67,606	1,969	5,617
Latvia	20,763	1,307	1,484
Lithuania	34,454	1,735	5,983
Poland	477,785	19,050	36,110
Romania	136,580	7,632	24,912
Slovakia	31,852	2,809	4,870
Slovenia	13,931	476	2,120
Germany	304,773	28,562	51,718

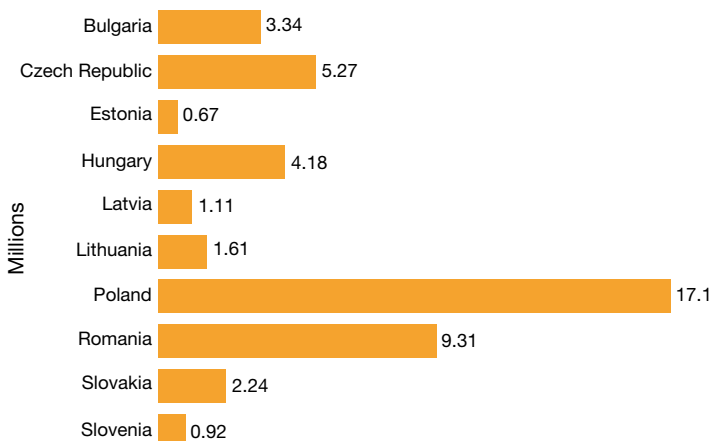
Source: Eurostat Education Statistics

The availability of labour

However, in some countries access to labour is now a serious concern (see sidebar, *The hunt for human capital*). Poland and Romania have by far the biggest working populations; hence the comparative ease with which it is possible to hire staff in both countries. Conversely, the workforce is very much smaller in the Czech Republic, Slovakia, Slovenia and the Baltic States, and the shortage of skilled workers much more acute (see Figure 4). Moreover, better access to tertiary education has exacerbated the problem for companies seeking blue-collar staff. As the number of university students increases, so the number of secondary-school leavers entering the workforce is declining. And people with degrees are not generally interested in working as factory-floor operatives or supervisors.

Demand for skilled labour has already resulted in some major intra-national differentials in wage levels. The average gross monthly wage is now 25% higher in Bratislava than it is in eastern Slovakia, for example. The differences are even more pronounced in the Czech Republic; wages in Prague are 43% higher than in Jižní Moravia and Severní Moravia (the southern and eastern regions of the country, respectively). Superficially, then, it might make sense to move to one of the areas where labour costs are lowest, but such places often lack the infrastructure required to support a manufacturing operation.

Figure 4: The size of the labour force in the Central and Eastern European accession countries



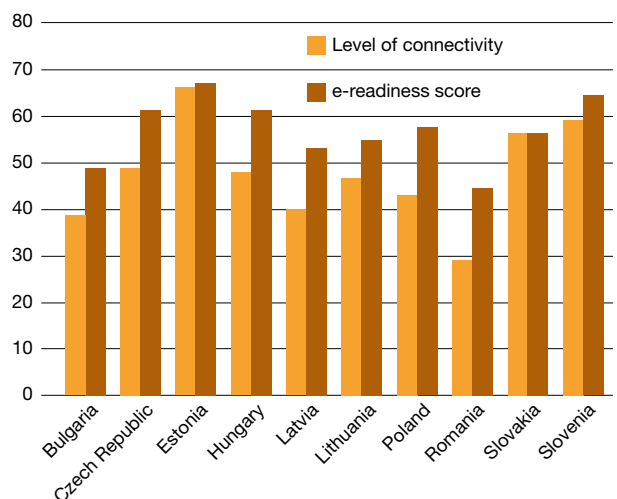
Source: CIA World Factbook 2007

The quality of the infrastructure

In fact, the electronic infrastructure is relatively robust. Most of the states that joined the EU in 2004 have good telecommunications and IT networks in all but the most remote locations. Slovenia leads the way; according to Eurostat, three-quarters of all enterprises in Slovenia had broadband access by the end of 2006, which puts it on a par with the average for the EU as a whole. Broadband access also increased by 17% in the Czech Republic, 14% in Hungary and 13% in Slovakia in the 12 months to November 2006, while Estonia became the first country in the world to introduce Internet voting in political elections. As a result, all four states now score highly in the e-readiness stakes (see Figure 5).

Bulgaria and Romania are still trailing somewhat behind the rest of the region. Although connectivity is good in the major cities, telecoms and energy supplies can be erratic in smaller towns and more rural locations. However, Bulgaria, in particular, has invested substantially in electronics, engineering and computer sciences, an

Figure 5: Levels of connectivity and e-readiness in the Central and Eastern European accession countries



Source: Economist Intelligence Unit & IBM Institute for Business Value, "The 2006 e-readiness rankings"

Note: Connectivity measures the degree of individual and corporate access to fixed and mobile telephony services, personal computers and the Internet, and the affordability, quality and reliability of service. The e-readiness score is a composite ranking reflecting the strength of the technological infrastructure, business environment, prevalence of e-business practices, legal and political environment, social and cultural environment and supporting e-services. Countries are ranked from one (worst) to 10 (best)

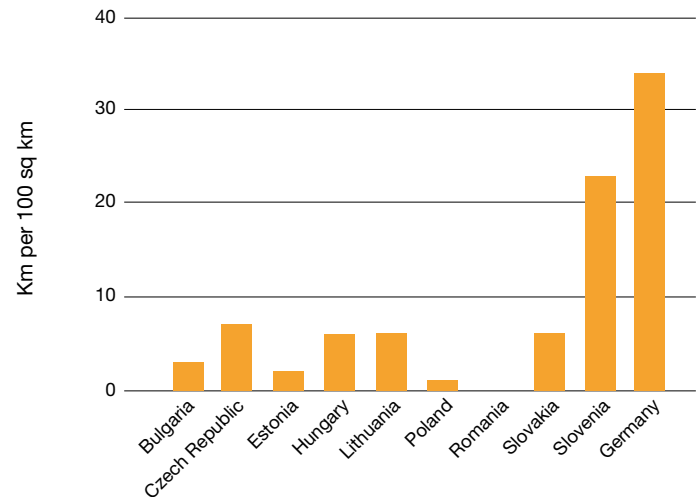
investment which appears to be paying off as it attracts an increasing amount of software development and technology-based contract manufacturing from neighbours like the Czech Republic and Hungary. So it seems likely that Bulgaria's electronic infrastructure will rapidly improve.

The quality of the physical infrastructure in the region is very much weaker. The Czech Republic and the western part of Slovakia have reasonably good highway networks. But the roads in Hungary, Poland and the Baltic States are largely "A" roads (although Poland is currently building several new highways in the south-western part of the country), and the roads in Romania and Bulgaria are quite poor. Congestion is also a major problem in some areas, as the volume of passenger and freight traffic rises, and the European Union Road Federation estimates that 14,000 kilometres of new highways will be required within the next 10 years, simply to create a network comparable with that in the rest of the EU (see [Figure 6](#)).

The railway network is arguably in even more urgent need of investment. The Community of European Railway and Infrastructure Companies reports that almost all the rolling stock in the new member states of Central and Eastern Europe is more than 20 years old. And though most capital cities have good air links with Western European hubs, many of the smaller provincial cities in the region do not have international airports.

Any company moving to one of the Central and Eastern European member states must therefore perform

Figure 6: Density of highways – 2003



Source: Europe in Figures – Eurostat yearbook 2006-2007
Note: No available data for Latvia

something of a balancing act. If it moves to a big city or centre of excellence, the infrastructure will be robust but real estate, labour and facilities are more expensive and there is always the danger that the place will already be saturated (see sidebar, [Checking out the competition](#)). If it moves to a smaller city or town, the costs are likely to be lower and the competition for labour less intense, but the infrastructure will be weaker and the logistical challenges correspondingly greater.

Checking out the competition

There are a number of centres of excellence in Central and Eastern Europe, says Rafal Krasnodebski, PricewaterhouseCoopers' leading regional expert on location services. Bratislava and Gliwice (in Slovakia and Poland, respectively) have become magnets for automotive manufacturing, while Bucharest (Romania), Brno (Czech Republic) and Central and south-western Poland specialise in IT. Similarly, Budapest (Hungary), Brno, Poznan and Wroclaw (Poland) specialise in high-tech manufacturing; Bratislava, Lodz (Poland) and Poznan in logistics; Bratislava, Brno, Gdansk and Silesia (Poland) in engineering; and Budapest and Krakow in shared service centres. But Prague is now very expensive, and Brno is rapidly filling up with manufacturers. Similarly, although Budapest and Krakow still have room for shared service centres, Budapest is no longer as cost-effective as other cities in the region, and Krakow will be at full capacity within the next 18 months. So it is imperative to take the investment activity of competitors and related companies into account when making an investment decision.

The local supply chain

The state of the road and rail network clearly has a direct bearing on the time and costs involved in shipping goods from one place to another, and that, in turn, affects inventory levels and working capital requirements. However, there are other supply chain issues to be considered. Any automotive manufacturer relocating to Central and Eastern Europe will, for example, need to source some of its materials from local suppliers – and the more it relies on other firms, the more it risks losing control of production. A single small incident with a single supplier can hold up the entire supply chain.

One of the most important aspects of choosing the right location is therefore checking out the quality of the local suppliers. Fortunately, labour productivity has improved a great deal in most of the new EU member states in recent years, but Poland, Hungary and Slovakia have recorded the biggest increases. Poland's productivity level is now higher than that of South Korea. Nevertheless, even in formerly Communist countries, not all suppliers are created equal; their capabilities and the quality of their work can vary dramatically.

Many companies take a blinkered approach to their suppliers; they pursue the lowest prices and content

themselves with a cursory inspection of the plant. In our experience, it is essential both to consider the bigger picture and to carry out a comprehensive inspection of the facilities and finances of any potential suppliers. A lot of suppliers have insufficient systems and expertise to cost their products properly or monitor their performance. It is equally important to ascertain whether they are able to look beyond their own operations to the supply chain as a whole, since understanding, and sharing, the risks along the supply chain is a prerequisite for minimising disruptions.

The tax burden

Such practical considerations are vital. So, of course, are fiscal issues like the tax burden, which also varies substantially from one state to another. Moreover, the headline figures can be quite misleading. Slovenia has the second highest statutory corporate income tax rate in the region, but the total tax take is lower than in any other country except Poland. Conversely, Hungary has a statutory corporate income tax rate of just 16%, but social security and health insurance costs raise the total tax take to 59.3% (see [Table 4](#)).

However, direct taxes are by no means the only form of taxation a carmaker or components supplier moving to

Table 4: The tax regime, 2006-2007

Country	Total Tax Rate	Corporate Income Tax	Labour Tax	Other Taxes	Statutory Corporate Income Tax Rate
Bulgaria	40.7%	7.4%	31.4%	1.9%	15%
Czech Republic	49.0%	0.0%	40.6%	8.4%	26%
Estonia	50.2%	9.6%	39.7%	0.9%	30% (corporate income tax) + 4% (municipal tax)
Hungary	59.3%	7.8%	42.9%	8.6%	16%
Latvia	42.6%	9.1%	28.0%	5.5%	15%
Lithuania	48.4%	5.9%	36.2%	6.3%	15%
Poland	38.4%	11.5%	25.0%	1.8%	19%
Romania	48.9%	9.3%	38.6%	1.1%	16%
Slovakia	48.9%	7.7%	40.8%	0.4%	19%
Slovenia	39.4%	15.6%	19.3%	4.5%	25%

Source: PricewaterhouseCoopers and the World Bank, "Paying Taxes: The global picture"

Note: The statutory corporate income tax rate is the official tax rate that applies in each country. The corporate income tax, labour tax, other taxes and total tax rate represent the percentage of commercial profits a standard modest-sized company must pay in its second year of trading

the region must take into account. All intra-EU shipments are exempt from customs duties, for example, but if a carmaker's supply chain spans countries outside the EU, the carmaker or its supplier could be liable for customs duties on any parts that are imported from non-EU countries. Similarly, a manufacturer based outside the EU which exports components from an EU member state and then imports finished vehicles into the EU could be liable for customs duties on all the imported vehicles. Several mechanisms exist for minimising these duties, but they are quite complex (see sidebar, [Securing relief on trapped duties](#)).

Variations in the local VAT regime may cause other problems. The new member states have implemented VAT systems based on the EU Sixth VAT Directive. However, since these systems are still in their infancy, few simplification measures are applicable. Carmakers often have to pay substantial VAT pre-financing on tooling charges, for example. Any supplier outsourcing its manufacturing to one of the new member states should therefore consider the transport arrangements it makes with the carmaker very carefully. If it transports equipment on behalf of the carmaker, it may have to register for VAT and pay local VAT pre-financing, hidden costs that should be included within the overall equation.

Drilling down into specific cities

In short, there are some major differences between the various Central and Eastern European member states, which can have a substantial bearing on how a company conducts its business. But it is not enough to compare national characteristics. Choosing the right location means choosing the right place in the right country, so it is essential to focus on cities as distinct from states.

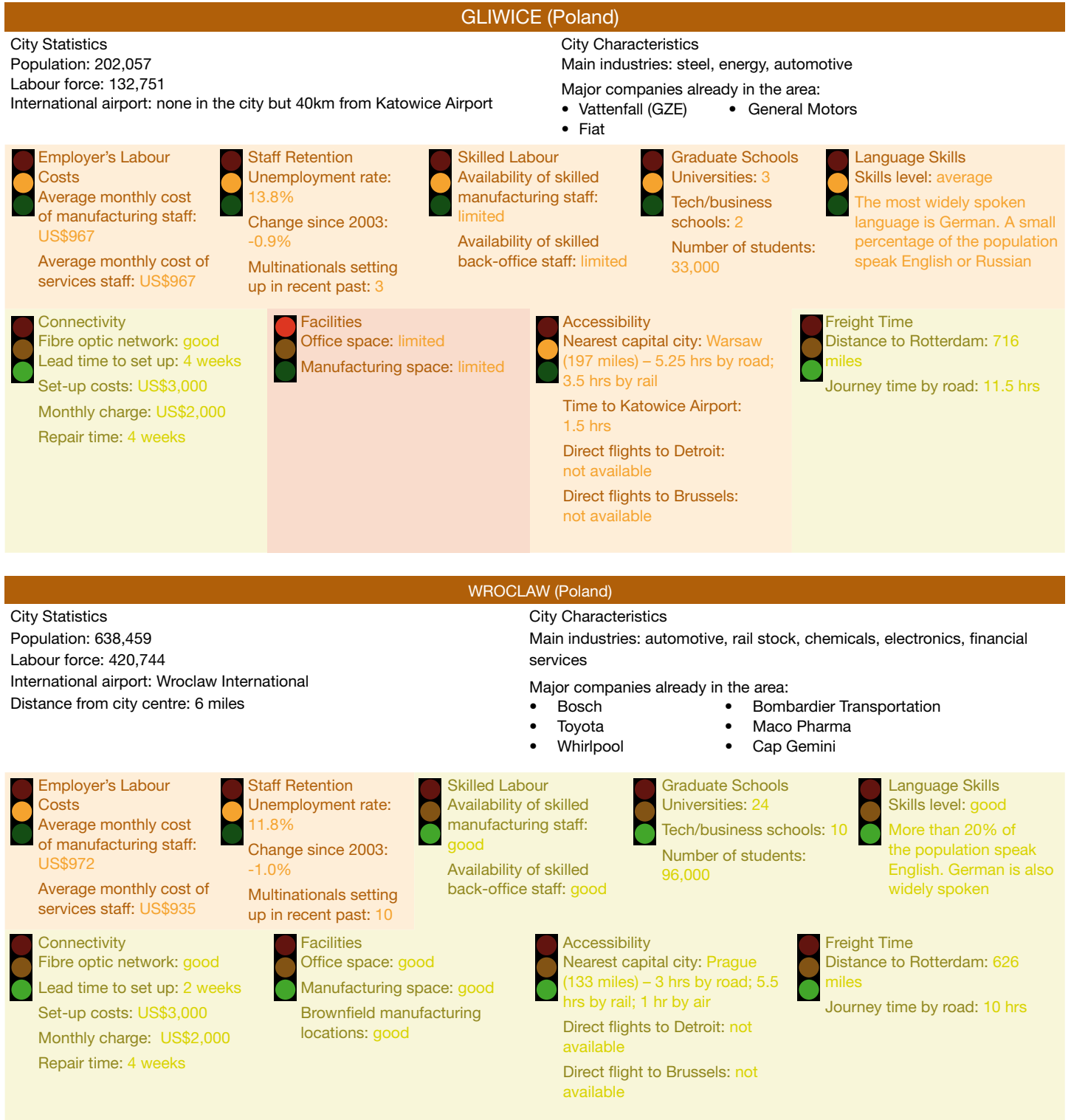
One sensible way of approaching the task is to identify all the cities with a population of, say, 100,000 or more and measure each against between five and 10 key criteria, such as labour costs, connectivity, language skills, facilities and accessibility, using traffic-light ratings to evaluate them. Additional criteria can be used to refine the numbers still further, until a company has a shortlist of two or three cities that look particularly promising. It can then send representatives to visit each city and meet the local authorities, suppliers and employment agencies, before making a final decision.

Securing relief on trapped duties

The complexity of the automotive supply chain often means that it covers countries based in different zones for the purposes of customs duties, notes PricewaterhouseCoopers tax specialist Bart Vanham. Suppose, for example, that a German carmaker imports components from a supplier with a factory in the Czech Republic, which sources some of its parts from Croatia. The supplier will be liable to pay customs duties on the parts it has imported from Croatia. But if it joins forces with the carmaker to map the destination of the finished goods, it can apply for inward processing relief – the suspension of customs duty – on all the parts imported from Croatia and used in vehicles to be sold in non-EU markets.

Parts shipped out of the EU, and then reimported, may also qualify for relief. Take the case of a supplier based in Poland and manufacturing for a carmaker outside the EU, which then imports some of its finished cars into the EU. Mapping the supply chain enables the carmaker to apply for outward processing relief on all the vehicles it imports into the EU, up to the value of the parts that have been exported from the EU in the first place.

Figure 7: Comparison of Gliwice and Wroclaw



Source: PricewaterhouseCoopers

In the following example, we have taken the hypothetical case of a components supplier based in Detroit and planning to set up a factory in Central and Eastern Europe. We have compared two Polish cities – Gliwice and Wroclaw – to show the importance of assessing local as well as national features (see [Figure 7](#)).

As our analysis shows, the two cities display markedly different characteristics. Gliwice has a strong automotive manufacturing base, with several major carmakers already located in the area. But good facilities are very difficult to find, wages are quite high and access to skilled labour is limited. In Wroclaw, by contrast, the pool of potential employees is much larger, as is the number of universities and technical schools; and more than 20% of the population speak English. The city also has an international airport, so it is more easily accessible from the US, and there is plenty of office and manufacturing space. On the downside, employment costs are also quite high and there are no vehicle manufacturers in Wroclaw. But, seen from the perspective of our hypothetical Midwestern components supplier, the advantages more than offset the drawbacks.

Conclusion

In short, any manufacturer planning to relocate to Central and Eastern Europe must do its homework, rather than following the crowd. It is only by focusing on the local as well as the national, and comparing specific cities in exhaustive detail, that a company can identify to what extent a place will meet its specific requirements. Moreover, although investment agencies can provide some assistance, it is important to remember that they are understandably eager to promote their own cities and do not understand the individual needs of the business. So any such advice should be treated with caution.

Choosing the right location is a time-consuming exercise, then, and one in which local knowledge is essential. But once a company has found the right place, it can start fleshing out its plans and drafting a timetable. It can also begin to consider how it will manage the transition from one factory to another. In our next paper, we shall look at the issues involved in closing down an existing site in readiness for the move to a new location.

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