

Eastern Influx

Automotive manufacturing in Central and Eastern Europe*

Part 4: How should an automotive manufacturer that has decided to move to Central and Eastern Europe manage the transition?



As the attractions of Central and Eastern Europe increase, a growing number of carmakers and components suppliers are relocating to the region. In our previous paper we discussed the issues involved in closing an existing plant in preparation for the move. In this paper we shall cover the challenges associated with managing the transition to a new site in one of the 10 Central and Eastern European states that have recently joined the European Union (EU).

Choosing the right mode of entry

The first question any company should ask itself is whether to build or buy. The choice it makes will depend on various factors. Building a new plant and supply chain takes a considerable amount of time, for example. So, if speed of entry is critical, it is generally better to form a joint venture or acquire a business that is already up and running.

However, acquisitions are much more difficult to manage, since the target firm's staff, working practices and so forth must be integrated with the purchaser's existing operations. Numerous studies suggest that at

least two-thirds of all mergers and acquisitions (M&As) never deliver the financial gains on which they were predicated. Hence the fact that getting value for money and managing the post-merger integration process are among the leading concerns of executives engaging in such transactions (see [Figure 1](#)).

Most new factories are also more productive than brownfield plants. Industry experts estimate that they are typically about 20-25% more efficient than older plants on brownfield sites because they incorporate current best practice in terms of their physical layout and operating procedures. Thus the decision to expand or acquire has various ramifications, both short- and long-term, all of which must be considered. The individual strategy, goals and planning horizons of the company concerned will also, of course, play a major role in determining its best mode of entry.

Finding the right target

Once a company has decided which route to take, it can begin looking for a suitable plot of land or business to buy. In fact, many firms prefer to acquire

Figure 1: The key concerns of chief executives performing acquisitions



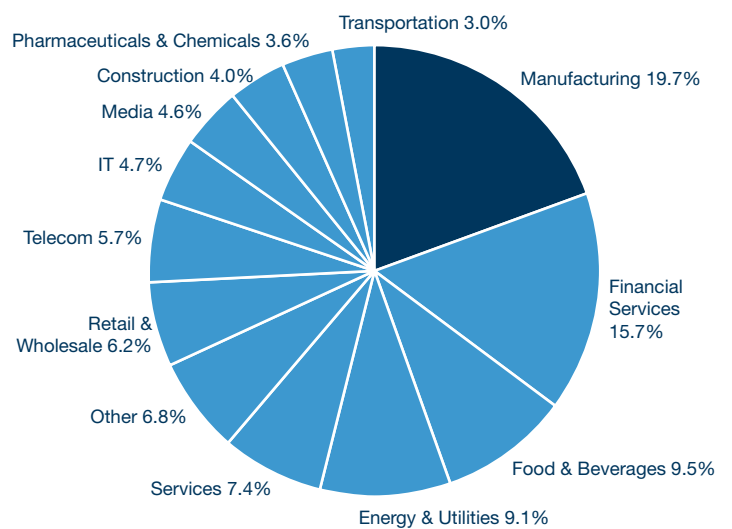
Source: PricewaterhouseCoopers Deal Confidence Survey

a business that is already trading than to start from scratch, although the criteria on which they focus may differ substantially. Corporate buyers generally want to purchase a company with the right strategic fit, for example, whereas private equity houses want to purchase underperforming operations. But, in either instance, the first stage of the acquisition process is to find a suitable target (see Table 1) – and this is becoming more difficult, as demand for good assets rises.

Research conducted by PricewaterhouseCoopers shows that there were 2,527 publicly-disclosed deals with an aggregate value of US\$163 billion in Central and Eastern Europe in 2006 – 70% more than the \$91 billion that changed hands the previous year. The manufacturing sector accounted for by far the largest share of the deal-making, with 499 acquisitions collectively worth \$32.6 billion (see Figure 2).¹

This level of interest is unlikely to abate for some time. In a survey recently published by legal firm DLA Piper, 33% of corporate respondents and 37% of private

Figure 2: The manufacturing sector accounted for one-fifth of all acquisitions in Central and Eastern Europe in 2006



Source: PricewaterhouseCoopers

Table 1: The five stages involved in any acquisition

	Finding the Target	Conducting the Deal	Planning for the Takeover	Taking Control	Integrating the Business
Corporate Buyer	Finding a company with the right strategic fit	Identifying the synergies Completing due diligence Determining the price	Completing the valuation Formulating an integration strategy	Ensuring the continuity of ongoing operations Stabilising the business	Capitalising on the synergies Exploring new opportunities Realising the strategic goals
Private Equity Buyer	Finding a suitable, under-performing target	Ascertaining improvement opportunities Assessing cash flows Identifying investment needs	Putting debt in place Recruiting a new management team		

Source: PricewaterhouseCoopers

¹ These figures are based on publicly-disclosed, private transactions in 11 countries: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia, Serbia, Slovakia, Slovenia and Ukraine. For further information, see "CEE M&A Survey 2006: Maturity, momentum and mega-deals", available at <http://www.pwc.com/extweb/pwcpublishings.nsf/docid/eb235c74e4756b35802572aa0031db69>

equity firms indicated that they expected to increase the number of acquisitions they made over the next two years. And it was Eastern Europe that held the greatest appeal. Twenty-five percent of corporate respondents said that they wanted to acquire assets in the region.

Moreover, the private equity industry raised a record \$406 billion last year, and a number of funds are now focusing exclusively on Central and Eastern Europe (see box, [Private equity heads east](#)). Borrowing for highly leveraged deals may become more expensive, as the banks re-price risk. But despite the recent volatility in the stock markets it is hard to see why credit should completely dry up, given that there has been no major private equity deal on which the bonds have defaulted.

Some companies also have very strong balance sheets. And though bank interest rates in the Eurozone and UK may increase again over the next few months, the market turbulence of the past few months may well have a silver lining. A number of

industry commentators predict that the European Central Bank and Bank of England will be very wary about lifting rates still further for fear of triggering an economic collapse.

These trends have two implications for would-be buyers. First, prices have risen sharply. Two or three years ago, manufacturing companies would typically sell for about six times earnings before interest, depreciation, taxes and amortisation (EBIDTA). Today, acquisition multiples are more like 10 or 12 times EBIDTA.

Second, it is becoming more important than ever to use local expertise, since most of the large targets in Central and Eastern Europe have already been acquired. There are plenty of good assets still to be found; many of the companies set up in the early 1990s will come up for sale during the next decade, for example, as the entrepreneurs who established them cash out and retire. But these companies are smaller and harder to spot, so it is crucial to have someone local who knows where to look.

Private equity heads east

Central and Eastern Europe has been attracting increasing interest from private equity firms. According to the Emerging Markets Private Equity Association, 15 funds raised nearly \$3.3 billion specifically for investing in Central and Eastern Europe or Russia in 2006 – an eightfold increase on the \$406m that was raised in 2003. Industry experts believe that there is plenty of room for further growth; private equity penetration in Poland, the region's largest market, is still only 0.05% of GDP, compared to a European average of more than 0.4%.

Returns to date have also been very promising. The European Bank of Reconstruction and Development estimates that the Central and Eastern European investments in its private equity portfolio generated a 36.8% return in 2005, almost 10% more than private equity returns from the US and 12% more than those from Western Europe.

Negotiating and getting the most out of the deal

Finding a suitable target is only the first step, however. The next is to identify the synergies and opportunities for improving the business, complete the due diligence process and agree on a price. It is vital to investigate and evaluate every facet of any potential purchase before signing on the dotted line – particularly in Central and Eastern Europe, where many business practices are quite opaque and legal remedies are difficult to obtain. It is therefore advisable to expand the scope of the due diligence process beyond the traditional elements.

Financial due diligence

On the financial side, for example, it is essential to undertake a thorough review of the target company's business plan, financial status, financial ratios, accounts, tax records, operating procedures, filings with relevant government agencies and the relationships it has cultivated with banks or other lenders. Only then is it possible to identify questionable practices such as the early recognition of revenues or one-off asset disposals that have temporarily inflated profits and any hidden liabilities or outstanding litigation (see sidebar, [Detecting the danger signs](#)). It is also necessary to check the assets of the business, including leases and deeds, and how it depreciates property and equipment values.

Commercial due diligence

However, in making an acquisition it is important to consider the context in which the business operates, as well as its individual merits. Without understanding the features of the particular sector in which the company is trading, it is impossible to arrive at a realistic valuation. Numerous factors can influence the commercial environment, including the emergence of new competitors, changes in government, the introduction

Detecting the danger signs

Any company planning to make an acquisition in Central and Eastern Europe should check the target firm's books very thoroughly because the core business may not be nearly as profitable as the vendors claim, says Miroslav Bratrych, a transaction services specialist at PricewaterhouseCoopers. Some vendors overstate the profits by including the revenues from non-core activities such as the provision of goods or services to related parties, he explains. Alternatively, they manipulate the working capital by postponing payments until the deal has been closed.

Bribery is another danger. If there is evidence that the target company uses bribes, the buyer will have to identify what effect stopping such practices would have on the vendor's revenues and margins. In addition, it will have to assess whether it needs to retain the incumbent management team, what controls would be required to prevent it from bribing other customers in future, and how much it would cost to dismiss any managers who persist in such behaviour.

We have also seen cases where the owners have stripped the target company of substantial amounts of money between signing the deal and closing it, Mr Bratrych adds. So it is essential to write a very robust price-adjustment mechanism in respect of working capital and net debt into the sales and purchase agreement.

of new laws and shifts in market conditions (see box, [Reform agenda running out of steam?](#)). Moreover, accession to the EU is not a guarantee of economic stability.

It is equally important to check out the target company's commercial relationships with its customers and suppliers, and establish whether these are likely to alter in the near future. Is a key customer planning to shift its supply base to another location within the next 12 months, for example? If so, how will this affect the target company's cash flows and profits? And will the change of ownership precipitate other changes? Will the acquiring company be able to continue supplying the target company's customers, or will those customers be competitors of its existing customer base and therefore want to move elsewhere? Will it be able to use the same suppliers and enjoy the same terms of business, or will it be forced to look for new suppliers who may charge more for the materials or services they provide? Such conflicts of interest may mean that a company which is completely viable as a standalone business loses much of its value in different hands.

Operational due diligence

The target company's manufacturing capabilities should likewise be assessed, both to measure the standards to which it operates and to identify any opportunities for increasing productivity. Operational due diligence entails examining a company's work centres, materials flows, scrap generation, inventory levels and stock turns, and evaluating its transportation, distribution and warehousing arrangements. In other words, it assesses the extent to which the company being sold uses lean manufacturing principles, quality initiatives like six sigma and organisational methodologies like 5S; what the buyer can do to improve the company's productivity and profitability; and how much it will cost to implement these improvements. Given the enormous diversity of the working practices and technologies used within Central and Eastern Europe, operational due diligence can have a decisive impact on business valuations.

Reform agenda running out of steam?

Central Europe has undergone a remarkable transformation in the past few years but there are now several signs of "reform fatigue", warns Matt Pottle, Central and Eastern Europe Automotive Leader at PricewaterhouseCoopers. The Czech government has substantially tightened the labour code, for example, while the Hungarian government has drafted a fiscal roadmap that includes significant tax increases. Similarly, the Slovak government has reduced the speed at which new market reforms are introduced and Poland's parliament includes two nationalist parties that are deeply opposed to the EU.

Political changes could have a considerable bearing on companies trading in any of these states, says Mr Pottle. They could impede further implementation of the market-based economic policies espoused by the EU. They could also restrict access to some markets, since government spending still accounts for between 44% and 51% of the region's gross domestic product. Central Europe is not in crisis, he adds. But the mainstream political parties are courting popularity by postponing some of the reforms needed to complete post-Communist modernisation. And in the short term, this may make some countries more difficult places in which to do business.

Human resources due diligence

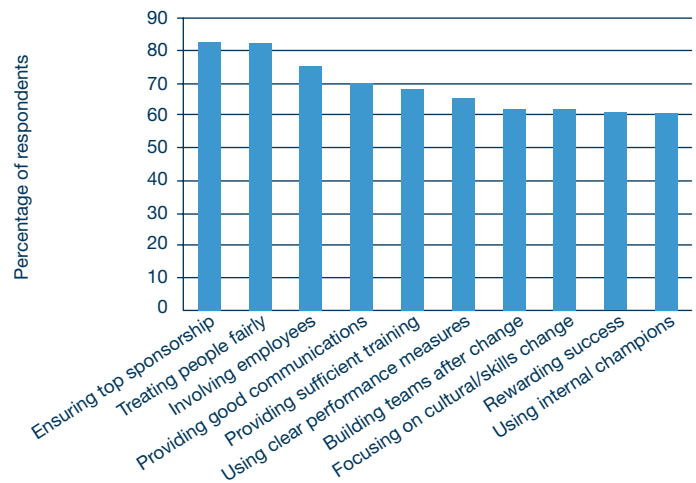
Much of the value that can be realised from an M&A also depends on the attitudes and behaviour of the people involved in the target business. Indeed, research conducted by PricewaterhouseCoopers shows that the top 10 factors contributing to the success of an acquisition are people-related, as are at least seven of the biggest barriers (see Figures 3 and 4). So it is vital to assess the calibre of the management team, the profile of the workforce, the company's culture and values, compensation and benefits systems, and its industrial relations (see box, [Reading the workforce aright](#)).

Reading the workforce aright

Most employees in Central and Eastern Europe have now been exposed to the Western model of management, says Branislav Hunčík, PricewaterhouseCoopers' regional adviser on human resource issues. But it would be wrong to assume that they share the same outlook as those based in Western Europe, North America or Asia. So any company that is moving into the area should invest in cross-cultural management training, he believes.

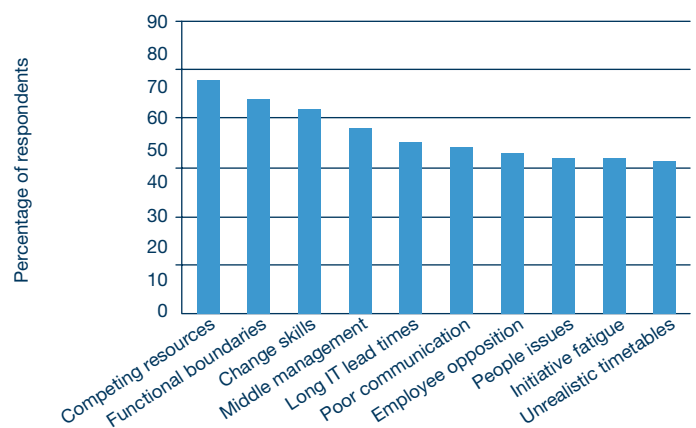
People in Central and Eastern Europe had a different approach to work in the past; they did not put their work above everything else, Mr Hunčík explains. The situation is changing, but absenteeism and sickness rates are still somewhat higher than they are elsewhere. In Western Europe, for example, the average absence rate is 3.9%, while in Central and Eastern Europe it is 4.2%. However, since labour rates are lower, absenteeism costs are only €1,080 per employee in Central and Eastern Europe, compared with €3,240 in Western Europe.

Figure 3: The 10 biggest factors contributing to the success of acquisitions



Source: PricewaterhouseCoopers Deal Confidence Survey

Figure 4: The 10 biggest factors obstructing the success of acquisitions



Source: PricewaterhouseCoopers Deal Confidence Survey

The buyer should, for example, decide whether it wants to retain the existing management and, if so, in what capacity. Some companies choose to keep the founder on the board, but it is often better to employ such people as consultants or non-executives, since they can find it very difficult to accept the changes a new owner makes. Many a disgruntled entrepreneur has left before his contract expires, and a number have even set up rival operations. Moreover, it is much harder to enforce employment contracts and non-compete agreements in Central and Eastern Europe than it is in North America or Western Europe.

The buyer should also look at the target company's staff turnover and how much it spends on hiring, whether its HR policies and procedures comply with the legal requirements, and the degree to which the workforce is unionised. In addition, it should identify any differences in corporate culture and the difficulties such differences might cause. The challenges of integrating employees from a formerly state-owned enterprise and those from a business set up by an entrepreneur may be very different.

IT due diligence

The target company's IT systems and technology may play a considerable part in determining how much value can be realised from the acquisition, too. Due diligence is generally thought of as a set of legal, commercial and accounting checks, but these days most companies use technology to do business – and this should be analysed just as rigorously. The systems that are used and how well they are used; whether they are up to date, sufficient to accommodate further growth or require considerable capital investment; the structure of the IT organisation and ownership of software – all these factors will have a bearing on how well the target company performs in future. They will also affect the speed and ease with which it can be integrated and assimilated, once the acquisition has gone through.

Green checks

There are a number of questions any potential purchaser should ask when it is evaluating the environmental risks associated with acquiring another company in Central and Eastern Europe, says Eric Davy, an environmental due diligence specialist at PricewaterhouseCoopers. It should ask:

- Can we obtain permits to increase production?
- Will we trigger or accelerate environmental clean-up or permitting requirements if we rationalise production?
- Are there differences in the financial reporting of environmental liabilities that would require adjustments to our reserves, modifications of our financial disclosures or even a restatement of earnings for previous accounting periods?
- How good is the target company's compliance management? Will changes in staffing, technology or other resources be needed?
- Does the target company use materials we have eliminated or contractors who do not operate to the environmental standards we are required to meet?
- Are there emerging issues, such as climate change, that will have a significant impact on the integrated company? Will they require additional capital investment or limit production?

Environmental due diligence

Lastly, it is essential to establish whether there are any environmental risks and liabilities that might affect the purchaser. These include operational risks like contamination, emissions, waste management and materials management; legal issues such as compliance with current and future national and

international environmental legislation; and reputational risks. The supply chain itself can also be a source of environmental problems where, for example, a key customer stipulates that certain environmental standards must be met (see sidebar, [Green checks](#)).

It is particularly important to perform such checks when planning to buy a business in Central and Eastern Europe because environmental degradation was a serious problem during the Communist era. Most of the countries that have joined the EU have now strengthened their environmental policies, institutions and financing, but there are still some marked variations in their performance. The Czech Republic faces some significant long-term environmental challenges, for example, but has been making strenuous efforts to improve its performance. Conversely, Romania is relatively undeveloped and unpolluted, but its systems for controlling pollution and protecting the ecosystem remain quite weak (see [Table 2](#)).

Once the various due diligence processes have been completed, the buyer can determine whether the price it has offered for the target company is sensible or whether there are grounds for reducing it. Proper due diligence will provide it with the evidence it needs to renegotiate the price or even decide to withdraw from the transaction altogether.

Planning for the takeover

The next step is to start planning for the takeover. Since any company that acquires another one usually has to pay a premium for the assets it wants, it must generate additional value just to cover its investment. Speed is essential, both to stabilise the target firm and to realise that value (see [Figure 5](#)). The first 100 days are particularly important, because it is then that the target company's employees, customers and suppliers are most open to change.

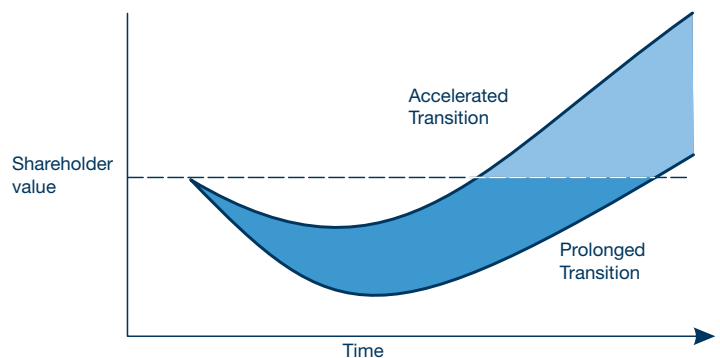
Table 2: The environmental performance of the Central and Eastern European accession states

Country	Environmental Sustainability Index Score	Environmental Performance Index Score
Latvia	60.4	N/A
Lithuania	58.9	N/A
Estonia	58.2	N/A
Germany	56.9	79.4
Slovenia	57.5	77.5
Slovakia	52.8	79.1
Hungary	52.0	77.0
Bulgaria	50.0	72.0
Czech Republic	46.6	86.0
Romania	46.2	56.9
Poland	45.0	76.2

Sources: 2005 Environmental Sustainability Index & Pilot 2006 Environmental Performance Index

Note: The ESI measures a country's long-term environmental trajectory, including the extent to which it has previously controlled pollution, the degree of ecosystem degradation and the effectiveness of its environmental policies. The EPI tracks its current environmental performance. Both indices use a scale of 0-100. We have included the data for Germany for comparative purposes

Figure 5: An accelerated transition will generate much greater shareholder value than a prolonged transition



Source: PricewaterhouseCoopers

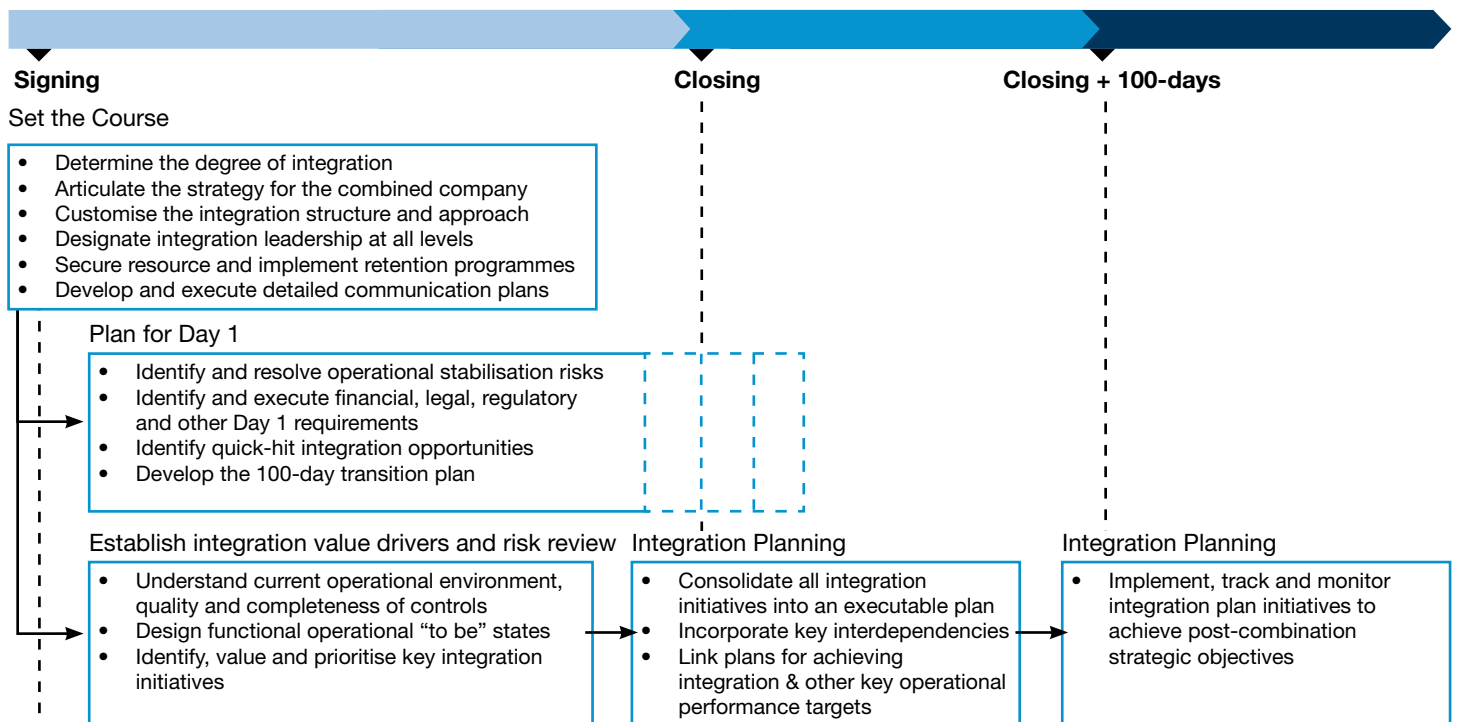
However, many purchasers find it very difficult to maintain their momentum. They may have put so much time and effort into negotiating the deal that they have no energy left for managing the integration of the two firms. Alternatively, they may have been forced to tender for the target company and thus had no idea beforehand which of the competing bids would succeed.

Many companies also use different people to manage the negotiating and post-merger integration processes. They set up one team to complete the acquisition and another to handle the operational issues when the deal has gone through, and those teams are often answerable to different executives. This makes it

very much harder to share information. The second team frequently fails to draw on all the data the first has collected, even though it may well be useful in managing the transition.

For various reasons, then, some companies manage the preliminary stages of an acquisition quite effectively, but lose their impetus shortly afterwards. Yet it is essential to look ahead. In the interval between signing and closing the deal, the purchaser should formulate and articulate a strategy for integrating the new entity; allocate resources for managing the integration process; prepare a list of checks to be performed as soon as it takes control of the target firm; and develop a 100-day transition plan (see Figure 6).

Figure 6: The interval between signing and closing the deal should be used to set the combined entity's new course and develop a 100-day transition plan



Source: PricewaterhouseCoopers

It will need, for example, to appoint senior managers – some of whom may come from other factories owned by the parent company – to lead the integration. Most companies use a combination of the “carrot and stick” to persuade key staff to relocate to another country; they make international postings a requirement for further promotion, but provide inducements in the form of relocation bonuses, housing and career management support. Some companies also pay mobility premiums, although this trend is decreasing.

Similarly, any company that is acquiring another business will need to put a retention programme in place to ensure that the change of ownership does not precipitate an exodus. It will have to identify

key employees, let them know that they still have a valuable contribution to make and discuss their new roles with them (see box [Capitalising on local talent](#)). It will also have to define the areas of the business that offer most potential for creating or destroying value, rank any initiatives in order of their financial impact and probability of success, and allocate its resources accordingly (see [Figure 7](#)).

Taking control

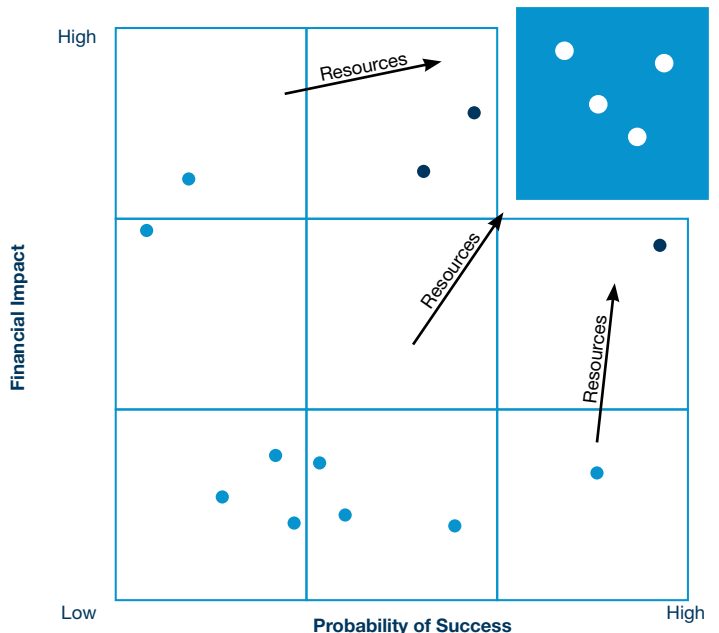
So much for the planning stage, but what happens when the lawyers have left and the doors of the newly bought business are finally flung open? Clearly, there is no single blueprint for managing the integration process, since the precise challenges the purchaser

Capitalising on local talent

Some acquiring companies with little prior experience of Central and Eastern Europe underestimate the business acumen many people in these countries possess because they wrongly assume that Communism stamped out all individual initiative, says Nick Stockdale, a regional supply chain specialist at PricewaterhouseCoopers. So they bring in their own management, who then make all the decisions and simply tell the local staff what to do. But treating intelligent human beings in this way is insulting, divisive and damaging to morale, as well as a waste of valuable resources.

It is worth making the effort to understand the target company’s culture before taking control of the business, Mr Stockdale explains. A buyer that incorporates its target’s best people and practices within its own approach is likely to do very much better than a buyer that imposes its own management team and style on its target.

Figure 7: The acquiring company should allocate its resources based on what will most affect shareholder value



Source: PricewaterhouseCoopers

faces will vary depending on the nature, structure and state of the company it has acquired (see [Table 3](#)). However, it is possible to break the first part of the process down into three distinct phases, each with its own specific emphasis.

In week one, for example, the buyer should concentrate on bolting down the deal and initiating any urgent actions that are required to preserve the value of the business it has acquired (see [Figure 8](#)). Some of

these actions are very basic – such as putting security measures in place, enabling the IT systems of the two predecessor organisations to “talk” to each other and re-setting authority levels, cheque signatories and approval limits. But they are critical in preventing “value leakage”. The buyer should also communicate with all its key stakeholders, including staff, customers, suppliers and investors, and ensure that adequate management information reporting mechanisms are in place.

Table 3: The key challenges involved in the integration process

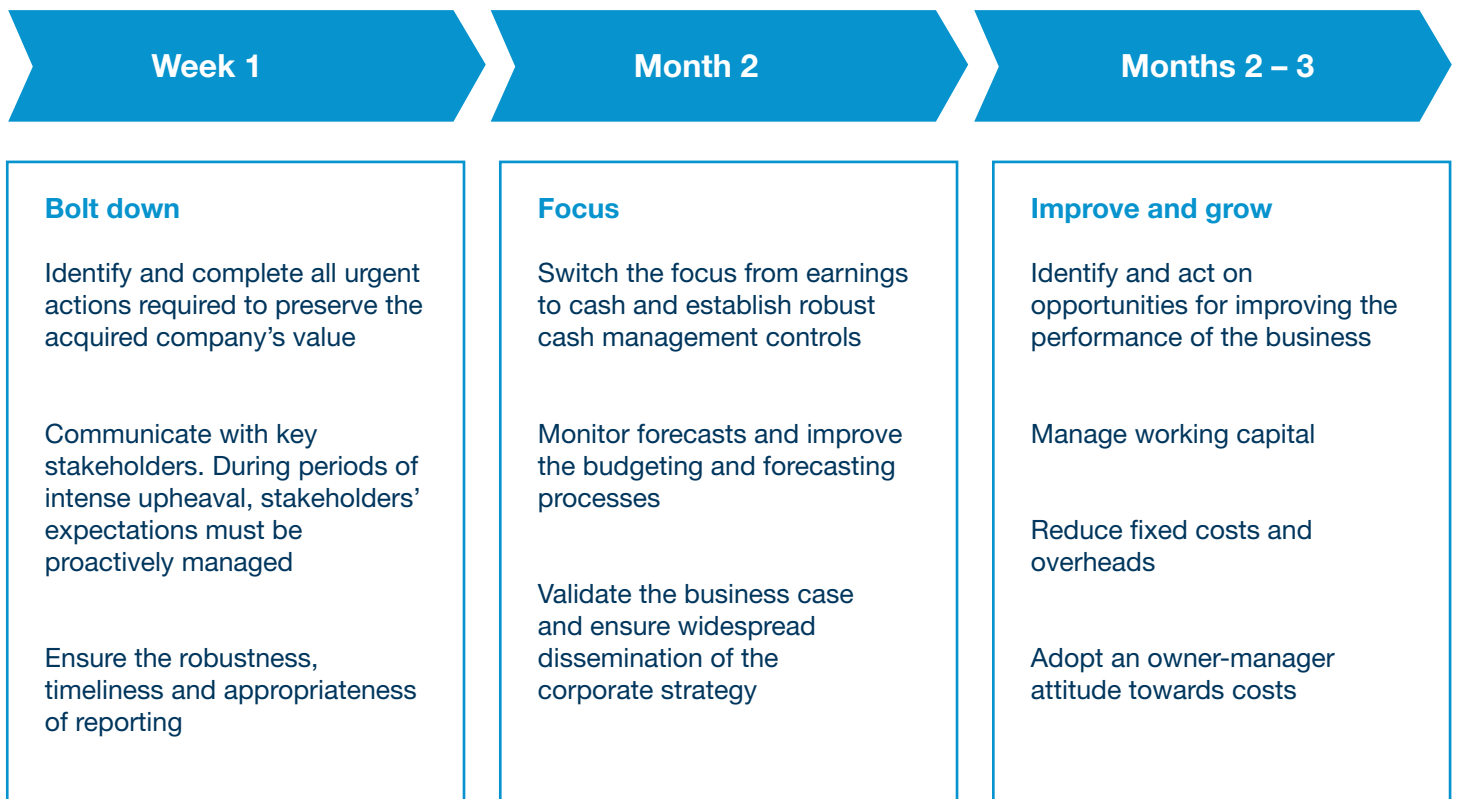
Growth	<p>Market response: How quickly can we respond to changing customer requirements and technologies?</p> <p>Product development: What is our long-term strategy for new internal development or future acquisitions?</p> <p>Management information: Are we providing the right business information to support decision-making and control?</p> <p>Stakeholder management: Do we have a consistent and reliable model for managing our internal and external relationships?</p> <p>Tax and treasury strategy: What is the most effective tax structure for the group, and how do we optimise our capital structure?</p>
Control	<p>Transparency: Do we know what’s going on in the business and to what extent can we rely on the numbers?</p> <p>Governance: Are our internal policies and controls effective, and are they fully embedded within the business processes?</p> <p>Risk Management: Have we identified and evaluated external and internal risks, and do we have procedures for managing them?</p> <p>Section 404: Can we meet the demands of the Securities Exchange Commission and other financial regulators?</p>
Efficiency	<p>Value for money: Are our processes efficient, and are we using an appropriate and cost-effective resourcing model?</p> <p>Benchmarking: How do the standards of efficiency we apply compare to best practice, and what can we learn from other organisations?</p> <p>Automation: Are we making effective use of technology and automating those processes that do not require human intervention?</p>
Functional Capabilities	<p>Role: What are the roles of each function, and how do they contribute to value creation within the business?</p> <p>Technology: How do we structure our information systems to adapt to constant changes in structure and reporting requirements?</p> <p>Organisation: How do we best align ourselves to the business and avoid potential conflicts of interest?</p> <p>Talent: Are the right people in the right roles, and are our management development and succession planning strategies effective?</p>

Source: PricewaterhouseCoopers

In the immediately succeeding weeks, the emphasis should switch to cash management and alignment of the business plan. The buyer will need to focus on controlling cash flows and producing accurate forecasts, validating its business case for undertaking the deal, making sure that everyone understands and consistently interprets its corporate strategy, and identifying which management tasks should be performed first.

In the two months after that, the main challenge is to start improving and expanding the newly acquired company and unlocking some of the value on which the deal was posited. The buyer will need to find out where the gold (if any) is buried, exploit any short-term opportunities for improving the newly merged entity's performance and release cash by managing its working capital as effectively as possible. It will also need to concentrate on reducing its fixed costs and converting fixed costs into variable costs where it can.

Figure 8: Taking control should be a managed, three-phase process



Source: PricewaterhouseCoopers

The hallmarks of the first 100 days should thus be speed, clarity of vision and stability. It is vital for any company that has just acquired another one to establish a clear plan of action with specific objectives, build the right environment with the right people in the right roles, stabilise the business and secure its value. Moreover, since each function will have different concerns, management must ensure that everyone is pulling in the same direction.

The IT function will want to focus on the consolidation of the technical infrastructure and systems integration, for example, while the human resources function will want to focus on retaining key staff, managing rumours and improving morale, and the supply chain will want to focus on production planning, procurement and plant rationalisation. But unless all the parts of the business work together, the integration process will come to a grinding halt.

Conclusion

In short, cross-border M&As inevitably involve an enormous amount of work – work that must usually be accomplished in a highly charged atmosphere under very tight deadlines. However, expert advice, forward planning and a sound framework for managing the first weeks and months of the integration process can all help to increase the chances of success.

This is not to say that everything will be plain sailing afterwards. On the contrary, some problems only emerge many months after a deal has been completed. But experience can be invaluable here, too. In our next and final paper we shall look at some of the most common challenges that arise after a company has established a presence in Central and Eastern Europe, and how best to resolve them.

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