

# Hungary



## ECONOMIC OVERVIEW

### GDP AND CPI

Hungary has been one of the most successful transition economies in Central Europe, exhibiting high real growth and declining inflation and unemployment.

Key economic indicators	1999	2000	2001	2002	2003
GDP growth (%)	4.2	5.2	3.8	3.3	2.9
CPI (%)	10.0	9.8	9.2	5.3	4.7

Source: EIU-Country report

### UNEMPLOYMENT

	1999	2000	2001	2002	2003
Unemployment rate (%)	7.0	6.4	5.6	5.9	5.9

Source: KSH (Central Statistical Office of Hungary)

Average unemployment figures hide quite marked regional differences with close to full employment in the Budapest-Vienna corridor, but pockets of high unemployment in former industrial towns in the northeast of the country.

### ECONOMIC FORECASTS

#### GDP and CPI

	2004	2005	2006	2007	2008
GDP growth (%)	3.3	3.9	4.1	3.8	3.8
CPI (%)	7.5	4.7	4.0	3.1	2.5

Source: EIU-Country forecast, 2004 May



**Area ('000 sq km):** 93.03  
(US 9,600 – EU 2,500 – World 133,700)

**Capital:** Budapest

**Population (million):** 10.1  
(US 288.4 – EU 305.5 – World 6,200)

**GDP (USD billion):** 82.5  
(US 10,400 – EMU 6,600 – World 32,300)

**GNI per capita (USD):** 5,290  
(US 35,400 – EMU 20,320 – World 5,120)

**Currency:** Forint (HUF)

**Language:** Hungarian

**Main religions:** Roman Catholic 52%, Reformed 16%, Lutheran 3%, others 29%,

**Government type:** Parliamentary democracy

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## Unemployment

	2004	2005
Unemployment rate (%)	5.7	5.6

Source: EIU-Country forecast 2004 May

While macroeconomic indicators have been slower to improve in Hungary than in neighboring accession

countries, performances remain good compared to current EU trends. The GDP growth rate has returned to an upward trend, driven primarily by exports and - to a lesser extent - domestic consumption. Nevertheless high interest rates, volatile currency movements and significant budget and balance of payment deficits continue to apply downward pressure.

## REGULATORY ENVIRONMENT

### FOREIGN DIRECT INVESTMENT

Capital and earnings can be freely repatriated in almost all instances. While the National Bank of Hungary retains some exchange controls, particularly for large capital movements, in order to guard against speculative attacks on the currency, the Forint is by and large freely exchangeable.

Contracts involving a foreign party or some other foreign aspect may be governed by non-Hungarian law. It is also possible in contracts with a Hungarian party to specify compulsory arbitration in a foreign jurisdiction, the rulings of which are enforceable under Hungarian law.

Foreign direct investment inflows

	1998	1999	2000	2001	2002	2003
FDI* (HUF billion)	573.8	626.2	687.8	661.0	745.4	871.8
FDI* (EUR million)	2.381	2.489	2.645	2.575	3.068	3.439

\*with reinvestments

Source: Hungarian National Bank

### EXPECTED IMPACTS FOLLOWING EU ENTRY

The European Union has agreed that Hungary may maintain legal restrictions regarding the purchase of agricultural land by foreign citizens (and domestic and foreign legal entities) for seven years starting from the accession date, May 1, 2004. The Hungarian government has imposed restrictions on the employment

of citizens of those EU countries, which placed similar restrictions to the free movement of Hungarian labor. This, however, is rather an administrative burden than a real deterrent.

As a result of EU accession the Hungarian VAT, customs administration and statistical reporting system has changed to comply with EU norms. Direct tax incentives (e.g. investment tax holidays) have been abolished and, in return, corporate income tax was reduced from 18% to 16% in 2004 and is forecast to be cut further to 12% by 2006.

Stricter health and food safety regulations are expected to affect the agricultural industry and place an additional burden on small retailers. As a result, the retail sector is expected to see further consolidation.

### PROPERTY / REAL ESTATE REGULATIONS

In general, foreign retailers and consumer products companies wishing to acquire real estate in Hungary have very little to contend with in terms of legal restrictions.

The largest barriers to foreign ownership are in the agricultural sector, where productive agricultural land may not be purchased by foreign companies or individuals. Other real estate titles may be acquired by foreign investors, however, certain local conditions or restrictions must be met. Stamp duty is payable on the purchase of property.

Restrictions exist on the level of private and/or foreign ownership permitted with certain state-owned and former state-owned companies. The decision to invest in such a

concern can be impeded by such restrictions, which are laid down in the Privatization Law. Nevertheless, these limitations are expected to be reduced over the next few years.

## OTHER REGULATIONS

### Competition Law

Hungarian antitrust and other competition regulations are in compliance with the relevant EU directives. This includes adopting the various exemptions available under EC law directly into Hungarian law.

### Opening Hours

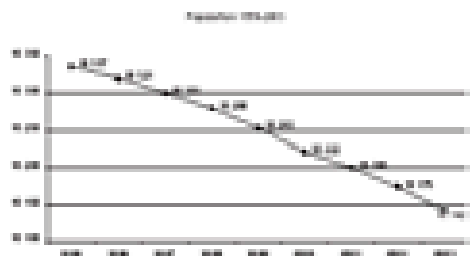
Retailers are free to decide their own opening hours every day of the year without limitation. However, restrictions specified in the Hungarian Labor Code make it difficult to require employees to work on public holidays. As a result, non-family run outlets tend to be closed on such days. In retail, evening and Sunday opening is increasingly common (especially in new malls, shopping centers and convenience stores). Tesco has become the first hypermarket operator to have twenty-four hour opening at all of its outlets.

## DEMOGRAPHICS AND CONSUMER BEHAVIOR

### POPULATION

#### Population evolution

The total population of Hungary and its trend is as follows:



Source: Central Statistical Office of Hungary

Although life expectancy continues to increase, the number of deaths still exceeds the number births due to low birth rates and an average family size of 2.57. The effect of this is an ageing population profile.

#### Population by age group

Age band (%)	1990	2002	2003
0-19 years	27.9	23.2	22.3
20-39 years	28.2	28.5	29.0
40-59 years	25.0	27.9	27.7
Over 60 years	18.9	20.4	20.8

Source: Central Statistical Office of Hungary

#### Urbanization of the population

As a consequence of its past as the twin capital of a large and diverse empire, a large portion of Hungary's population is concentrated in Budapest (1,708,000). Although the population of Budapest is gradually decreasing, there is a parallel increase in the population of the surrounding small towns and villages in the conurbation. None of Hungary's other major cities: Debrecen, Miskolc, Pécs, Szeged and Győr, has a population greater than 250,000.

Population: Urban vs. Rural (1990 vs. 2001)

(%)	1990	2001
Urban	65.9	64.5
Rural	34.1	35.5

The increase in the rural population is largely a consequence of lower urban birth rates and greater mobility as former city dwellers commute to work in the major conurbations.

### INCOME / BUYING POWER

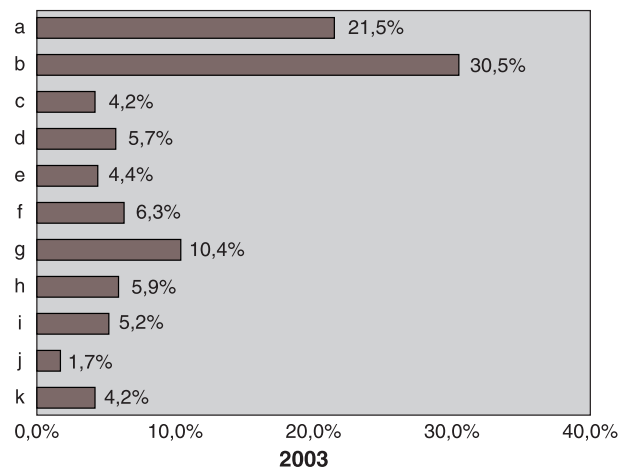
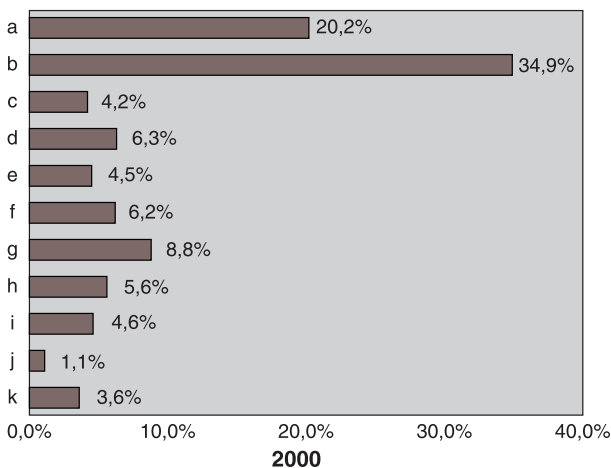
Wage rates in the economy as a whole are low by EU standards, averaging under HUF142,927 (EUR638) per month in 2003. The statutory minimum wage is HUF53,000 (EUR209) per month. However, 2003 represented the third consecutive year of real wage growth, driven primarily by the public sector.

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These figures hide substantial differentials: highly trained professionals in multi-national companies can expect something approaching international level salaries, while unskilled workers in economically depressed areas may receive little more than the minimum wage.

## CONSUMER BEHAVIOR

### Average household spending patterns



HUNGARIAN CENTRAL STATISTICAL OFFICE - KOZPONTI STATISZTIKAI HIVATAL

- a) housing, water, electricity and other fuels
- b) food and non-alcoholic beverages
- c) alcoholic beverages, tobacco and narcotics
- d) clothing and footwear
- e) furnishing, household equipment

- f) health
- g) transport
- h) communication
- i) recreation and culture
- j) education
- k) other

The chart above illustrates the trend from 2000 through to 2003. There have been marked shifts in consumer spending even in this relatively short period of time, thereby illustrating the dynamic nature of the retail and consumer environment. In particular the following trends can be seen:

- A decline (from 34.9% to 30.5%) in the proportion spent on food and non-alcoholic beverages. This hides a real increase in such spending and a considerable shift in expenditure patterns to new and more exotic foodstuffs and year round availability of formerly seasonal goods. It is expected that this trend will continue as there has been price deflation of local and regional foodstuffs driven by two factors:
  - i) A fall in agricultural produce prices due to domestic oversupply and a lack of export support;
  - ii) The buying power of the major retail groups who have been negotiating price reductions for volume orders of staple foodstuffs. This resulted in significant price deflation between 2000-2003 compared to the general inflation rate.
- An increase in spending on transport (from 8.8% to 10.4%), largely the result of increased expenditure on motor vehicles. Vehicle ownership is relatively high for the CEE region but relatively low by Western European standards.

- A small decline in relative spending on fuel and power, largely caused by government efforts to restrict price increases in domestic energy prices. This trend is likely to reverse as a result of liberalization of the energy market and EC membership.

### **Brand / Price sensitivity**

Despite its development, the Hungarian market is still extremely price sensitive, with other customer satisfaction measures assuming less importance. All

retailers can give anecdotal and empirical evidence of the price sensitivity of the Hungarian consumer.

Consumer brand awareness (loyalty) falls behind the average level for western countries and is even lower than the average for the CEE region due to heavy price sensitivity. The market share of retailers' own brands has significantly increased to reach 15% in 2003 thanks to extensive promotional efforts and favorable pricing. This represents an increase of 25% in relation to 2002. While Tesco is the market leader in the sale of own label products, the discount chains also offer a wide variety.

## RETAIL & CONSUMER SECTOR PERFORMANCE

### MAJOR CONSUMER GOODS PLAYERS

#### *Top 10 consumer goods companies*

Ranking	Company name	Core activity	2002 Net sales (EUR million)	2003 Net sales (EUR million)	2002-2003 Growth (%)
1	BAT Magyarország	Tobacco	512	569	11.1
2	Philip Morris Magyarország	Tobacco	373	391	4.8
3	Unilever Magyarország	Household, food and cleaning products	345	306	-11.3
4	Bábolna	Poultry and other meat products	278	287	3.2
5	Nestlé Hungária	Food, dairy	222	232	4.5
6	Henkel Magyarország Kft	Cleaning products	207	224	8.2
7	Fotex Rt	Foto-optic, furniture, misc.	235	210	-10.6
8	Procter & Gamble	Household and cleaning products	218	200	-8.3
9	Pick Rt	Salami and meat products	276	194	-29.7
10	Imperial Tobacco Hungary / Reemtsma	Tobacco	182	193	6.0

Source: Figyelő Top 200 Companies, Hungary

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Virtually all of Hungary's major consumer products companies are part of International Groups. The main exceptions to this are:

- Pick - Szeged-based salami and meat products manufacturer. Probably Hungary's best-known international brand, Pick exports around 50% of its sales, mainly to Western Europe. Pick is controlled by Arago, a group of local financial investors. The year on year decline in sales is due to divestment of a non-core business.
- Bábolna - Vertically integrated meat products company is still in the state sector and was intended to be privatized in late 2003 without success. Past privatization efforts have been undermined by poor

returns in the poultry meat sector and difficulties dealing with employment and social issues.

- Fotex is listed on the Budapest Stock Exchange and operates under such brands as Domus (furniture), Keravill (home electronics), Fotex (photography), Fotex Records (entertainment) and Ajka Kristály (glassware).
- Among the top ten, there are three tobacco companies. Due to the shrinking tobacco market and the potential synergies offered by EU accession, ITG / Reemtsma and Philip Morris decided to cease production activities in Hungary and have started to reorganize their activities on a regional level.

## Consumer electronics

### Top 10 consumer electronics producers

Ranking	Company name	2002 Net sales (EUR million)	2003 Net sales (EUR million)	2002-2003 Growth (%)
1.	Nokia Komárom	1,643	2,234	36.0
2.	Philips Magyarország*	1,829	2,054	12.3
3.	GE Hungary *	1,230	1,543	25.4
4.	Samsung Electronics Magyar	600	565	-5.8
5.	Electrolux Lehel	428	486	13.6
6.	Sony Hungária	308	360	16.9
7.	Siemens Nemzeti Vállalatcsoport	315	296	-6
8.	Sanyo Hungary	184	281	52.7
9.	Videoton Holding	279	235	-15.8
10.	LG Electronics Magyar Kft	145	167	15.2

\* also includes non consumer electronics

Source: Figyelő Top 200 Companies, Hungary

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The electronics sector accounted for 36% of Hungary's exports in 2003, employing over 70,000 people. This sector is mainly driven by demand for consumer electronics products. Hungary has a number of sizeable electronics companies, in particular Tungsram and Lehel, which were taken over by GE and Electrolux respectively following their privatization. At the same time, the country has attracted significant additional investments in greenfield sites due to:

- Skilled labor at a reasonable cost,
- The receptive attitudes of national and local government,
- A good communications network, particularly with western Europe,
- Low corporate tax, at 18%,
- The availability of tax and investment incentives.

Whilst EC membership will restrict the ability to offer the previous tax advantages and investment incentives and the strong forint has increased relative labor costs, this sector is expected to continue to grow. However, the trend is likely to lead to the production of higher value added products that require more sophisticated skills (high end phones, combined DVD televisions and large format televisions) whilst production of simpler products

## Major retailers

Ranking	Parent company	Outlets	Format	Number of stores	2002 Gross sales (EUR million)	2003 Gross sales (EUR million)
1.	CBAKereskedelmi	CBA	Foods stores Buying group	2,895	1,440	1,598
2.	Tesco	Tesco	Hypermarket Other	33 27	1,151	1,398
3.	Co-op Hungary	Coop Mini & Maxi Adu	Supermarket Food stores Cash & Carry	45 3,457 73	1,234	1,321
4.	Metro	Metro	Cash & Carry	12	1,123	1,037
5.	Louis Delhaize (Provera)	Cora Match / Smatch Profi Alpha	Hypermarket Supermarket Soft discount Cash & Carry	6 133 68 7	885	844
6.	Real Hungaria	Real Elelmiszer	Cash & Carry Food stores	46 1,998	609	754

is likely to migrate eastwards (e.g. low-end consumer electronics and monitors).

## MAJOR RETAIL PLAYERS

### Retail sales

Retail sales growth 1999 - 2003

	1999	2000	2001	2002	2003
Total turnover (HUF billion)	1,290	1,450	1,650	1,900	2,095
Change year on year %		12.4	13.8	15.5	10.3

Source: GfK Market Research Institute

The significant increase of retail turnover is the direct result of the increase in wages and purchasing power.

As can be seen from the table below, the trend towards shopping in larger outlets continued in 2003. This reflects the growth and importance of the major retail players.

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Ranking	Parent company	Outlets	Format	Number of stores	2002 Gross sales (EUR million)	2003 Gross sales (EUR million)
7.	Tengelmann	Plus Interfruct	Soft discount Cash & Carry	129 20	716	688
8.	Auchan Group	Auchan	Hypermarket	8	462	612
9	SPAR	Spar / Interspar Kaisers	Supermarket Hypermarket Supermarket	120 16 22	474	576
10.	Rewe	Penny Market	Soft discount	132	593	532

Source: *Mai Piac* May 2004

Most of Hungary's major retail players are now foreign owned. However, there are still a number of large domestic businesses, including:

- CBA - This is a buying group that acts mainly for independently owned outlets and at least one of the major oil retailers, for significant levels of non fuel purchases.
- COOP - This is the umbrella purchasing organization for a network of regional coop stores. Whilst the movement has declined in importance in Hungary's urban centers, it continues to represent the only significant retail outlet in many rural communities.

Among the international players, Tesco is the largest with Metro cash and carry, Praktiker (DIY) and Media Markt (consumer electronics and entertainment) banners.

In terms of hypermarkets chains, Tesco is again the leader with 33 stores opened by the end of 2003. The runners up are Auchan, Cora and Interspar. Tesco has continued to invest in Hungary and has also started to operate fuel stations in 2004.

The Louis Delhaize group also has significant retail presence but has set about reducing the number of formats from four to two (the "Profi" and "Smatch" supermarkets are being merged into "Match" and the group also operates Cora hypermarkets) Similarly, Spar

has two formats and is growing by acquisition, having purchased Billa in 2002 and Kaisers in 2003.

Although the competition in the retail market has further increased, Lidl opened its first hard discount store in the second half of 2004.

In 2003 the number of stores closed exceed the number opened. This reflects a continued concentration of retail spending. The share of hypermarkets in the retail market can be said to be increasing primarily at the cost of small corner shops.

### Food retail channels

Rising affluence has also affected how people purchase goods and the channels they use to make their purchases. As little as eight years ago, retailing in Hungary followed opening hours closer to the German and Austrian model and few outlets would be open on Sundays or in the evenings. In all major conurbations late night shopping is now the norm with shopping centers, malls and hypermarkets open seven days a week. There has also been a significant increase in the number of convenience stores operating extended opening hours. The major petroleum retailers, led by MOL, Shell and Austria's OMV, have put a lot of focus on this sector.

This change in availability is illustrated by consumer preferences in terms of retail channels.

Share of store types in FMCG spending of households in December each year (%)

Type of store	1997	1998	1999	2000	2001	2002	2003
Hypermarket	3	8	12	14	17	19	21
Supermarket	20	16	16	15	15	14	14
Discount store	20	20	20	16	15	15	15
Cash and Carry	5	6	8	6	5	4	4
Small stores (less than 100 <sup>sqm</sup> )	41	39	34	34	35	35	35
Others (convenience stores, bakeries and others)	11	11	10	15	13	13	11

Source: ConsumerScan by GfK Market Research (May 2004)

In Hungary, hypermarkets account for 21% of all FMCG spending, largely at the expense of supermarkets, discount stores and small stores. The number of hypermarkets will continue to increase – a further 20 are to be opened in the near future. 21 out of the 63 hypermarkets are in Budapest or its direct vicinity.

### Major non-food retail players

The main local player is a diversified group listed on the Budapest Stock Exchange as Fotex. The group operates brands such as Domus (furniture), Keravill (home electronics), Fotex (photography) and Fotex Records (entertainment). Total turnover for 2003 was EUR210 million.

The increase in spending on household equipment has engendered significant expansion in retail outlets devoted to home and garden and appliance sales, in particular Praktiker, OBI (Tengelmann) and BRICO, together with KIKA and IKEA for furniture. This positive trend is expected to continue as spending on housing is

a priority among the more affluent Hungarians. However, the home appliance and consumer electronics market saw price deflation in 2003 since Electroland (ultimately owned by Dixons Group of the UK) opened two outlets in Budapest. Competing against Metro Group, Media Markt, the hypermarkets and the smaller domestic high street retailers, the arrival of Electroland could have triggered the demise of a number of smaller independent retailers.

### E-commerce

In Hungary, electronic commerce is in its infancy, as far as both B2B and B2C are concerned. Access to the Internet is still relatively low: approximately only 25% percent of households are online, and of that number only 6% made Internet purchases in 2002.

Internet access has increased by 20%, but penetration is rather low in the CEE region. Although access is at 25%, only 18% uses the internet on a regular basis.

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## RETAIL & CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

### CHALLENGES

#### *Continued concentration*

The five largest food retailers controlled 48% of the market in 2001 and 51% in 2002. This figure is expected to grow as they continue to pad out their respective networks. The market seems to have stabilized to the extent that some of the largest multinational players, like French hypermarket chain Carrefour, appear to have cancelled or at least postponed their entry to the Hungarian market. There are also signs that sector market consolidation could be on the way. The disposal of Kaisers by Tengelmann and the entry of Lidl reveal how the market continues to evolve at the expense of small, unorganized retail outlets. Furthermore, Hungary's EU accession opened doors for retailers who supply goods derived primarily from EU imports and who had previously been hampered by customs administration and other burdens, which are now lifted.

#### *Prospects for smaller players in the food industry*

Hungary continues to have in excess of 8,000 businesses active in the food industry. Many of them are small, lacking adequate capital and do not meet EC regulations, particularly in the meat, poultry, dairy, milling, fruit processing and wine industries. There are approximately 25,000 companies in this sector in the EU. Since Hungary alone can account for one third of that number, it seems obvious that many are destined to fold. The Ministry of Agriculture has estimated that HUF120 to 140 billion will be required to render these businesses competitive. Whilst SAPARD funds will become available on accession, they are unlikely to cover the whole bill.

### OPPORTUNITIES

#### *Development of purchasing power*

In 1998, per capita purchasing power in Hungary stood at half of the average for the existing 15 EU member states. In 2002 it reached 54%, and by 2005 it is expected to surpass 60%. Increasing purchasing power is a direct result of increasing nominal wages. Countries that continue to offer cheap labor may become more attractive, at least as far as some industries are concerned.

#### *Changes in the supplier-retailer relationship*

The Hungarian CPG environment is characterized by direct sales to major key accounts (major retailers) and by indirect distribution through wholesalers to the remaining customer base. Whilst wholesale margins are low, this form of distribution can obscure the channel for market and customer data from the retail outlets. There has been a trend towards direct distribution led by the soft drinks and tobacco sectors and we believe that this will continue.

#### *Centralized warehousing and logistics*

Until recently, even the major players have relied upon their suppliers to deliver direct to stores. However, opportunities exist to centralize distribution into dedicated hubs in order to reduce aggregate stock cover, reduce working capital, simplify supply chain management and avoid stock-outs.

The development towards centralization of distribution is likely to be further encouraged by a desire to avoid increased transport costs emanating from compliance with EC rules on driver safety and hours. EC membership may also facilitate cross border distribution as customs and other controls are removed. At the same time, other barriers such as national language and packaging requirements will remain.

The accession of the ten new countries into the EU increased the possibility of efficiently reaching more customers on a wider European market. We cannot overestimate the effects of this enlargement on the Pan-European sourcing and distribution networks. Both logistics service providers (LSCs) and manufacturers – the two most important participators of supply route configurations – are more and more encouraged now to establish business growth in Central and Eastern European (CEE) countries.

Although the establishment of European Distribution Centers (EDCs) is not yet present either in the region or in Hungary, many of the manufacturers (i.e. GE, Sony, IBM, Audi, etc.) and some of the LSCs (i.e. Rynart) have already recognized the opportunities, and made investments in Hungary.

## EMERGING TRENDS

### *New retailing formats*

Food retailing is already seeing the emergence of the discounters with Lidl announcing ambitious plans for a nationwide network. However other new formats are also starting to emerge such as “factory outlet stores “ for branded products. Historically Hungarians have not had such outlets and have had to journey to Austria to enjoy this type of retail experience (and suffer from the restricted weekend opening hours in that country). However, it is clear that many of them have made this journey and there are now plans for at least two such malls in the vicinity of Budapest and there are outline financing proposals for others. We would expect that this could restrict the current flow of business to Austria and could even reverse it altogether as more Austrians take advantage of Sunday opening hours in Hungary to take a weekend shopping break.

In the recent years a number of shopping malls were built especially in Budapest and in the larger country towns including some of the largest in the region. These shopping complexes give space to a large variety of retail and entertainment outlets (including fashion, consumer electronics, jewelry, glassware and also food) and attract a large number of customers at the expense of traditional high street shopping. We expect that this trend will continue as shopping malls are still being built in the country which - with the exception of tourist centres - will result in pressure on high street rental fees.

### *Cost control*

Cost control has always been a top item on the board agenda at any retail and consumer companies in

Hungary. With the increase of competition in many industries and especially in retailing, cost effectiveness has gained even more importance and attention. In the recent years, the development of information technology has contributed significantly to cost control. However there are still new opportunities, which are not fully exploited in the sector. These include teleworking, using new technology solutions to improve operational effectiveness and cost control by applying new work flow management methods. We believe that teleworking will be given more attention in the near future by the management of many retail and consumer companies, as Hungary is significantly behind Western Europe in the application of technology solutions supporting teleworking.

### *EU compliance*

Since 1 May 2004, Hungary’s EU accession, retail companies are required to meet new reporting obligations mainly for VAT and statistical purposes. However, the ERP systems of many companies are not upgraded and are unable to generate correct VAT returns, EC Sales and Purchase Lists and Intrastat reports. This may result in high penalties, when authorities discover the mistakes during a later tax inspection.

On the other hand, the abolishment of import VAT, the introduction of the “VAT warehouse” (where it is possible to sell goods without having to charge VAT) significantly eased the burden of many companies having exports and imports to and from other EU countries. Hungarian retail companies will also have to pay attention to the decisions of the European Court of Justice, including decisions on business promotions, free gifts, discounts, reward goods, buy-now-pay-later and voucher schemes.