FROM BEIJING TO BUDAPEST

Winning Brands, Winning Formats*

2005/2006
4th Edition

*connectedthinking

PRICEWATERHOUSECOOPERS

Hungary

Hungary

ECONOMIC OVERVIEW

Hungary has a population of 10.1 million and a landmass of 93,000sq km. It gained entry to the European Union on 1 May 2004.

GDP and CPI

Hungary has completed its transition to a market economy and is one of the most successful economies in Central Europe, exhibiting high real growth and declining inflation.

GDP and CPI

	2001	2002	2003	2004
GDP growth (%)	3.8	3.5	2.9	4.2
CPI (%)	9.2	5.3	4.7	6.8

Source: EIU, August 2005

Unemployment

The average unemployment figures are below those of most mature Western and Central European market economies. However, there are quite marked regional differences within Hungary, 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. Accession to the European Union (EU) on 1 May 2004 has not brought significant and rapid changes in the unemployment rates, primarily because of the immobility of the Hungarian workforce. Certain industries, such as healthcare and construction, suffer from a lack of available workforce.

Unemployment

	2001	2002	2003	2004
Unemployment rate (%)	5.7	5.8	5.9	6.1

Source: EIU, August 2005

Area (‘000 sq km)[1]: 93
(US 9,600 – EU25 3,981 – World 133,700)

Capital[2]: Budapest
(Number of inhabitants: 1.89 million)

Population (million)[3]: 10
(US 293 – EU25 456 – World 6,376)

GDP (USD billion)[3]: 99.7
(US 11,735 – EU25 12,723 – World 39,503.5)

GNI per capita (USD)[1]: 6,350
(US 37,870 – EU25 22,810 – World 5,110)

Currency: Forint (HUF)

Languages: Hungarian

Main religions: Roman Catholic, Calvinist, Lutheran

Government type: Parliamentary democracy

Sources: CIA Factbook; (1) World Bank 2005; (2) City Population;
(3) Economist Intelligence Unit 2004 data

Economic forecasts

While macroeconomic indicators are improving slower in Hungary than in neighbouring countries joining the EU, performances remain good compared to current EU trends. The GDP growth rate has returned to an upward movement. While interest rates are declining, they are still some of the highest in the region. This is primarily due to threats against the Hungarian forint, which forces the National Bank of Hungary to keep interest rates at higher levels. Of further threat to the Hungarian economy are the balance of payments deficit and the record high budget deficit, which the government is struggling to overcome prior to the parliamentary elections due in spring 2006.

Key economic forecasts

	2005	2006	2007
GDP growth (%)	3.6	3.9	4.0
CPI (% annual change)	3.8	2.7	2.5
Unemployment rate (%)	7.1	7.0	6.8

Source: EIU, August 2005

REGULATORY ENVIRONMENT

Foreign direct investment

Since the abolition of the exchange control regime in 2001, capital and earnings can be freely repatriated from Hungary without any administrative approval or permit. Large movements of capital, however, must be reported to the National Bank of Hungary for statistical purposes. The Hungarian forint is freely convertible.

Non-Hungarian law may govern contracts involving a foreign party or other foreign aspect. It is also possible in contracts with a Hungarian party to specify compulsory arbitration in a foreign jurisdiction, the rulings of which, with certain exceptions, are enforceable under Hungarian law.

FDI

	2001	2002	2003	2004
FDI (HUF bn)	703.71	541.32	396.96	757.84
FDI (USD bn)	3.9	3.0	2.2	4.2

Source: EIU, August 2005 (Exchange rate: December 31, 2004)

Impact following EU entry

The EU 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 1 May 2004. The Hungarian Government has imposed restrictions on the employment of citizens of those EU countries that placed similar restrictions on the free movement of Hungarian labour. This, however, is an administrative burden rather 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 corporate income tax was reduced from 18% to 16% in 2004.

The stricter EU health and food safety regulations 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 foreign companies or individuals may not purchase productive agricultural land. Foreign investors may acquire other real estate titles. 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 legislation of the EC. Since Hungary is an EC member, various market practices, which affect trade between member states, may fall within the Commission's competence.

Opening hours

Retailers, within certain statutory limits, are free to decide their own opening hours every day of the year. Restrictions specified in the Hungarian Labor Code prohibit employers to require employees to work on public holidays. As a result, outlets are closed on such days. In the retail sector, evening and Sunday opening is increasingly common, especially in new malls, shopping centres and convenience stores. Tesco has become the first hypermarket operator to have all of its outlets operate 24-hours.

Corporate tax

The current corporate tax rate is 16% on taxable income, which is one of the lowest in the region.

VAT

The general VAT rate is 25%, one of the highest in the EU. Food is generally taxed at 15%. The government has recently announced the proposed reduction of the higher VAT rate to 20%, which is expected to result in a general price deflation, improvement of the competitiveness of Hungarian small- and medium-sized enterprises and a general increase in consumption. It is, however, uncertain at this stage to what extent such tax cuts are passed on to the final consumers, and hence the effects of the tax cut on the rate of inflation are unknown.

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

Population

Population evolution

Although life expectancy continues to increase, the number of deaths still exceeds the number of births due to low birth rates and an average family size of 2.6. The effect of this is an ageing population profile.

Population

	2001	2002	2003	2004
Population (m)	10.11	10.08	10.06	10.03

Source: EIU, August 2005

Population by age group

Age profile

% of total population	1998	2003	2004
0 – 14 years	17.4	16.1	14.8
15 – 64 years	68.2	69.0	69.5
Over 65 years	14.4	14.9	15.7

Source: EIU, June 2004

Urbanisation 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 Györ, has a population greater than 250,000.

Urban/Rural split

% of total population	1998	2003	2008 (f)
Urban	63.6	64.8	66.1
Rural	36.4	35.2	33.9

Source: EIU, June 2004

Income/Buying power

Wage rates in the economy as a whole are still low by EU standards, averaging HUF143,500 (EUR543) per month in 2004 – the fifth lowest in EU. The statutory minimum wage is HUF57,000 (EUR215.6) per month. The growth rate of real wages slowed in 2004-05 due to restrictions on expenditures in the public sector.

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

Consumer behaviour

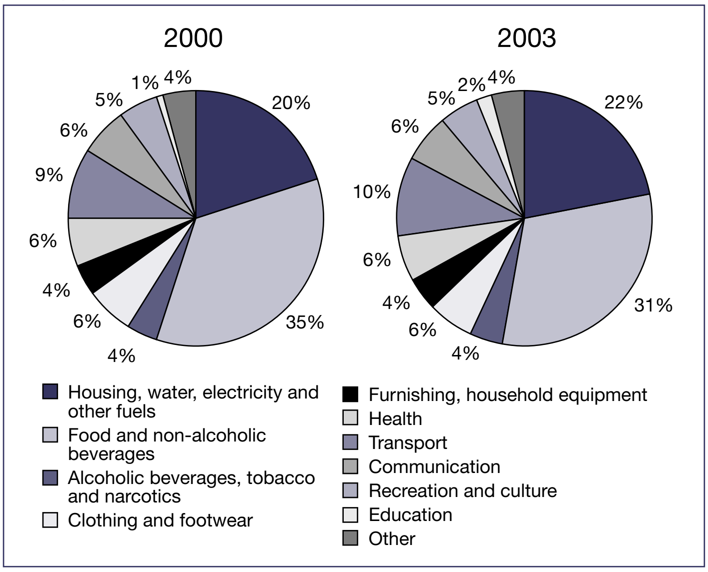
Average household spending patterns

There have been marked shifts in consumer spending in the relatively short period from 2000-03, illustrating the dynamic nature of Hungary's retail and consumer environment. In particular, there was 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 a price deflation of local and regional foodstuffs driven by two factors: a fall in agricultural produce prices due to domestic oversupply and a lack of export support; and the buying power of the major retail groups that have been negotiating price reductions for volume orders of staple foodstuffs, resulting in significant price deflation between 2000-03 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, also occurred during this period. Vehicle ownership is relatively high for the CEE region, but relatively low by Western European standards.

There was a small decline in relative spending on fuel and power, largely due to the government's efforts to restrict increases in domestic energy prices. This trend is likely to reverse as a result of liberalisation of the energy market and EC membership.

Composition of household expenditure, 2000 vs. 2003



Source: Hungarian Central Statistical Office – Központi Statisztikai Hivatal

Brand/Price sensitivity

Despite its development, the Hungarian market is still extremely price sensitive, with other customer satisfaction measures assuming less importance, creating opportunities for hard discounters in particular.

Consumer brand awareness (loyalty) still falls behind the average level for Western countries and is even lower than the average for the Central and Eastern European region due to heavy price sensitivity. The market share of retailers' own brands significantly increased to 15% in 2004 thanks to extensive promotional efforts and favourable pricing. Retailers own brands are recognised by consumers. especially in dairy, household paper-made products and pet food. While Tesco is still the market leader in the sale of own-label products, more and more chains offer a wide variety. The share of private label products from total household consumption is expected to further increase in the coming years.

One of the more increasingly widespread means to improve brand loyalty is the introduction of loyalty cards offering a wide range of discounts to their holders. A greater number of retailers are issuing loyalty cards at a wider variety of retail outlets (e.g., cinemas, bookstores, hypermarkets). In the process of making purchase decisions, price is still the most important factor, and this is only gradually giving place to other variables.

RETAIL & CONSUMER SECTOR PERFORMANCE

Major consumer goods players

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

- Pick, a 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 another local meat producer company, a private business, which acquired Pick in 2005.
- Bábolna, a vertically integrated meat products company still in the state sector that was intended to be privatised in late 2003 without success. Past privatisation efforts have been undermined by poor returns in the poultry meat sector and difficulties dealing with employment and social issues. The partial privatisation of the company took place in 2004, when some of its profitable businesses were carved out and are in the process of being sold.
- Fotex, a Budapest Stock Exchange listed company operating under such brands as Domus (furniture), Fotex (photography), Fotex Records (entertainment) and Ajka Kristály (glassware). In addition, Fotex operated the Keravill chain (consumer electronics), which closed in December 2004. Keravill became one of the victims of the ambitious multinational players in the consumer electronics sector. The group's strategy is to gradually move away from retailing towards services and property utilisation.

Key consumer goods companies

Ranking	Company	Core activity	2003 net sales (EUR m)	2004 net sales (EUR m)	2003-04 growth (%)
1	BAT Magyarország	Tobacco	569	551	-3.2
2	Philip Morris Magyarország	Tobacco	391	421	7.7
3	Unilever Magyarország	Household, food and cleaning products	306	309	1
4	Bábolna	Poultry and other meat products	287	N/A	N/A
5	Nestlé Hungária	Food, Dairy	232	N/A	N/A
6	Henkel Magyarország Kft	Cleaning products	224	248	10.7
8	Procter & Gamble	Household and cleaning products	200	N/A	N/A
9	Pick Rt	Salami and meat products	194	167	-13.9
9	Imperial Tobacco Hungary/Reemtsma	Tobacco	193	181	-6.2
10	Fotex Rt	Foto–optic, furniture, miscellaneous	210	153	-27.1

Source: Figyelö Top 200 Companies, Hungary

Electronics

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 privatisation. At the same time, the country has attracted significant additional investments in greenfield sites due to:

- Skilled labour at a reasonable cost
- The receptive attitudes of both the national and local governments
- A good communications network, particularly with Western Europe
- Low corporate tax at 16%.

Although EC membership restricts the ability to offer the previous tax advantages and investment incentives, and the strong forint has increased relative labour costs, this sector is expected to continue to grow. The trend, however, 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), while production of simpler products (e.g., low-end consumer electronics and monitors) is likely to migrate eastwards.

Key consumer electronics producers

Ranking	Company	2003 net sales (EUR m)	2004 net sales (EUR m)	2003-04 growth (%)
1	Nokia Komárom	2,234	2,988	33.8
2	Philips Magyarország*	2,054	N/A	N/A
3	GE Hungary *	1,543	N/A	N/A
4	Samsung Electronics Magyar	565	580	2.7
5	Electrolux Lehel	486	437	-10
6	Sony Hungária	360	302	-16
7	Siemens Nemzeti Vállalatcsoport	296	214	-27.8
8	Sanyo Hungary	281	288	2.5
9	Videoton Holding	235	217	-7.7
10	LG Electronics Magyar Kft	167	166	-0.6

Source: Figyelö Top 200 Companies, Hungary
* also includes non-consumer electronics

Major retail players

Retail sales

A significant increase in retail turnover was seen in 2004 as the direct result of an increase in wages and purchasing power, despite the slowing growth rate of total retail sales that same year.

Total retail sales growth

	2000	2001	2002	2003	2004
Total turnover (HUF bn)	1,450	1,650	1,900	2,095	2,200
Growth rate (%)	12.4	13.8	15.5	10.3	5.0

Source: GfK Market Research Institute

The trend towards shopping in larger outlets continued in 2004, reflecting the growth and importance of the major retail players and the concentration in this sector.

Key retail stores

Ranking	Group name	Store brands	Retail formats	Number of stores	2003 gross sales (EUR m)	2004 gross sales (EUR m)
1	CBA Kereskedelmi	CBA	Foods stores Buying group	2,836	1,598	1,967
2	Tesco	Tesco	Hypermarket Other	42 27	1,398	1,648
3	Co-op Hungary	Coop Mini & Maxi Adu	Supermarket Food stores Cash and carry	253 4,168 66	1,321	1,422
4	Metro	Metro	Cash and carry	13	1,037	1,049
5	Reál Hungária	Reál Élelmiszer	Cash and carry Foodstores	410 1,430	754	954
6	Louis Delhaize (Provera)	Cora Match / Smatch Profi Alpha	Hypermarket Supermarket Soft discount Cash and carry	7 132 67 5	844	866
7	SPAR	Spar / Interspar Kaisers	Supermarket Hypermarket Supermarket	113 18 22	576	732
8	Auchan Group	Auchan	Hypermarket	9	612	722
9	Tengelmann	Plus Interfruct	Soft discount Cash and carry	157 22	688	606
10	Rewe	Penny Market	Soft discount	142	532	515

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, 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; and Coop, the umbrella purchasing organisation for a network of regional Coop stores. While the movement has declined in importance in Hungary's urban centres, 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), Media Market and Saturn (consumer electronics and entertainment) banners.

In terms of hypermarket chains, Tesco is again the leader with 42 stores total (nine opened in 2004), followed by Auchan, Cora and Interspar. Tesco in continuing to invest in Hungary, commencing the operation of fuel stations in 2004.

The Louis Delhaize group also has significant retail presence and operates the Csemege and Match supermarkets, and the Cora hypermarket chain. Similarly, Spar has two formats and is growing through acquisitions, having purchased Billa in 2002 and Kaisers in 2003.

Although competition in the retail market has increased, Lidl started its operation in 2004 and has more than 18 stores. The market also expects to see the appearance of Aldi in the near future – a sign of the success of hard discounters in Hungary's very price-sensitive retail environment.

The share of hypermarkets in the retail market is increasing primarily at the cost of small corner shops.

Food retail channels

Rising affluence has affected how people purchase goods and the channels they use to make their purchases. As recent as eight years ago, retailing in Hungary followed opening hours closer to the German and Austrian model, and few outlets opened on Sundays or in the evenings. In all major conurbations, late night shopping is now the norm with shopping centres, 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, the Hungarian national oil company, Shell and Austria's oil company OMV have put a lot of focus on this sector.

This change in availability is illustrated in fast moving consumer goods (FMCG) spending of households in terms of retail channels.

Share of store types in FMCG spending of households (%)

Type of store	1997	1998	1999	2000	2001	2002	2003	2004
Hypermarket	3	8	12	14	17	19	21	22
Supermarket	20	16	16	15	15	14	14	15
Discount store	20	20	20	16	15	15	15	15
Cash and carry	5	6	8	6	5	4	4	4
Small stores (less than 100sq m)	41	39	34	34	35	35	35	32
Others (convenience stores, bakeries)	11	11	10	15	13	13	11	12

Source: ConsumerScan by GfK Market Research, May 2005

In Hungary, hypermarkets account for 22% of all FMCG spending, largely at the expense of supermarkets, discount stores and small stores. In food retailing, the share of hypermarkets is even higher at 26% of all food expenditure compared to 24% in 2003. This is primarily the result of the spread of hypermarkets in smaller country towns.

It is anticipated the share of hypermarkets and supermarkets of all retail outlets will exceed 40% by 2006. The concentration of retailing will adversely affect small convenience stores, the market share of which will drop by 5% and their number by 2-3% by 2006.

Non-food retail channels

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 (Tengelman) and BRICO store, 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 has seen price deflation in 2003 since Electroworld (ultimately owned by Dixons Group of the UK) opened two outlets in Budapest. In 2004, another Metro company, Saturn opened its doors in the Hungarian consumer electronics market, further strengthening competition. In competition against Metro Group, hypermarket Media Market and Saturn, and the smaller domestic high-street retailers, the arrival of Electroworld could have triggered the demise of a number of smaller independent retailers.

The main local player is a diversified group listed on the Budapest Stock Exchange, Fotex, with 2004 total turnover of EUR153 million. Fotex made a substantial loss in 2004 and was forced by competition to close its consumer electronics retail chain Keravill.

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 with approximately 25% of households online, and of that number only 6% made internet purchases in 2002.

Internet access has increased by 20%, but penetration is lower than in the Central and Eastern European region. Although access is at 25%, only 18% use the internet on a regular basis.

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. There are also signs that sector 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, unorganised retail outlets. Furthermore, Hungary's EU accession opened doors for retailers that supply goods derived primarily from EU imports and had previously been hampered by customs administration and other burdens, which have now been 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, lack 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 that many are destined to fold. The Ministry of Agriculture has estimated that HUF120-140 billion will be required to render these businesses competitive. While Special Accession Programme for Agriculture and Rural Development 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 end-2005 it is expected to surpass 60%. Increasing purchasing power is a direct result of increasing nominal wages. Countries that continue to offer cheap labour may become more attractive, at least as far as some industries are concerned.

Changes in the supplier-retailer relationship

The Hungarian CPG environment is characterised by direct sales to major key accounts (major retailers) and by indirect distribution through wholesalers to the remaining customer base. While 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.

Centralised warehousing and logistics

Until recently, even the major players have relied on their suppliers to deliver direct to stores. However, opportunities exist to centralise distribution through dedicated hubs to reduce aggregate stock cover, reduce working capital, simplify supply chain management and avoid stock shortages.

The development towards centralisation 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 10 new countries into the EU increases 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 increasingly encouraged to establish business growth in Central and Eastern European countries.

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

Emerging trends

New retailing formats

Food retailing is already seeing the emergence of discount stores, 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 travel to Austria to enjoy this type of retail experience (and suffer from the restricted weekend opening hours in that country). It is clear many Hungarians have made this journey and there are now plans for at least two such malls in the vicinity of Budapest, along with financing proposals for others. We would expect this to restrict the current flow of business to Austria and even reverse it altogether as more Austrians take advantage of Sunday opening hours in Hungary for a weekend shopping break.

In recent years, a number of shopping malls have been built in Hungary, especially in Budapest and 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, jewellery, glassware and food), and attract a large number of customers at the expense of traditional high street shopping. We expect 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 company in Hungary. With the increase of competition in many industries, and especially in retailing, cost effectiveness has gained even more importance and attention. In recent years, the development of information technology has contributed significantly to cost control. However, there are still new opportunities that have not been fully exploited in the sector, including teleworking (using new technology solutions to improve operational effectiveness and cost control by applying new work flow management methods). We believe 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 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 have not been 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 later tax inspections.

On the other hand, the abolishment of import VAT and the introduction of the VAT warehouse (where it is possible to sell goods without having to charge VAT) have 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.