

## MANAGING CHANGE IN AUTOMOTIVE INDUSTRY IN CENTRAL AND EASTERN EUROPE

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*This article critically analyzes the reasons for developing international business activities in CEE. Primarily a short overview of global strategy is presented. In order to succeed in today's global Marketplace, a company must be able to quickly identify and exploit the occurring opportunities. Then, focusing on CEE region, the key success factors in developing companies in this region are presented. The strategic options are either green field investments or acquisitions. In that case, global companies headed in Western Europe or USA can identify critical success factors for developing international business in CEE. These factors are critically assessed in order to develop a clear vision for going global strategy in the CEE context. Then, towards the end, the article shows the switches in Foreign Direct Investments in CEE focused on higher value-added activities in automotive industry in the region.*

*Key words: globalization, strategy, international business*

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### **1. Argument**

Globalization has been one of the most significant developments in international business during the last decades. More and more companies have become, and many more would like to become, global in their operations. Which are then some factors which have served to drive this growth and spread of globalization? Some of the more important factors include the following:

#### *(a) Deregulation of trade/Open markets/fall down of communist economies in CEE*

More and more markets have opened up to the aspiring global business. Even markets which have traditionally been very difficult to move into, such as China, are now open. Japan, at one time highly protected against foreign companies, has opened up in recent years.

#### *(b) Global competition*

Partly as a result of freer world trade, we have seen the growth of global competitors. Even companies that have traditionally been very insular in their outlook and approach to business and marketing have woken up to the recognition that increasingly their competitors operate in global markets. One approach to dealing with local competition is for companies to go global themselves.

#### *(c) Risk spreading*

Nowadays, more than ever, the global business environment is much more dynamic and complex. In particular, financial and other global trading systems mean that markets can change overnight. Global operations enable the business to spread the risks of sudden downturns and changes in economies and markets.

#### *(d) Economies of scale/Experience curve effects*

Usually, global business involves increases in the scale of operations of an organization. As such, it enables a company to achieve potentially large economies of scale and/or experience curve effects which would be restricted if only domestic markets or relatively few overseas markets were targeted.

#### *(e) Supply chain management*

A further impetus to developing global strategies by organizations has been the desire to manage the supply chain more effectively - so, for example, some companies have been prompted to go global in order to secure access to low-cost labor or raw material supplies. Sometimes companies are prompted to go global in order to gain access to skills which are simply not available in domestic markets, such as research and development, design, manufacturing skills.

(f) *Global enabling technologies and skills*

These perhaps facilitate the growth of global business and strategies rather than prompt it. Increasingly, global business strategies may be developed through access to new technologies and skills. So, for example, developments in information technology and databases facilitate the growth of global strategies and positions. These databases enable the construction of detailed customer profiles across the globe by cross-matching this intelligence to other databases, such as economic data, socio-economic groupings, geo-demographic data and so on.

## 2. Literature review

Global strategy was analyzed by different researchers, including **Porter (1979, 1986 and 1996)**. He was the one that described the forces governing competition in an industry, creating also the known Porter Model which includes the threat of new entrants, the bargaining power of customers, the threat of substitute products or services and the bargaining power of suppliers. He considers that the essence of strategy formulation is coping with competition – Porter (1979).

In co-operation with **Bartlett, Ghoshal** researched successful enterprises on international markets. They found three types of internationalization, differing in structural approach and strategic capabilities. The types were dubbed *Multinational*, *Global* and *International*. Due to the faster changing environment, they see a further need for adaptation with a drive toward a company that masters not one, but all three of the strategic capabilities. They named this ideal-type thus created the *transnational enterprise*. **Bartlett, Ghoshal (1995)** described also the main characteristics of the transnational organization: integrated network configuration of assets and activities, flexibility due to specialization and the facility of learning due to the multiple innovation process.

**Stremersch and Tellis (2004)** considered that in today's business environment there are significant advantages to be gained from the global scope, configuration and co-ordination of a firm's international activities. Expanding the company globally can lead to the increase of their profitability in ways not available to purely domestic (companies serving only their national market) companies.

The differences in economic development and the diversity of cultures conduct to local marketing strategies in CEE according to **Czinkota, Gaisbauer and Springer (1997)**. Some of the key factors tend to inhibit this growth are revealed. Cultural factors are limiting the growth of global business and particularly standardized global strategies are different, depending on the national culture. Cultural differences exist in different parts of the world with these differences often being substantial.

## 3. Going Global within the CEE Economic and Business Environment

In a global economy, companies market their products internationally and strive to optimize their global cost structures. They are searching for an optimal global sourcing and manufacturing footprint, to source materials and components competitively and locating production in countries where the biggest cost and quality advantages can be obtained. Sourcing and manufacturing in low-cost countries has become an imperative for competing successfully on a global scale.

In this context, Central & Eastern Europe has attracted large foreign investments since the early 1990s. From 1995-2002 Poland has attracted cumulative foreign direct investments of more than \$45 billion, the Czech Republic more than \$35 billion, which constituted 24% and 48% of their 2002 GDP. EU accession has again raised interest in this region. But there are now questions

about CEE's fundamental attractiveness and future competitiveness, in particular when compared with China. In this respect, there are many misperceptions about CEE which may hinder companies from optimal investment decisions to the detriment the companies themselves (Wadell, K, BCG Poland, 2005).

### ***Investing in the automotive industry in Central & Eastern Europe***

The automotive sector was one of the fastest growing sectors in the Central & Eastern Europe before 2009, primarily due to the significant amount of brown and green field investments either operative or currently being planned. It is expected that other automotive manufacturers will establish their operations in the region and thus will generate significant opportunities for supplying companies to serve the needs of Original Equipment Manufacturers (OEM's). It was forecasted that more than 3 million car units are to be produced annually in the CEE region by the year 2010.

Locating a value creation activity in the optimal location for that activity can have one or two effects: it can lower the costs of value creation and help the firm to achieve a low-cost position, thus sustaining a cost leadership strategy, and/or it can enable a firm to differentiate its product offering from that of competitors, thus sustaining a differentiation strategy

The differential in labor rates is large enough that the gap between them will remain substantial for the foreseeable future, even if there are double-digit differences in the rates at which they grow. In fact, without a major economic dislocation, the gap in real wages will actually increase in absolute value, at least for the next several years. In addition, the "hidden" costs of going global will shrink as companies scale up, ascend the learning curve, and stabilize their supply chains.

When developing and assessing strategic alternatives, it is important to remember that companies competing in international markets confront two opposing forces: reduction of costs and adaptation to local markets. In order to be competitive, firms must do what they can to lower costs per unit so that customers will not perceive their products or services as being too expensive. This often results in pressure for some of the company's facilities to be located in places where costs are low, as well as developing products that are highly standardized.

### ***Labour cost convergence will take at least several decades, keeping CEE labour costs attractive in the medium term***

The EU accession of CEE countries has raised the concern that existing wage differentials towards Western Europe will now quickly disappear, possibly rendering further investments unattractive. Today, the difference in the average hourly compensation of production workers between Germany and "New EU" countries can sometimes be as high as 90%. With forecasted growth rates of around 2% in Western European countries and 5% to 7% in "New EU" countries, labour cost convergence will take several decades because the differences in growth rates are quite small.

However, in addition to pressures to reduce costs, managers also must attempt to respond to local pressures to modify their products to meet the demands of the local markets in which they do business. This modification requires the company to differentiate its strategy and product offerings from country to country, reflecting differences in distribution channels, governmental regulations, cultural preferences, and similar factors. However, modifying products and services for the specific requirements of local markets can involve additional expenses.

### ***Improving Research and Development***

The much lower cost of engineers and skilled research staff in FMEs allows companies to dramatically increase the amount of R&D they do—often achieving three to five times as much

development for the same budgets. Another advantage of R&D centers in FMEs is that they are often very good at developing lower-end value-for-money products.

International companies have established over the last years their R&D and customer support centers and this have generated a crisis of personnel. Employment rate for the approximately 7000 IT science graduates per year is 100%. Moreover, there is a strong personnel fluctuation, to the disadvantage of Romanian-owned SMEs. In 2006 Romania's IT market value reached 176.5 million euro, an 18.4% increase as compared to 2005, making it one of the fastest growing markets in Eastern Europe. Integrated system services received the highest revenues of the IT market, accounting for 24.3% of the market, while hardware and installation sectors made up for 17.8%. The Romanian IT service market grew by 20% up to 210 million euro in 2007 alone and IT investments are expected to grow by a similar percentage in 2008. The competition is tough in the sector and both national and international companies will fight for investments destined for IT services.

Changes in strategy relevant for CEE region:

- *Opportunity of developing the emerging economy beyond low-cost strategy* (for example, develop R&D sector in the region like Nokia, Renault, Emerson and Microsoft in Romania). The first way of emerging global companies offered low cost products and services by utilizing relatively inexpensive personnel but the second generation has developed an additional competitive edge through cost innovation.

- *Cost innovation strategy*. Innovation is associated with developing new products and services or adding more functionality and features to existing ones. Customers migrate to CEE determining companies to produce and offer value added services for this region (compared with 90's when production was designated for Western Europe, like subcontracting in textiles and leather industry, called *lohn* operations).

- *Develop a functional product in the emerging country and then bring it home through global learning phenomenon*. Multinationals exploit the full potential of innovations developed in foreign subsidiaries and integrate flow of ideas from delocalized branches in company core competencies.

R&D localized in emerging economies in CEE is a major success factor for tailoring goods and services to these burgeoning local markets. Another advantage of R&D centers in CEE is that they are often very good at developing lower-end value-for-money products (for example Logan Car produced by Renault in Mioveni City, Romania continued by opening Renault Technologies Romania, a key location for R&D for Renault Group delocalized in Romania ).

### ***The Continuing Cost and Capital Advantages in the region***

A major driver of the move to CEE remains the opportunity to make very large—and sustainable—reductions in both operating costs and capital investments. Companies that globalize their cost structures to include CEE can realize important savings in costs of their products while reducing capital requirements by similar amounts.

Another important source of the FME advantage is lower capital-investment requirements. Lower capital investments can mean significant savings on the balance sheet. In terms of total return on capital, the combination of lower product cost and lower capital investment can have a big impact on the total economics of a business. Two fundamental factors reduce the need for capital in FMEs: first, less expensive plant infrastructure, machinery, and equipment (PME); and second, the opportunity to replace substantial amounts of costly technology with human labor services.

**The power of buyers** can capture more value by forcing down prices, demanding better quality or more service and generally playing industry participants off against one another, influencing industry profitability. A customer group has negotiating leverage if: there are few buyers, or each one purchases in volumes that are large relative to the size of single vendor (high fixed costs and low marginal costs amplify the pressure on rival to keep capacity filled through discounting); the

industry's products are standardized or undifferentiated; buyers face few switching costs in changing vendors; buyers can credibly threaten to integrate backward and produce the industry's product themselves if vendors are too profitable.

**The threat of substitutes** is real because a substitute performs the same or a similar function as the industry's product. The main threat is coming from Asia. When the threat of substitute is high, the profitability, and often growth potential, suffers. The threat of substitute is high if: it offers an attractive price-performance for automotive products; the buyer's cost of switching to the substitute is low. Technological changes or competitive discontinuities in seemingly unrelated business can have major impacts on industry profitability. Improvement in advanced materials, for instance, allowed them to substitute steel in many automotive components. The distance between the assembly plant and subcontractor, provider of spare parts is vital in automotive industry, especially for emergency cases when a certain part is needed in short time. For this reason, CEE is placed better than Asia.

**The rivalry among existing competitors** takes many forms, including price discounting, new product introduction, advertising campaigns and service improvements. A high rivalry limits the profitability of the automotive industry. The automotive industry profit potential depends on the intensity with which companies compete and on the basis on which they compete. The rivalry degree is high if the competitors are numerous or are equal in size and power and without a leader inside the industry; the industry desirable practices go unenforced; industry growth is slow and it will precipitate fights for market share; exit obstacles are high because of such things as highly specialized assets or management's devotion to a particular business; the rivals are highly committed to the business and have aspirations for leadership, especially if they have goals that go beyond economic performance in the particular industry (employment or prestige); firms cannot read each other's signals well because of lack of familiarity with one another, diverse approaches to competing goals. As Porter said, the strength of rivalry reflects not just the intensity of competition but also the basis of competition. The profitability is influenced by the dimensions on which competition takes place, if the rivals converge to compete on the same dimensions. Furthermore, rivalry is especially destructive to profitability if it gravitates solely to price because price competition transfers profits directly from an industry to its customers. Price competition is most liable to occur if products or services of rivals are nearly identical and there are few switching costs for buyers encouraging competitors to cut prices to win new customers; fixed costs are high and marginal costs are low creating intense pressure for competitors to cut prices below their average costs, even close to their marginal costs, to steal incremental customers while still making some contribution to covering fixed costs; capacity must be expended in large increments to be efficient; the product is perishable creating a strong temptation to cut prices and sell a product while it still has value.

The strength of the five competitive forces determines the industry's long-run profit potential because it determines how the economic value created by the industry is divided. Considering all five forces, a strategist keeps overall structure in mind instead of gravitating to one element. So, the strategist attention remains focused on structural conditions rather than on fleeting factors. The strength of the competitive forces affects prices, costs, and investment required to compete, so, the forces are directly tied to the income statements and balance sheets of automotive industry participants. The five competitive forces provide a framework for identifying the most important automotive industry developments and for anticipating their impact on automotive industry attractiveness. Shifts in structure may be caused by changes in technology, changes in customers needs. Changes in automotive industry structure are shifting threat of new entry changing any of the obstacles described above; changing supplier or buyer power; shifting threat of substitution; new bases of rivalry, taking into account that eliminating rivals is a risky strategy.



#### 4. Conclusions

The need to adapt and innovate in automotive industry will require organizations to better use their human capital, as there is still a big gap between wages in western countries compared with CEE region. In this respect emerging economies from CEE still remain a profitable key location in terms of production costs but also by providing solid basis for companies to create market differentiators due to the skilled labour force and good training of local personnel, which can lead to a global learning flow of information within the company branches. Companies acting in CEE are transforming the value for money equation. Thus, we consider that the implications of present paper are relevant for both academic and managers in global companies acting in CEE.

The understanding of industry structure guides the manager toward good possibilities for strategic action, which may include any or all of the following: positioning the company to better cope with the current competitive forces; anticipating and exploiting shifts in the forces; and defining and shaping the balance of forces to create a new industry structure that is more favorable to the company. The best strategy exploits more than one of these possibilities.

Europe is facing a fundamental change in its manufacturing strategy due to the economies which can be realized by locating the production in some key locations which reveal important labor savings, transport cost saving and qualified work force.

Moreover, the CEE countries entered the European Union, which means no more duties and other taxes at commodities exchange.

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