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PROCTER & GAMBLE IN EASTERN EUROPE (B)[1]

> We knew there were significant risks, but there were many advantages that outweighed these. Above all, we sensed an unrelenting commitment to change, and we were determined to lead it. We saw that the situation would quickly evolve, and we elected to do a lot fast.
>
> John Pepper, Chairman and CEO, The Procter & Gamble Co.

In December 1990, Herbert Schmitz, a senior executive with Procter & Gamble (P&G), was given the mandate to establish and develop P&G's business within the countries of Eastern and Central Europe. The Berlin Wall had crumbled in late 1989, and communist governments were quickly being replaced by democratically elected ones. Observers were heralding the freeing of these economies as offering "more potential for future prosperity than any region on earth."[2]

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[2]*M. Smith, D. Conklin, and J. Gandz, "Procter & Gamble in Eastern Europe (A)," Richard Ivey School of Business, case #9A97H001, 1996.*

P&G officials, including John Pepper, President, Wolfgang Berndt, Group Vice-President, and just-retired Chairman John Smale, visited the cities of Warsaw, Prague, Budapest, and Moscow, and they mapped out a strategy for developing P&G's business within the region. Key points of the strategy included: leveraging global success models and technologies; approaching Eastern Europe as one region; and prototyping West European brands for this new market. Schmitz and his team of managers, chosen from throughout the company's global operations, were then handed the challenge of building P&G's operations from scratch.

By mid-1993, with their high priority countries, product categories, brands, and implementation strategy, Schmitz and his team had succeeded in building annual sales of US$350 million. Over 20 P&G brands had been successfully introduced within Eastern Europe, and most of these brands had become leaders within their product categories. P&G now sought to triple the volume of business and reach the US$1 billion milestone within three years. Achieving this growth, however, would require managing risks and obstacles in advertising, distribution, and human resource management. These risks and obstacles were embedded in a heritage of decades of Soviet-style communism.

CHOOSING HIGH PRIORITY COUNTRIES

From all of the countries in Eastern and Central Europe, P&G chose Czechoslovakia, Hungary, Poland, and Russia as the first countries in which to establish marketing and sales operations, and then to develop production facilities. A major criterion applied to determine the sequence of countries to enter was the speed and extent of economic development and political changes. Specifically, P&G analyzed the following changes in the business environment:

- <u>The likelihood and speed with which a country would actually evolve towards a market-based economy</u>. An environment of pricing freedom where prices reflected real economic costs and signalled effective demand and supply conditions was seen as critical to achieving profitable operations in the long-run. Within communist economies the vast majority of prices had been fixed by the state for income redistribution purposes; as a result, consumer prices often bore little relation to actual costs of production or to consumer demand, and inappropriate pricing led many industries into perpetual loss-producing results.

- <u>The extent to which privatization was likely to be implemented</u>. Critical to P&G's overall success was the distribution system. For a distribution system to be effective, entrepreneurs motivated by profit and gain were needed instead of government bureaucrats who ran the traditional distribution system.

- <u>The probability that external convertibility of the country's currency would occur within three years</u>. Although P&G's overall East European operation was not forecasted to break even on a cash flow basis for a minimum of three years, the overall operation did have a mandate to achieve break-even on a cumulative cash-flow basis within seven years, after paying appropriate contributions towards the fixed costs that had been incurred.

- The seriousness of ethnic tensions. The concern was that ethnic tensions could lead to widespread social unrest and, eventually, might bring about political regression towards communism or a new form of totalitarianism.

While Hungary had been more pragmatic in its reforms than Poland and Czechoslovakia, the leaders in the latter countries seemed to be more desirous and active in undertaking future reforms. Hungary was at the top of the list for most corporations considering Eastern Europe, but P&G was surprised by the Poles' determination and readiness for change. The Baltic States as well as the former Yugoslavia, Bulgaria, and Romania, were transforming their political and economic systems much quicker than Russia. Nevertheless, P&G elected to establish a small foothold within the former USSR's largest republic because of its potential market size and its traditional dominance within the entire region. According to Berndt, "Central Europe was a sprint. We believed we had to get out of the block fast and get a piece of the pie. Russia, however, was more of a marathon."

Parallelling P&G's development of organizations within its four priority countries was the development of operations to export to the other countries of Eastern and Central Europe, a first step to building P&G's future organizations in each of them. Within two to three years, further expansion into the Ukraine and other former Soviet Republics had been planned.

CHOOSING HIGH PRIORITY PRODUCT CATEGORIES

From in-depth market research undertaken early into the planning process, P&G learned that East European consumers wanted first-rate Western goods as quickly as possible, but that, in contrast with Western consumers, they were limited by their incomes, had different habits, and used different appliances. As a result, P&G adopted a strategy of leveraging its West European expertise and product portfolio. Tactics employed included smaller packages for lower price-points and reformulation of selected brands to meet unique needs. In Czechoslovakia, for example, the traditional laundry detergents' odour was very noticeable because the wash water drained into the bathtub; P&G's laundry brand therefore emphasized fragrance together with efficacy. To the extent possible, other products were modified and standardized for Eastern and Central Europe.

Ten products from three product groups — laundry, paper, and health and beauty care — were selected to launch P&G's entry into these new markets. This approach contrasted with P&G's traditional strategy of entering new country markets category-by-category, brand-by-brand. Given the relatively high costs involved (e.g., overhead, expatriot compensation, R&D, etc.) and the targeted time lines for profitability, a substantial number of products were necessary to generate the revenue base over which to spread fixed costs and reach profitability quickly. Generally, P&G chose product categories where only single share-point competitors existed and the first mover advantage was highest over the long-term, such as dentifrice. Added Schmitz, "To get critical business mass, we needed a portfolio of products that had been tested successfully around the world, that had a pedigree, and that we felt would work in Eastern and Central Europe."

CHOOSING AN EXPANSION PLAN

Beginning in the second quarter of 1991, P&G proceeded to test-market its selected brands, each within one of the four priority markets: Czechoslovakia test marketed laundry detergents; Hungary tested toothpaste, paper, and diaper products; Poland became the test market for shampoo and other health and beauty-care products; and St. Petersburg tested hair-care products. According to Berndt, "We looked at Eastern Europe as a region, designing plans that can fit practically all the countries. We focus a given product in one country. Then, after a model proves successful in the first country, we expand it to the others."[3] By late 1992, initial testing was completed, and the entire portfolio of products was being marketed throughout the region. By mid-1993, up to 15 P&G products were being marketed in some of the region's largest urban centres. As a result, volumes increased quickly.

Given their relatively small size, the markets in Czechoslovakia, Hungary, Poland, and St. Petersburg were quickly developed in parallel. Speed of entry within the region was also driven by the cash-poor nature of these economies. All were following extremely tight monetary policy in an environment of high inflation — an adverse consequence of the reforms being implemented — which resulted in trade and consumers having limited resources at their disposal. Hence quickly establishing a strong market presence became strategically important as there would be room for only two, at best three, main competitors for each product category. P&G's experience within the countries of Latin America and India had proved how difficult and costly it was to build market share following the prior establishment of a strong international competitor such as Unilever. A further motivation was the fact that P&G's technologies were quickly being copied and introduced to markets where it had not yet established itself. P&G's regional approach also sharply contrasted with its entry into Europe during the 1950s and '60s when it took over two decades to develop businesses in almost every country of Western Europe.

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[3] *"Pioneering Pays Off,"* P&G World*, January - March, 1995.*

CREATING NEW ORGANIZATIONAL STRUCTURES

To run its East and Central European operations, P&G developed a management structure that balanced the need to minimize costs with the need to be close to the business. Headquarters based in Frankfurt, Germany, managed production, supply, and R&D in order to manage P&G's product technology, packaging, and exports. On a country level, organizations were responsible for selling, distribution, advertising, pricing, finances, human resources, public relations, and local market research and customer service. Each of the four initial country organizations, all established by April 1991, also had regional marketing responsibility as lead countries for the brands they had tested; this matrix structure was similar to that which P&G had developed in Western Europe and elsewhere within its worldwide organization. Central office functions and staff were pushed down to the local organizations as these developed, thereby maintaining an overall lean organization.

P&G required a group of managers with international experience to develop the new operation. Herbert Schmitz, who had 32 years experience within P&G and had worked in the Middle East, Latin America, North America, and Asia, had the desired mix of entrepreneurial initiative, experience, and knowledge of P&G to lead the development of the business in the new markets. Characteristics sought in managers brought in from various parts of P&G's global operations included: flexibility, cultural sensitivity, tact, compassion, an adventurist spirit, and entrepreneurial instincts. Heavy recruitment from local universities, required to develop the future local management teams, commenced in late 1991.

DEVELOPING A REGIONAL PRODUCTION STRATEGY

Although P&G's East and Central European business was initially supplied from plants located in Western Europe, a regional production strategy was devised in order to produce Western-quality goods at prices East Europeans could afford. The long-term orientation was to have large regional plants throughout the area that could justify state-of-the-art technology and be world-class from a quality and cost standpoint. These facilities would supply the region and, eventually, markets in Western Europe. However, P&G would continuing to import products from other parts of P&G's organization on a lowest-cost/best-quality basis.

Organizing production on a seamless basis throughout the region would not only generate economies of scale, but would also give P&G's business an important competitive advantage in terms of speed and agility in responding to changing needs. However, trade patterns among the countries of Eastern and Central Europe had been disrupted by the dismantling of COMECON (The Council for Mutual Economic Assistance). According to one P&G manager, "We had some cost penalties versus our competitors who had chosen to take a country-by-country approach; but over time, we were building great scale." Evolving political events had suggested that these trade barriers would be overcome. Most countries of Eastern and Central Europe were eagerly looking to join the European Community (EC); many had become members of international organizations such as the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT); and the countries of Czechoslovakia, Hungary, and Poland, representing a population of over 80 million, had negotiated the Central European Trade Agreement, a process to which P&G's top management had contributed.

Given the need to start up fast and without much capital exposure, P&G chose not to build new plants at the outset. Instead, the company proceeded to form joint ventures with local manufacturers and to make acquisitions of existing production facilities in order to implement its regional supply strategy quickly.

Czechoslovakia

P&G's first acquisition was Rakona, Czechoslovakia's leading cleaning chemicals company and one of the country's three most highly regarded enterprises. Rakona's detergents, fabric softeners, household cleaners, dishwashing products, and shampoos supplied up to two-thirds of the Czechoslovakian market. Founded in 1875 and nationalized in 1946, it became the first state enterprise to be fully privatized and sold to a foreign interest under the country's new privatization laws. The employee group that had been running the plant since the demise of Communism had invited several multinationals to consider purchasing it. Their main objective was to find a buyer that would upgrade the plant, which was located in close proximity to the German border, and make it into a viable, export-oriented enterprise. By the spring of 1991, after seven months of discussions, P&G and the workers of Rakona concluded a tentative agreement that then had to be re-negotiated with a variety of ministries at different levels of government for another three months. An acquisition agreement was eventually signed with the government on June 15, 1991, and it came into effect September 4, 1991. However, there was no system of property ownership in place to allow for legal transfers of property from the state to private corporations.

P&G's acquisition defeated bids by long-time competitors Benckiser, Henkel, and Unilever. Henkel had already introduced the detergent brand *Dato* into the country in 1990. The Rakona acquisition gave P&G speed of entry into the Czechoslovakian marketplace. Building a new plant would have taken up to two years, whereas with Rakona, Tide laundry detergent was already being produced to P&G's worldwide standards by August of 1991. For 100 percent control, the purchase price included US$20 million cash, payable to the Czech government property fund, plus the following outlays and guarantees: each employee received five P&G common shares; P&G assured no layoffs for two years and no more than 30 percent within the following three years; and P&G committed an additional US$24 million in spending over four years to double output, improve product quality, increase occupational health and safety, and ensure higher environmental protection of the area surrounding the plant. Arriving at an acceptable price was challenging as it involved valuing dilapidated buildings and equipment while appeasing government and citizens about the fairness of the proposed purchase price. In order to arrive at a valuation, a dollar value per kilogram of output (detergent) that it would cost P&G to build a new plant was applied to the assessed output of the Rakona plant; this value was then reduced by calculating depreciation over the expected life of the plant. By early 1993, Rakona detergent products were being exported to Hungary and Poland, and overall results were surpassing P&G's initial expectations of the acquisition.[4]

Poland

To enter the Polish market, P&G negotiated a 50/50 joint venture (JV) with a British firm to form *P&G Poll*. The JV was given a three year tax-holiday, and its first initiative was the purchase of a large complex of warehouses in the South-West of Warsaw for approximately 40-billion zloty (approximately US$2.5 million). Serving as a central distribution centre for the entire country, the complex initially employed 100 workers, doubling to 200 by the end of 1992. In early 1993, the JV announced the purchase of a 15-hectare site in the suburbs of Warsaw where a partially completed manufacturing facility was located. The total first stage investment of 960-billion zloty[5] (approximately US$50-60 million) would enable the facility to manufacture Pampers diapers, with 80 percent of total planned production destined for export to neighbouring countries. Eventually the plant would produce shampoo and bleach, and total employment would reach 300 workers and involve approximately 750 suppliers.

The decision not to buy Polish state-owned manufacturing facilities was partially motivated by the tendency for these facilities to be over-staffed and heavily governed by worker-unions. According to P&G, fundamental changes to their levels of employment due to the introduction of self-directed work teams would have been difficult and slow. Communist accounting also made it difficult to know exactly what was being purchased, and the products appeared to have very little brand equity. Indeed, market research in early January of 1993 showed that washing powders most often found on shop shelves were P&G products — Ariel and Vizir — with over 86 percent of shops stocking these brands. In second place were Unilever products with about 80 percent, followed by Benckiser and Henkel products. The first Polish brand was eighth with about 45 percent of shops stocking the brand.[6]

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[4] *"Czech Republic: Rakona Exports to Poland and Hungary,"* Reuter Textline Rude Pravo*, January 14, 1993.*
[5] *"Poland: P&G to Build a Warsaw plant,"* Reuter Textline Rzecpospolita*, February 5, 1995.*
[6] *"Poland: Foreign Brands Dominate Polish Powder Market,"* Reuter Textline Rzeczpospolita*, January 20, 1993.*

Hungary

Within Hungary, P&G followed a pattern similar to Poland, of establishing JVs. In particular, P&G formed a joint venture with Pharmafontana to market skin care products. P&G also formed other JVs to distribute other personal care products such as shampoos, bar soap, and toothpaste.

Russia

In Russia, P&G started with small exploratory activities, and formed its first JV with the University of St. Petersburg to market products in the area. This was an essential link in translating P&G's plans to the environment of business in Russia. St. Petersburg was seen as a more manageable point of entry than Moscow. By early 1991, it was reported that the operation was selling as much toothpaste in the USSR as P&G was selling in Canada.[7] In late 1991, P&G had announced that a licensing agreement had been arranged with a Soviet manufacturer located in the republic of Kazakhstan to produce P&G toothpaste. At the time, the break-up of the USSR was imminent, and the deal eventually fell though. In early 1993, P&G announced it had taken a 14 percent stake in the biggest washing powder factory in Russia. The company was planning to invest US$50 million over 5 years, making it the largest shareholder.[8]

THE POST-COMMUNIST ENVIRONMENT OF BUSINESS

Western companies that entered Eastern Europe following the fall of the Berlin Wall found mass markets of well-educated consumers who were benefitting from essential health and social services, as well as from steady incomes and employment. Little was known, however, of these markets given the lack of data and experience of operating within former communist countries. East Europeans, as well, knew little of what Western companies had to offer in terms of business practices and products. The Iron Curtain had restricted the exchange of ideas and products. For example, television antennas in East Berlin were required to face east by law. Schmitz observed:

> Eastern Europe was isolated to avoid any of the so-called 'social infections or diseases' from the West. [The communist governments] had put it under a protective shield that was suddenly blown away. The Wall had come down, and there was free communication, free pricing, and free buying of goods and services without any transition. Normally this would happen in a gradual way, but in Eastern Europe, the Wall came down

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[7] *"43rd Annual Report on American Industry," Forbes, January 7, 1991.*
[8] *"P&G Invests in Russia and China," Reuter Textline, December 17, 1993.*

suddenly as Communism imploded from under its own lethargic weight, and euphoria reigned for the first year of non-communist rule.

At the upper echelons of society, the political class in power aspired to transform their country into a democracy and a market-based economy. However, this group of intellectuals and reformers represented a small proportion of the population. Much of the population knew little of the proposed changes and were passive towards them, while many others were actually hostile to deep structural reforms. This latter class of people had enjoyed material rewards and social stature under communism, often benefitting from ill-defined work, high-income guarantees, and various support services.

During times of communist rule, state bureaucrats had accumulated enormous power over all political and economic affairs of their country. According to one former member of the Soviet State Planning Committee (GOSPLAN), up to 23 percent of the USSR's workforce had been employed within the country's bureaucracy. In the GOSPLAN pricing division, some 45,000 bureaucrats were responsible for approving over 200,000 prices for key goods annually, and they tracked some 24-million prices overall, some unchanged for 25 years. A central function of the bureaucracy was to elaborate and implement detailed production and sourcing plans, which filled 70 volumes or 12,000 pages, for the millions of raw material and intermediate goods.[9]

Communist enterprises were extremely large. At an average of 1000 workers each, they were among the largest in the world. Usually, only one or two enterprises produced a country's entire output for a given product. As well, many enterprises had integrated backwards in order to reduce their dependence on outside suppliers, as meeting quota targets was an important part of the planning process. However, the technological sophistication found in the defence industry, driven in part by the competition from the West, was uncommon in other industries. The USSR also had the world's largest agricultural enterprises; on average, 500 employees covered 15,000 hectares, ten times the average size within the United States. Banking and credit facilities were almost non-existent compared to the West, except for accepting deposits. Credit was available to state enterprises to cover unexpected shortfalls in revenue, but, in many cases, these credits were never repaid and were eventually written off by the state bank.

Following the first year of freedom from communism, euphoria was quickly replaced by gloom as the GDP of former communist countries began to drop precipitously, with little indication of any turn around (see Exhibit 3). The suddenness of political change had inevitably led to the collapse of long-time economic infrastructure. Many critical aspects, such as production, retail and wholesale trade, distribution, transportation and logistics, and inter-country trade structures, had merely ceased to operate, and this led to widespread confusion and conflict. According to Schmitz, "We did not expect the chaos

[9] *Economics, Canada in the Global Economy, Rubin Bade and M. Parkin, Addison-Wesley, 1991.*

in the way we found it. In fact, nobody in the West imagined how badly communism and its structures had fallen apart. As we started digging and digging over the first six to twelve months, we had our hangovers. And in year two, one frustration followed another."

This chaos was compounded by a lack of market-oriented government legislation and rules. Bureaucrats were still clinging to their traditional power bases, unsympathetic to Western business practices. P&G efforts at developing its business were hampered by administrative barriers to product registrations and product testing, as well as deep resentments and generally very time-consuming bureaucratic procedures. To sell Pampers in Poland, for example, P&G was asked to do 16 different tests for the product, even though it was already being sold all over the world. According to Schmitz:

> There was pride, as well as fear of being taken advantage of by the West. Suspicions ran deep. Easterners, who were very well educated and had been trained for years under the collective and dogmatic way, questioned whether the West or their way was better. They had a bias to protect what they had first, out of pride. Pride was a very important feature which I had not faced elsewhere in the world. Sensitivities were running high as their entire systems of production and government were being replaced wholesale. They saw themselves as once being great, but now they saw themselves as being poor, admitting that they were in real terms a third-rate power, while they had been told for seventy years that they were number one.

As economic and political change advanced with post-communist countries, people realized the extent to which their economies had become uncompetitive with those of the West. Although many were rich in natural resources, a lack of knowledge concerning how to commercialize, transport, and develop their resources to Western standards made the development of natural resources uneconomical. Disappointment and bitterness mounted as the grand promises of the market economy did not quickly materialize. Difficulties inherent in market-based economies, such as unemployment and inflation, created social backlashes that paved the way for the return of non-Soviet-influenced communist governments within many countries of Eastern Europe.

One of the most important and powerful set of obstacles for P&G were the unforeseen problems associated with the values, beliefs, and expectations inherited by the people from decades of communist rule. "The need to recycle the mind of our consumers and our people after so many years of communism was one of the biggest challenges we faced," commented Schmitz.

Typically, all citizens in communist countries were guaranteed a secure job. Wages were set by the State Labour Committee, and enterprises were forbidden to pay more than stipulated. By the late 1980s, within the USSR, very few differences existed in wages across most professions. The ratio of incomes of the most affluent 10 percent of citizens compared with the least affluent 10 percent was estimated to be 3.5:1, compared to 10:1 in the United States. However, within many activities such as services where wages tended to be lowest, “access payments,” bribes, or disappearing inventory and equipment supplemented incomes. Workers also benefitted from a range of services such as free or heavily subsidized housing and health care, and other benefits such as pensions and vacation sites. Highest quality services and goods tended to go to state bureaucrats.

Within enterprises, behaviours were deterministic as the communist system of command had stifled initiative. “‘Who makes decisions for me?’” commented Schmitz, “was now an important issue of concern among workers.” Generations of managers and workers had been trained to obey, without question, decisions coming from above. Stating different opinions was not something considered to be wise, although, privately, many people had long ago disenfranchised themselves from communist ideology and propaganda. The idea of meritocracy and leadership, however, were new for many of the people hired by P&G. According to Ian Troop, P&G’s country manager for Poland, “for 50 years, the saying went that ‘the nail that sticks out gets hammered down.’ People saw lots of friends get struck down in various ways for not conforming. So the idea of a capitalistic free-market mind-set of meritocracy, of risk-taking, and of being a leader was completely against what they had been brought up to believe. On top of that, what you and I take for granted as the rules for success — that we probably learn through osmosis from our family and friends and upbringing — they missed completely.”

Inherent in worker attitudes was a deep and fundamental distrust of institutions. Indeed, the most credible source of information were friends. Rumours were very powerful, and anything said publicly was viewed with deep suspicion. Reporting the truth was simply not part of the managerial culture.

RAKONA: THE CHALLENGES OF MANUFACTURING IN EASTERN EUROPE

Although the Rakona plant proved to surpass expectations, P&G’s purchase of the plant illustrates the myriad of issues the company found itself having to confront throughout Eastern Europe, from the remnants of communism to the scarcity of experienced and skilled local business managers.

When Bill Harter, P&G’s first country manager in Czechoslovakia, arrived at the plant, the previous director, a Communist and government appointee, had just been fired. At the time, it was not clear whether the government had given the workers permission to sack the management. It had simply been done in one of the biggest factories in the country, which then encouraged other factories and their workers to follow suit. Harter observed:

> At the management level, there were no Western management skills or functions. The plant manager was, in effect, the CEO of a corporation. There were no

> advertising, marketing, or sales functions, although there were individuals responsible for finance and human resources who reported to the plant manager. There was someone called the Commercial Manager. He answered questions from wholesalers about why he couldn't deliver, or why he was only supplying brand A and B, and not C. That was the sales function. A plant accounting system was in place which was accurate in tracking raw material costs, but costs were allocated on averages. So whether a brand took 70 percent of personnel, for example, but was only 30 percent of output, that brand would be charged just 30 percent of the associated fixed costs of the factory. This absence of precise information made it difficult for P&G to determine what actual costs were, and it required extremely specific questions to obtain precise information. Otherwise, you got the generality which was useless. They weren't intentionally avoiding the question, but they weren't used to giving straight answers; that was dangerous in the old days. Also, they weren't sure what the real answer was because it had been done kind of roughly, and if the whole operation, the whole country, operated as one big company, you didn't care if you were allocating from the left pocket or the right pocket.

Almost every enterprise in the country was realizing a 5 percent after-tax margin. This was considered to be a 'non-capitalistic' margin from which an enterprise could reinvest in plant and equipment. Manufacturers could manage back from this to determine what their prices would be. Using Western accounting practices, the plant was probably in the red, just given the fact that they did not depreciate plant and equipment.

Technology

The Rakona plant was using technology that was approximately fifteen years old, the last modernization having been in the 1980s. Maintenance was poor, and much had to be done to upgrade the existing facilities. Furthermore, the plant was over-designed given the capacity that was being generated. As Harter explained, "By luck, the lack of maintenance had not killed them. It was like a 300-horsepower car that was driving at 20 miles an hour. On that kind of basis, you could probably skip spark plug and oil changes indefinitely." Energy was inexpensive, and the plant was consuming immense amounts of energy. In terms of product formulation, the specifications were comparable to Western standards, but when analysing some of the products against these specifications, P&G discovered that the firm was not producing them according to design. There were problems with raw material supplies which forced the plant to omit key ingredients. They were meeting planned output and were often exceeding it, but with very little quality control. The plant also had a gigantic coal field and burner, which caused serious air pollution. Finally, as with many other plants in former Soviet countries, they were highly integrated with the community, providing water and heating for many sectors of the town;

housing for employees, winter and summer places for workers; a large town hall for meetings and social gatherings; and medical services.

P&G found that the employees were technically very capable. One of their strengths, in fact, was their ability to make do with whatever was available. Since labour was cheap and parts were expensive, the habit was to recreate parts and not throw anything away. As Harter indicated, "those guys have a machine shop, the likes of which I have never seen in my life, probably better than what you would find on American aircraft carriers. Although basic technology was not advanced, high skill levels were staggering."

Employee Attitudes

The biggest worry in the early stages of P&G Rakona was the attitude of the employees in terms of work standards. As part of its corporate culture, P&G did not accept variability in the formulation of its products, and convincing the plant employees of this practice took time. "They would say, 'What is the big deal? Nobody has got everything in detergents anymore,'" commented Harter. P&G needed to explain consumer choice and value, elements that were entering the marketplace given the presence of other foreign competitors such as Unilever and Henkel. Employees also had to learn to equate employment with profitability and quality. P&G installed performance-based systems over a two-year period with the help of the union and Czech managers. For over forty years, everybody had the same compensation package, whether they showed up for work or not.

The average employee did not care much about what he or she did. People smoked on the lines, did not care much about quality, and the attitude was generally bad. According to Harter, absenteeism was high. At any one time, 12 percent of the workforce was sick; the average in P&G worldwide was 2 percent. "There was one thing that blew me away. I looked at the employment level and asked, 'where are all these people?' I could never figure out where these 800 people were because I could never find more than 500 at a time. About 100 were on a three-year maternity leave, and about 200, not the same ones, were always sick — taking turns I guess." About one-third of the plant never bought into the concept that you get paid for the work you do. It took about a year for the other two-thirds to accept this. The employees were presented with a new pay system that was based on the merit pattern, and everybody was appraised annually. Neither of the employment reduction options that P&G had in the original deal were exercised. Within two years, employment at the factory was fairly stable with about 25 percent replaced.

CHALLENGES TO FUTURE EXPANSION

From a marketing point-of-view, P&G was in a totally strange and hostile environment. "We were faced with 430 million consumers, but we didn't have the marketplace," said

Schmitz. The communist legacy included a lack of familiarity with marketing, and the absence of all elements that create a marketplace such as: supply, demand, competition, advertising, promotion, and sales. In all of the countries of Eastern Europe, these elements had not existed since at least the Second World War. Communist governments, through their hierarchy of ministries and bureaucrats, determined what was to be supplied and therefore demanded, as opposed to free-markets where consumers expressed preferences that producers competed to satisfy.

The Retail/Wholesale System

By 1992, the state retail and wholesale system — a hub-and-spoke structure — had collapsed completely as a result of the economic restructuring of the countries of Eastern Europe. "You had factories that didn't produce and consumers that went into empty stores, and the ownership of the stores was changing daily. The store didn't even know where to buy goods because the state system used to give them everything," said Harter. Getting goods to retail establishments was a huge challenge. "Within other poor countries, such as some in Asia, the entire [distribution] system was born in an evolutionary way so that trade and logistics existed, although not perfectly. The bazaars and the trading places existed, as did the transportation system, even if it involved camels or boats. In Eastern Europe, we had nothing, because it stopped overnight," said Schmitz.

Distribution

The private system that began to emerge from the chaos was very informal. Bazaars and kiosks were the beginnings of a new retail system in many of the countries. Throughout Poland, for example, P&G was facing a motley crew of over 135,000 retail distribution points. Distribution was done by individuals using trucks, who purchased products from the factory paying in cash. These products were often sold while driving down streets. Trading, an easy access point to consumers, drew a wide variety of entrepreneurs, some of whom knew nothing about business. "We had guys who were truck drivers, ship captains, sailors, gardeners, teachers, all trying to be wholesalers," said Troop. In Poland, P&G was dealing with over 250 distributors considered to be wholesalers, of which 60 were preferred, based on their credit-worthiness. At the time, prospecting for the right kind of distributor was a key activity for the company. "In 1992, we ran a trade fair. We wrote a million cases of orders in two days, shipping for 200,000. Half the guys couldn't pay. It was just a madhouse. And our incentive was a free truck if you ordered a certain amount. That was the deal. It was absolutely wild. But that is how we found some of our current distributors," said Troop on P&G's efforts in Poland.

Most distributors were small, the largest doing approximately US$2 million worth of business a year, many operating from small garages and shops. Most had little capital, expertise or the financial management skills to operate a business. None had been in business for more than two years, and many were fly-by-night operators looking for a quick profit.

Getting product to stores was a very time-consuming and costly process that needed to be compressed in order to boost volume. Under the old system, consumers bought what was available. For example, if detergents were in stock, consumers purchased enough to last up to six months. As for producers, they would produce the quantity dictated by the state plan, and then the bureaucracy would arrange to have it delivered to the retail outlets. Expectations of stock-outs which were regular occurrences in the old system, hampered P&G's efforts to develop its business. According to Peter Heissen, the P&G manager in the Baltic states, "I saw an example in East Germany where a shop was running out of a specific product by 2 or 3 p.m. everyday because it was selling so well. The idea of increasing the quantity ordered to satisfy the demand had to be pointed out." Other examples included distributors who would automatically push up their prices to cover their costs in the face of diminishing volume, a practice that would simply aggravate their plight and often lead them into bankruptcy. The challenge P&G faced was how to establish a distribution system which would allow P&G products to be available easily and conveniently, everyday at the right price to any consumer, anywhere in the country. Making the system more efficient, bringing costs down and getting sales up would require refocussing energy and capital to create a new distribution system.

The McVan Model

One option P&G was considering was to choose a smaller network of preferred distributors who showed integrity, talent, and good business acumen, and convince them to dedicate themselves exclusively to P&G. Within Poland, for example, distributors were also carrying products from P&G's competitors. In return, P&G would give distributors exclusive territories, as well as provide them with training and capital, and then show them how to run a wholesale distributorship. The question was how to make the proposal attractive in an environment where suspicions ran deep, something that was heavily exploited by competitors to discredit each other.

One of the models being considered in Poland at the time was called the McVan model. P&G would provide vans, handheld computer equipment (for tracking sales, orders, and inventory), working capital, and expertise to the selected distributors. Three-person P&G teams would work with each distributor and would help them set up logistics and systems, and train them in financial management, human resources, and sales. The team would work with each distributor one or two days per week. In return, the distributor would be expected to hold the inventory and pay and manage people to run his vans. From 10 to 20 vans per distributor could be involved. These vans would pick up product from the distributor's storage facility, and travel through the territories, making sales and deliveries.

If successful, this system could give P&G tremendous competitive advantage in terms of speed, coverage, and costs. No direct competitors had yet developed such a system, although other Western companies such as Wrigley's and Mars, two food product companies, were developing their own networks. If successful, P&G could then roll out this model throughout Eastern Europe. The proposal was risky, however, as it had the potential to implode and discredit P&G in the process if it failed. Alternatively, P&G could wait for the wholesale and retail infrastructure to continue its own development or until the new economic structure had evolved.

Advertising

Another huge problem was people's attitude towards advertising. P&G discovered that many of its global success models were ineffective and often counter-productive in Eastern and Central Europe. In most communist countries, advertising was seen in a negative way and associated with official propaganda. Furthermore, in a society that was undersupplied with quality goods, the logic held that anybody who advertised was trying to sell low quality goods. P&G's massive television advertising campaigns raised its profile with negative consequences. People questioned whether P&G products were dangerous: if their detergents, for example, washed so well, how would they affect the skin? Dermatology clinics had posted signs that read: "If you are here and you use these three brands from P&G, go home and stop using them." Door-to-door sampling was also a difficult issue. As people received samples from P&G, their interest was not in the product, but how P&G got information about where they lived. Newspaper articles questioned whether P&G had a deal with the secret police. Generally, typical Western advertising tactics were viewed with suspicion and distrust.

For example, in August of 1991, P&G launched Vidal Sassoon's 'Wash and Go' shampoo supported by a marketing blitz on a scale never before seen in Poland.[10] Though the country's most expensive shampoo, it quickly became the most popular, capturing more than 33 share points of the market by the end of that year. In early 1992, however, sales began to plummet on the heals of rumours that suggested the shampoo caused dandruff and baldness. Images of locker-room life in advertisements reminded people of prison camps and further compounded the product's image problems.[11] Tactics used to counter these negative perceptions included: changing the ads to feature Polish gymnasts with a healthy head of hair, mass-mailing free samples of the product to households, and organizing a whistle-stop tour by Vidal Sassoon, the British-born hairdresser.

Under the many years of communist rule, word-of-mouth had become one of the most reliable means by which to transmit information, usually via networks of friends. Long queues would typically form in front of shops before certain desired goods arrived, as

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[10] *"Poland: Wash and Get into a Lather in Poland," Chemical Business News, June 11, 1992.*
[11] *"Poland: Ad-Lib Pole Axed - P&G Gamble Advertises Wash & Go," Observer, August 16, 1992.*

word spread of their imminent arrival. These networks were even capable of mobilizing hundreds of thousands of people overnight for political reasons as had happened in mid-1991, when the attempted coup in the USSR was defeated with the help of mass demonstrations in Moscow.

Human Resource Management

P&G had been solidifying its organizations by heavily recruiting out of universities. The company recognized the risk that other corporations would attempt to hire these people within a few years. As more international firms poured capital into these emerging economies and boosted demand for local management expertise, salaries would escalate. P&G's highly- recognized training usually resulted in its people becoming prime recruiting targets. Compounding these market conditions was the short-term attitude of the local population. Furthermore, for decades, people had been made to focus on the collective good. However, the economic and political changes that had been occurring instead made people think in terms of what they could gain for themselves. According to Troop: "We need a succession of benefit packages which sequentially give them higher rewards but in a way which helps them to think about a career."

For P&G, the short-term view of workers conflicted with its corporate values of a long-term perspective, training and promoting from within, and employment as a career. Modifying these corporate values to suit the environment was not an option for P&G. As Harter observed, "We believe that it is better to lose by sticking to our principles than win and walk all over what we think is important. We can win in the long run as long as we understand the environment and stick to our principles."

P&G's human resource policies and benefits needed to be well-planned in order to mitigate the risk of losing unacceptable numbers of local recruits after they had been trained. Training, at about US$30,000 to $50,000 per person per year, was expensive as well as time consuming. Losing these recruits could lead to: higher training expenses, higher overhead through longer-term use of ex-patriots, and a slowing-down in the process of building a profitable business.

Some options being considered to motivate P&G's new recruits to stay with the company were: repayable five year house-loans, free cars, stock ownership programs, and long-term stock-bonus plans. Questions still remained as to how effective the policies would be at limiting turnover and attrition, and poaching by competitors. At the same time, it was imperative that costs be kept to a manageable level.

DEVELOPING AN EXPANSION STRATEGY

Schmitz and his team faced many issues as they considered how to move forward. By mid-1993, P&G's business was approaching break even, and over 20 P&G brands were now being distributed in the region. To date, P&G had invested over US$200 million to establish the business. Competitors, as expected, had entered the fray: Unilever, Henkel, Johnson & Johnson, Colgate, L'Oreal, Gilette, etc.[12] Henkel, in particular, was very aggressive and had an excellent sales organization.

By 1993, P&G had gained invaluable experience in Eastern Europe, but many questions remained. Had the time now come to expand into other geographical areas of the formerly Communist nations? Should the product line be expanded? Should more production facilities be developed, and could these attain the productivity and quality to serve as an export base for global markets? What kind of time profile should the expansion strategy take, and what difficulties might lie ahead?

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[12] *For a description of these companies refer to Exhibit 4 of 'P&G in Eastern Europe (A)', Ivey Business School case 9A97H001.*

Exhibit 1
SEGEMENT INFORMATION, THE PROCTER & GAMBLE COMPANY AND SUBSIDIARIES

A. PRODUCTS

Procter & Gamble manufactures and markets over 300 brands within 39 product categories divided into the following four product groups:

1. Laundry and cleaning products include detergents, hard surface cleaners and fabric conditioners. Well know product names include: Bounce, Bounty, Cascade, Charmin, Cheer, Comet, Downy, Mr. Clean, Spic and Span, and Tide.
2. Personal care products include personal cleansing products, deodorants, hair care products, skin care products, oral care products, paper tissue products, disposable diapers, digestive health products, cough and cold remedies, and other pharmaceuticals. Well know product names in North America include: Always, Attends, Bain de Soleil, Chloraseptic, Clearasil, Cover Girl, Head & Shoulders, Ivory, Camay, Luvs, Metamucil, Oil of Olay, Pampers, Pepto-Bismal, Pert, Scope, Secret, Vicks, Vidal Sassoon, and Zest.
3. Food and Beverage products include shortening oil, snacks, prepared baking mixes, peanut butter, coffee, soft drink and citrus products. Well known North American products include: Citrus Hill, Crisco, Duncan Hines, Folgers, Jif, Pringle's, and Sunny Delight.
4. Pulp and chemical products; about one-third sold to other P&G business segments.

B. FINANCIAL RESULTS AND ASSETS BY PRODUCT GROUPS (millions of US dollars)

1. Laundry and Cleaning Products:

	1993	1992	1991	1990	1989	1988	1987	1986	1985
Net Sales	10,061	9,531	9,002	7,942	7,138	6,668	5,784	5,348	4,884
EBT:[1]	837	1,278	1,013	781	754	699	510	667	691
Assets	4,422	4,399	4,094	3,296	2,964	2,852	2,690	2,369	2,038
Capital Expenditures	575	467	599	383	273	285	245	233	216
Depreciation/ Amortization	233	215	193	170	151	149	120	99	79

2. Personal Care Products:

	1993	1992	1991	1990	1989	1988	1987	1986	1985
Net Sales	16,238	15,142	13,468	11,767	10,032	8,676	7,512	6,451	5,107
EBT:[1]	117	1,651	1,602	1,314	1,031	888	498	625	332
Assets	12,811	12,630	9,908	8,786	7,511	7,114	6,679	6,446	3,776
Capital Expenditures	1,134	1,215	1,081	586	510	483	473	539	594
Depreciation/ Amortization	675	593	503	464	428	375	332	243	165

3. Food and Beverage Products

	1993	1992	1991	1990	1989	1988	1987	1986	1985
Net Sales	3,271	3,709	3,546	3,318	3,029	2,963	2,976	2,923	2,815
EBT:[1]	(195)	229	47	304	(14)	32	(282)	(64)	(110)
Assets	2,173	2,492	2,565	2,726	2,023	1,721	1,690	1,761	1,717
Capital Expenditures	107	151	177	131	101	120	142	157	165

Exhibit 1 (continued)

4. Pulp and Chemical Products/Other:

	1993	1992	1991	1990	1989	1988	1987	1986	1985
Net Sales	1,712	1,429	1,709	1,666	1,778	1,532	1,186	1,161	1,237
EBT:[1]	(59)	74	222	307	362	248	148	74	104
Assets	133	1,679	1,563	1,450	1,431	1,410	1,273	1,279	1,244
Capital Expenditures	80	143	168	197	138	117	52	108	110
Depreciation/ Amortization	78	108	110	101	90	79	77	74	69

C. FINANCIAL RESULTS AND ASSETS BY GEOGRAPHY (millions of US dollars)

1. United States:

	1993	1992	1991	1990	1989	1988	1987	1986	1985
Net Sales	15,362	15,579	15,276	14,962	13,312	12,423	11,805	11,210	10,243
Net Earnings	415	461	1,360	1,304	927	864	354	634	521
Assets	10,027	10,811	10,705	9,742	8,669	8,346	8,483	8,394	6,829

2. International[2]

	1993	1992	1991	1990	1989	1988	1987	1986	1985
Net Sales	6,650	6,211	4,666	9,618	8,529	7,294	5,524	4,490	3,625
Net Earnings	59	263	239	467	417	305	95	143	96
Assets	4,641	4,060	3,524	6,516	5,260	4,751	3,849	3,461	1,946

3. Europe

	1993	1992	1991
Net Sales	9,206	8,371	7,739
Net Earnings	28	362	288
Assets	5,471	6,329	4,171

4. Total[3]

	1993	1992	1991	1990	1989	1988	1987	1986	1985
Net Sales	30,433	29,362	27,026	24,081	21,398	19,336	17,000	15,439	13,552
Net Earnings	269	1,872	1,773	1,602	1,206	1,020	635	709	635
Assets	24,935	24,025	20,468	18,487	16,351	14,820	NA	13,055	9,683

Notes:
1. EBT: Earnings Before Taxes
2. The differences between "Total" and the sum of "1. United States," "2. International," and "3. Europe" are due to corporate allocations.
3. International = Canada, Asia, and Latin America

Sources: 1994, 1993, 1990, 1987, 1985, 1936 Annual Reports, The Procter & Gamble Company, Form 10-K, The Procter & Gamble Company Securities and Exchange Commission, Washington, DC, 1990.

Exhibit 2
CONSOLIDATED STATEMENT OF EARNINGS, THE PROCTER & GAMBLE COMPANY AND SUBSIDIARIES
(millions of dollars except per share amounts)

Years Ended June 30	1993	1992	1991
Income	$30,433	$29,362	$27,026
Net Sales	445	528	380
Interest and other Income		29,890	27,406
Costs and Expenses			
Cost of products sold	17,683	17,324	16,081
Marketing, administrative, and other expenses	9,589	9,171	8,243
Provision for restructuring	2,705	-	-
Interest Expense	552	510	395
	30,529	27,005	24,719
Earnings Before Income Taxes	349	2,885	2,687
Income Taxes	80	1,013	914
Prior years' effect of accounting changes	(925)	-	-
Net Earnings	269	1,872	1,773
Net Earnings Per Common Share*	NA	$2.62	$2.46
Net Earnings per Common Share Assuming Full Dilution*	NA	$2.45	$2.31
Dividends per Common Share*	NA	$1.03	$0.98
Average Shares Outstanding (in millions)*	NA	677.4	689.5

* Adjusted for two-for-one stock spilt effective May 15, 1992

CONSOLIDATED STATEMENT OF RETAINED EARNINGS THE PROCTER & GAMBLE COMPANY AND SUBSIDIARIES
(millions of dollars)

Years Ended June 30	1993	1992	1991
Balance at Beginning of Year	$7,810	$6,775	$6,581
Net Earnings	656	1,872	1,773
Dividends to Shareholder			
- Common	(748)	(694)	(675)
- Preferred, net of related tax benefit	(102)	(94)	(78)
Excess of cost over the stated value of common shares purchased for treasury	(56)	(49)	(826)
Balance at End of Year	$6,248	$7,810	$6,775

Exhibit 2 (continued)
CONSOLIDATED BALANCED SHEET
THE PROCTER & GAMBLE COMPANY AND SUBSIDARIES
(millions of dollars)

Years Ended June 30	1993	1992	1991
Assets			
Current Assets			
Cash and cash equivilents	$2,322	$1,776	$1,384
Marketable securities	306	-	-
Accounts Receivable, less allowance for doubtful accounts	3,111	3,341	3,024
Inventories	2,903	3,311	3,190
Deferred income taxes	740	-	-
Prepaid expenses and other current assets	593	938	837
	9,975	**9,366**	**8,435**
Property, Plant, and Equipment	9,485	9,696	8,273
Goodwill and Other Intangible Assets	3,762	3,861	2,882
Other Assets	1,713	1,102	878
Total	**$24,935**	**$24,025**	**$20,468**
Liabilities and Shareholders' Equity			
Accounts Payable - Trade	$2,269	$2,323	$2,045
Accounts Payable - Other	642	587	375
Accrued Liabilities	2,838	2,115	1,807
Taxes Payable	726	615	537
Debt due within one year	1,812	2,002	1,969
	8,287	**7,642**	**6,733**
Long-term Debt	5,174	5,223	4,111
Other Liabilities	3,550	606	578
Deferred Income Taxes	183	1,483	1,310
	17,494	**14,954**	**12,732**
Shareholders' Equity			
- Convertible Class A preferred stock	1,969	1,986	1,995
- Common stock - shares outstanding*	682	679	338
Additional paid-in capital	477	366	609
Currency translation adjustments	(99)	112	(56)
Reserve for employee stock ownership plan debt retirement	(1,836)	(1,882)	(1,925)
Retained Earnings	6,248	7,810	6,775
	7,141	9,071	7,736
Total	**$24,935**	**$24,025**	**$20,468**

* Adjusted for two-for-one stock split effective May 15, 1992.

Exhibit 2 (continued)
CONSOLIDATED STATEMENT OF CASH FLOWS
THE PROCTER & GAMBLE COMPANY AND SUBSIDIARIES (millions of dollars)

Years Ended June 30	1993	1992	1991
Operating Activities			
Net Earnings	$269	$1,872	$1,773
Provision for restructuring	2,705	-	-
Depreciation, depletion, and amortization	1,140	1,051	956
Deferred income taxes		125	(34)
Change in accounts receivable		23	(428)
Change in inventories		160	(334)
Increase in Payables and accrued liabilities		45	305
Change in other liabilities	67	(48)	-
Other	79	(206)	(169)
	4,260	**3,022**	**2,069**
Investing Activities			
Capital Expenditures	(1,911)	(1,911)	(1,979)
Proceeds from asset sales and retirements	725	291	182
Acquisitions	(138)	(1,240)	(386)
Changes in marketable securities	(306)	-	-
	(1,630)	**(2,860)**	**(2,183)**
Financing Activities			
Dividends to shareholders	(850)	(788)	(753)
Change in short-term debt	(277)	(156)	988
Additions to long-term debt	1,001	1,608	297
Reductions of long-term debt	(939)	(433)	(604)
Issuance of preferred stock issues	-	-	1,000
Proceeds from stock options	77	71	-
Purchase of treasury shares	(55)	(49)	(837)
Effect of Exchange Rate Changes on cash and cash equivilents	(119)	(26)	-
	(1,162)	**227**	**91**
Increase (Decrease) in Cash and Cash Equivilents	**$1,468**	**$389**	**($23)**

Sources: 1990, 1989 Annual Reports, The Procter & Gamble Company.

Exhibit 3
MACROECONOMIC DATA ON EAST EUROPEAN COUNTRIES

GDP[1]	Bulgaria	Czechoslovakia	Hungary	Poland	Russia
1985-1988	3.7%	2.5%	1.0%	3.8%	2.5%
1989	-0.3	2.4	0.4	0.2	1.6
1990	-9.1	0.8	-3.3	-11.6	-4.0
1991	-12.0	-14.9	-10.0	-9.0	-17.0
1992	-8.0	-7.0	-5.0	1.0	-20.0
1993	-4.0	-1.0	-1.0	4.6	-12.0
1994*	-4.0	-1.0	-1.0	4.6	-9.0
Poverty[2]					
1989	-	5.7%	10.1%	20.5%	27.1%
1991	-	19.4	21.3	38.8	28.7
1992	62.7%	18.2	-	42.5	77.1
Real Income[3]					
1989	100	100	100	100	100
1991	58.5	88.5	96.5	71.8	105.3
1992	60.8	94.0	91.8	70.3	61.7
Unemployment[4]					
1990	1.6%	-	1.6%	6.1%	0.0%
1991	11.7	-	7.5	11.5	0.0
1992	15.0	3.0%	12.0	15.0	1.0
1993	17.0	3.5	12.0	17.0	1.0
1994*	17.0	8.0	13.0	16.0	6.0
Inflation					
1990	26.0%	-	28.0%	585.0%	5.0%
1991	334.0	-	35.0	70.0	103.0
1992	90.0	11.0%	23.0	43.0	2,000.0
1993	64.0	18.0	23.0	37.0	1,000.0
1994*	75.0	14.0	21.0	28.0	400.0

* Estimated -- Some figures are the average of the OECD and *The Economist Intelligence Unit* forecasts.

Notes:
1. Annual percentage change in per capita real GDP in Bulgaria, Hungary, and Russia and the population has declined slightly since 1989. Pre-1989 data are for Czechoslovkia.
2. Percentage of Households earning less than 45% of 1989 average wage (35% for Czechoslovakia)
3. Index of per capita real income: 1989 is the base year.
4. If those working on partial shifts and those on paid or unpaid leave are included, 10.4% of the labor force is either unemployed or partially employed.

Sources: OECD, The Economist Intelligence Unit, 1993, 1994; UNICEF, 1993; World Bank, 1993; Lipton & Sachs, 1992; Mokrycki, 1993; Surdej, 1992; Klusak & Mertlik, 1992; and Brady, 1993.