

**Buckinghamshire Chilterns University College  
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# **MBA**

**Listing on the Budapest Stock Exchange:  
'Clear strategy or just empty words'?**  
(Financing alternatives the Hungarian economy offers for  
growing companies)

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## TERMS OF REFERENCE

Hungary was a steadily developing country, with advanced economy during the 19th Century, which unfortunately failed to continue after the World Wars, due to the economic mechanism of socialism. Following a step-by-step destruction of the “regime” and the transition in 1990s, it returned to the market economy, as a young student.

Nowadays the companies facing competitors based in highly developed economies are not merely fighting for survivor, but we can also find some prosperous enterprises among them. In this battle, financing can be an important weapon.

### *Objectives*

The dissertation aims at analysing financing opportunities available for Hungarian companies and suggests improvements – where necessary – in securing a healthy business climate. Central questions are grouped in the following way:

- Based on wide range of theoretical literature and international examples: *‘What kind of financing alternatives are suggested for consideration?’*
- A considerable part is selected for deeper analysis: *‘How the Stock Exchange can help companies - directly or indirectly - in obtaining the necessary financing? Why listing is so important (beyond financing)?’*
- Following the ‘offers’ collected and described, the focus shifts to see: *‘How the various market players see the Hungarian financing trends?’*
- Finally to draw conclusions and make recommendations to summarize Hungarian trends and highlight the present difficulties the companies experiencing, together with the possible helping solutions.

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## EXECUTIVE SUMMARY

The Stock Exchange has always stayed close to my heart and that might be the reason why I write about this topic. I consider this the top of financing. However it is still in its teenage years in Hungary (again), and will celebrate its 16<sup>th</sup> anniversary this year (although it prospered 100 years ago). The same applies to the economy, for the companies and business culture.

In my hypothesis I intended to study how reasonable it was for companies to list their shares on the Budapest Stock Exchange (BSE). Based on the theoretical knowledge I acquired during my studies, I investigated the events of the previous years (from the transition), to understand how the Hungarian companies have developed. Theories of Corporate Strategy proved why they lag behind the leading Multinational Companies (MNC) - based in developed countries. It is not surprising; this is the way financial evolution evolves.

When I turned my attention towards financing questions I realized that far more financial methods are available in the modern financial world, unlike in Hungary, where it can be quite problematic for companies to get access to ideal means of financing. Several alternatives are not yet available (like corporate bonds), banks seldom offer attractive terms, while for capital holders the Hungarian companies are too small in size.

Thereafter, I deeply analysed the pros and cons of having a company's shares listed on the Bourse. My recommendations were based on several international examples; furthermore, various articles have been studied carefully in order to bring the 'Market' closer for the potential candidates.

When asking the question about the reasonability of listing, I would definitely say YES, but under certain conditions. However these conditions are hardly satisfactory in Hungary. Since some announcements of interested companies made 2 years ago, only one company actually made the step, while two others are close to it. The outcome responds to the main question: rather empty words than clear intention.

It would be better to see more listings, but these are not only the companies who are responsible for the failure. This question should not be isolated from the companies' development in general, their financial and strategic culture; the missing parts of the financial system is also an important consideration along with the Budapest Stock Exchange's position and ability to fulfil the main role of capital mediation. These are all inter-related and analysed during the Dissertation to understand the background of the present situation.

Regarding economic trends, there is no problem at all, as Hungary has just entered the EU (1<sup>st</sup> of May 2004) and has been developing in a fast pace (around 4% annual GDP growth), while the money supply is plentiful on the markets, and investors prefer the country. The last is mainly due to some real success stories: Hungarian oil company MOL and bank giant OTP are considered as regional MNCs, and can be measured on an international scale too, as they both exceeded the value of 10 Billion USD in capitalisation. They were state owned socialist companies not so long ago, but now they are well-managed, competitive and attractively profitable, while also leaders in the regional consolidation.

So there are some promising trends, however at the end of this work I listed the main obstacles the companies face when looking for the optimal means of financing. Various financing alternatives exist and they number increases over time. Nevertheless, it is still problematical for the companies to find the appropriate one, because in the financial world 'all road leads to the Bourse' and the Hungarian Bourse is undeveloped in some way. The main concerns are discussed in the 'Conclusions and Recommendations' section, to list the obstacles and to give suggestions on how to improve the unfavourable present conditions.

MOL and OTP are the few exceptions compared to the big average and great efforts have to be done to repeat their success. I believe, the performance of a country's economy depends on the achievements of its' companies. In my Dissertation I have collected various international examples, formulated new ideas to help repeating the achievements of MOL and OTP, as Hungary needs to keep its illustrious position in the Central-Eastern European Region.

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## CHAPTER 1 - INTRODUCTION

### *The History of the Hungarian Economy*

For some people living in an old and matured democracy it is difficult to understand why the market economy is not enough developed enough in other countries, even more interesting to see how the emerging markets has developed, how they functioned earlier. It will help understanding the difference is not as high as it was thought at first sight.

#### **Transition and Democracy**

In 1989-1990 the socialist system collapsed and setting the foundation of a stable democracy started. Democratic institutions were established and new Acts were passed such as the Company Act, Privatisation Act, and Bank Act that allowed returning back to market conditions. The Budapest Stock Exchange also reopened its floor (the summary of it's history is available in [Appendix 1.](#))

The country was very successful in building up the democracy and the open market economy and as of 1<sup>st</sup> of May 2004 is the member of the European Union.

The country became one of the well-developed, praised countries in the region. In 2004 for example 4% GDP growth was reached, while in the next year the projections are about to exceed this level. Further Economic Indicators can be found in [Appendix 2.](#)

### *The Creation of Private Companies (The Privatisation)*

Market economy cannot exist, if the state ownership is general, which was the case in the early 90s with more than 85% state share. There were 3 ways to change this:

- Promote starting private enterprises with privatising state ownership
- Supported “green-field” investments
- Joint ventures

Unlike the surrounding countries, Hungary has chosen the ‘market’ friendly way of privatisation, not selling the wealth for ‘coupons’ like other CEE countries (despite it was far more popular among citizens). The reason behind was, that the investor who risks its money too, has more interest in using the acquired assets in a profitable way.

The process is getting close to its end with a private ownership in the economy over 80%. There are around 100 state owned companies from which some 30-40 are strategically important. In general we can say that the priorities of privatisation listed in [Appendix 3](#). were met. (Some figures and facts can also be found there.)

This period also made it possible for people, who were well informed and had good entrepreneurial spirit to get possession of some prestigious companies (those were in dangerous financial situation). They bought them for a fraction of investment and the rapidly reviving economy with more financial possibilities along with quickly developing property market (as the companies possessed lot of good properties) made them rich in a short time. This was the time when the new aristocracy and entrepreneurs were born.

## ***The Growth Phase (Stabilisation)***

### **Growth of SMEs**

According to the course material of Business and Management in Central and Eastern Europe<sup>(1)</sup> there are four models describing small firms’ development, that is a very good summary of the events in Hungary:

- The Boston Model: large companies are creating demand for goods and services because their focus is on the core activity. The increasing demand leads to a growth of this sector.
- The Birmingham Model: because of the collapse of several industries and firms, the ex-employees became entrepreneurs to avoid unemployment.
- The Bologna Model: regions are playing role in creating good atmosphere for small firms in collaboration and inter-firm rivalry. They share knowledge and expertise, supported by public and professional organisation (closest to this

model is the present reliance on health tourism, where thermal bathes, hotels, restaurants and authorities are co acting to offer attractive recreation programs).

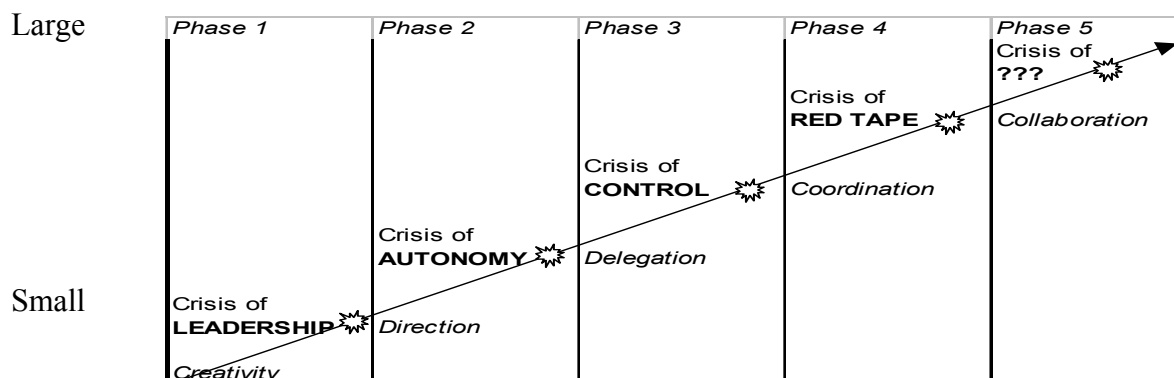
- The Budapest Model: this is characterised by the large number of new firm creation due to both the depression of the transition in the economy and the generation of new opportunities in previously tightly regulated markets.

Following the creation of the first private companies, they produced stable growth, despite several obstacles (Asian and Russian crisis, economic problems). The growth of the economy, the declared state support to entrepreneurs (subsidies, credit facilities and tax allowances) and the peaceful period allowed them to develop continuously. New ideas were realised in new products or in services and new markets were conquered along with the organic growth. Managers quickly learned (through trial and failures) how to run an enterprise, how to live in market conditions.

The growth was also a must for these companies, as they have to reach the economically optimal size, have to face with the strong competition of multinational companies or simply to survive. Of course some enterprises are not willing to exceed a level and want to defend only the positions (mainly small retailers, producers), but they are not discussed in this study.

Herewith it is necessary to add, that Hungarian companies are not in a very good position if we take into consideration the size of their markets, as the country is relatively small in size compared to most of the developed countries, and it is especially painful when we are counting with the strength of the economy (good measurement can be the size of the GDP, which is even smaller then the value of some MNCs).

*Table 1: Greiner Model describes the phases of growth*



*Table 2.: Phases of Development:***Phases of Development**

	<i>Phase 1</i>	<i>Phase 2</i>	<i>Phase 3</i>	<i>Phase 4</i>	<i>Phase 5</i>
<b>FOCUS</b>	<b><i>Make and Sell</i></b>	<b><i>Efficiency</i></b>	<b><i>Market Expansion</i></b>	<b><i>Consolidation</i></b>	<b><i>Problem solving, Innovation</i></b>
<b>STRUCTURE</b>	Informal	Centralized, functional	Decentralised	Line-staff, product groups	Matrix teams
<b>MANAGING STYLE</b>	Individualist, entrepreneur	Directive	Delegative	Watchdog	Participative
<b>CONTROL SYSTEM</b>	Market results	Standards, cost centers	Reports, Profit centers	Plans, Investment centers	Mutual goal setting
<b>MOTIVATION</b>	Ownership	Salary and rank	Individual bonus	Profit sharing, Options	Team bonus

The above two charts from Greiner<sup>(2)</sup> are showing very well the scope of this assignment. Most of the companies are left behind in the first phase and are mainly in the phase 2-4. Unfortunately there are still a large number of companies is in the first stage, but it is expected that in the long-run more-and-more will reach a matured phase as Hungary has returned to market economy 15 years ago (we can say that this development is very promising; the fact, that the later stage of socialism allowed some entrepreneurial attitude, supported to reach this quick development).

The significance of the mentioned phases will be clearer in the later parts, when their link to financials will be discussed (link between corporate and financial strategy).

**Growth of companies**

Before turning to financial matters, at last I would like to add another part of growing entities. Those are originated in the previous socialist time. They are not starting from zero, but transforming into a company, that can survive under market conditions.

*Table 3.: Stages of Company Development*

<b>Stage of Company Development</b>	<b>Nature</b>	<b>Content</b>
<b>Command Economy</b>	Central decision making by state: limited discretion of enterprises, even less of plants; consensual approach	State: output targets; Enterprise/plant: achievement of output targets and overall goals
<b>Independent existence</b>	Decision-making largely responsibility of top managers	Independent existence of organisation; organisational purpose
<b>Structural adjustments</b>	Top management; beginning of devolution + decision-making hierarchy	Shape and structure of organisation
<b>Inner directedness</b>	Top management; + devolution	Internal upgrading
<b>Outer directedness</b>	Top management + new 'expert' managers from West	Focus on product-market relationship
<b>Explicit formulation of Strategy</b>	Top management preoccupation with strategic decision-making	Strategic issues; identification and evaluation of strategic choices; linkage of strategy and operations

The above chart is showing the development phases, from which the most relevant are the last four. The reason is the involvement of financial decisions, as it is crucial to allow further steps ahead.

Consequently, those companies are in the scope of this study are in a growth phase mainly because of three things:

- Good economic climate with attractive future outlook, along with the membership of the EU (political environment is also favourable)
- Creation of the market economy (out of the previous Command economy) brought structural changes, and allowed companies to live in free market conditions (it creates alone growth opportunities)
- There is an obvious and unquestionable need for development, to conquer new markets, launches new products. The aim for progression (evolution) is also part of the human nature and there are people behind all organisations.

As can be seen from the above charts, these are the phases where the growth opportunities are creating the demand to involve financial decisions, on how to create funds to make them happen. The following parts of the assignment will present the available financial methods and will discuss in details their applicability.

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## CHAPTER 2 - METHODOLOGY

### *Literature Review*

This part as a classical review goes through those publications valuable to take the preliminary steps before making judgement. It is focused on four areas:

- Strategy related publications,
- Financing theories (very detailed to allow good insight into the available tools),
- About the Stock Exchanges, and
- Finally, the theory of the first two together (strategy and financing), completed with the Financial Decision Making part.

During the work some Secondary Research findings were also built into, to allow a complete and detailed basis for further investigation in Research and Conclusion parts. Despite the Review is mixed up with research in some way, it is still easy to distinguish them, as the first is rather providing alternatives, while the later is the materialisation of those, mainly based on international examples.

I would like to underline that the review was not intended to list one theory after another, rather the aim was to put together the summary of the findings, which is also integrated the opinions of others along with the writer's own.

### *Secondary Research*

During the "Desk Research" a wide range of strategies and financial literature were investigated. Not only books, various articles, case studies, company reports or other publications were used, but a considerable amount of other information have been collected, such as: the history, practical guides and publication of Stock Exchanges; analyst and market reports (together with their comments); and a considerable number of articles with relation to listed companies; financial news and economic developments (special thanks to [www.portfolio.hu](http://www.portfolio.hu) because their journalism helped in bringing to light the reasons behind several decisions, happenings).

## ***Primary Research***

The method selected to conduct this part was the interview, simply because the topic itself is forcing soft discussions (more opinions, experience than just statistical figures).

All interviews were started with an e-mail to kindly request the targeted people to help the writer to finalize the dissertation, which is about the so-much interesting topic of 'going to the Stock Exchange' and ask for the opportunity for a maximum 1-hour long conversation. The e-mail also stated why the partner's thinking it was so much interesting from not only the study, but also from the Hungarian economy's point of view.

Finally a letter was attached to the mail containing:

- A short introduction to excite the curiosity of the partner (I am sure that most of them read only these few sentences),
- The agenda (stating the detailed schedule – to reassure the short time-need)
- The proposed guiding questions.

The pre-work made the interviews successful, easy flowing, honest and opened to express the opinions of the topic, so it contributed a great-deal to form the conclusions.

## CHAPTER 3 - LITERATURE REVIEW

As I wrote in the Methodology, this section will not only ‘rework’ one author after another (however the first, strategic part is like that), but will create a new theoretical guidance around financing, with paying special attention to Hungarian specialities, but does also include international examples.

### *A/ Growth Strategies*

In the previous section I have pointed out that growth or size in itself has strategic implications. According to the Corporate Strategy course handbook<sup>(3)</sup>, “it affects the ability to communicate, social cohesion, alienation, the ownership of ideas”. Besides there are other pressures driven by either shareholders, creditors (mainly banks) or directors, as they are the most powerful stakeholders and they also “programmed” to believe that growing figures are nicer. We also learned the belief of “bigger is better”, however, there is no proof on it, but rather it may reflect to psychological need only.

All these facts necessitate implementing and formulating a strategy. This section will first describe the implications of strategic decisions, especially the impact on or relation to financial decisions. First let’s start with some basic definitions.

According to Henry Mintzberg<sup>(4)</sup> there are 5 definitions of strategy:

- *Strategy as a Plan* - Some consciously intended course of action, a guideline to deal with a situation
- *Strategy as a Ploy* - Set of manoeuvres and actions worked out in advance
- *Strategy as a Pattern* - Consistency in behaviour, whether or not intended
- *Strategy as a Position* - Seeking to locate the organisation in the external environment, with the aim of creating “match”
- *Strategy as a Perspective* - Highlights the ingrained way of perceiving the world

The definition of James Brian Quinn<sup>(5)</sup> shows a different way of interpretation: “A strategy is the pattern or plan that integrates an organization’s major goals, policies, and action sequences into a cohesive whole. A well-formulated strategy helps to marshal and

allocate an organisation's resources into a unique and viable posture based on its relative internal competencies and shortcomings, anticipated changes in the environment, and contingent moves by intelligent opponents.”

- *Goals* - What is to be achieved, but not stated How
- *Policies* - Rules or guidelines that express the limits for the actions
- *Programs* - Step-by-step sequence of actions to achieve major objectives, to express how will be achieved within the limits set by policies
- *Strategic decisions* - Determine the overall direction of an enterprise

Finally to complete understanding, I would like to add the definition from Porter<sup>(6)</sup>:

- “Strategy is the creation of a unique and valuable position, involving a different set of activities.”
- “Strategy is making trade-offs in competing. The essence of strategy is choosing what not to do.”
- “Strategy is creating fit among a company's activities. The success of a strategy depends on doing many things well – not just a few – and integrating them.”

Simply saying strategy is about the intention (of owners), planning (to reach a desired position) and implementation (to make it happen).

It was very important to get through this short discussion about definitions as the title of the dissertation points to strategy making concerns. Afterwards the basics were summarized; the piece of work shall not cover a deeper discussion about strategy, because that would surely turn up into a theoretical book.

### ***B/ Financing Opportunities (capital, debt, bond, private equity) Based on the Financial Literature***

When we are talking about financing the strategically decisions of a company, we should deal with sources of long-term finance. Given the time frame, the objective is to consider the maximalization of shareholders' wealth. So in this section the sources of finance will be discussed in details.

## 1. Retained profit

Firstly mention the retained earnings, the easiest way and the most frequently used method for financing (according to a McKinsey survey<sup>(7)</sup>, more than 50% of companies used this way in the past 10 years in the UK). In this case the owners should make a choice between paying dividend or using the funds for other investments.

From the shareholders' point of view there is a clear opportunity cost, that is the yield of possible other investments. So retained profits can be used for investments where the expected return exceeds the return of alternatives (comparison can be made easily where developed capital markets exist and it is suggested to make benchmarking with the shares of companies from similar industry).

## 2. Debt financing

### 2.1. Bank loan

The most obvious way for a company to increase its funds is to turn to banks for credit facilities. Banks alone or in the form of consortium can provide the money based on the credibility of the company. The terms of the long-term loan (interest, time-horizon, instalments, collateral) are subject to negotiation between the bank and the company.

The prudence requirement of banks (as they are using the debtors money) makes it necessary to limit their risk taking, so they are willing to finance a company up to the limit of the credit-debit ratio. Therefore the usage of this method is limited and can be a barrier if a company would like to take a significant step in growth (like acquisition). As the mentioned ratio is increasing, the interest premium tends to be higher and higher.

Banks are also having requirements in their control-system for further indicators, to assure the return of money. These requirements are decreasing the flexibility of companies (start-ups, new ideas are difficult to be financed through this way).

### 2.2. Corporate Bonds

These are similar to bank loans but taking the form of a security. This way the provider of the money is not limited to banks, or financial institutions, but this instrument is available for the general public too.

There are several bond types existing, like secured bond, debentures (non-secured), subordinated debentures, callable bonds (convertibles will be discussed later).

More details can be found in the book: Financial Markets (1998), Saldo (pages 36-60)<sup>(8)</sup>.

Bonds usually have a secondary market (exchange, OTC) to allow trading with the debt. Because of the wider involvement of equity providers, more information have to be submitted by the company and also stricter rules have to be followed (the Financial Supervisory Authority is approving the process). It can cause higher cost to the company, when choosing this type of financing.

In case of issuing bonds, the involvement of a financial institution is a pre-requisite so asking a bank or rather an investment bank is unavoidable. They are able to organize the whole process on behalf of the company.

### 2.3. Term loans

These are negotiated between the borrowing firm and some financial institution (banks, insurance companies).

They differ from bonds in that they are not usually transferred from lender to lender in the way bonds typically are (not traded) so the regulation is not as tight. However the conditions are nearly the same as in the case of a bond or bank loans.

### 2.4. Subsidized loans

Besides traditional loans there are wide possibilities to access loans with better conditions than those provided by banks. These facilities mainly offered by special institutions backed by a country or other organisation (like institutions of the EU).

The followings offer such solutions, from which the last two is relevant for sizeable projects not for the general finance of individual companies:

- MFB (Hungarian Development Bank): providing a wide range of loans in several categories. The bank not only provides loan, but also subsidizes and equity (will be discussed later). (More info can be found on [www.mfb.hu](http://www.mfb.hu))
- Eximbank: special bank with the aim of promoting export activity of Hungarian companies. Provides credit for exporters, customer-loans, project financing, guarantees, and forfeiting, risk-sharing products. ([www.eximbank.hu](http://www.eximbank.hu))

- EBRD (European Bank for Reconstruction and Development): The EBRD provides loan and equity finance, guarantees, leasing facilities and trade finance in CEE and CIS. The Bank also finances professional development through support programmes. Mainly concentrating on larger projects. ([www.ebrd.org](http://www.ebrd.org))
- EIB (European Investment Bank): The task of the European Investment Bank, the European Union's financing institution, is to contribute towards the integration, balanced development and economic and social cohesion of the Member Countries. To this end, it raises on the markets substantial volumes of funds, which it directs on the most favourable terms towards financing capital projects according with the objectives of the Union. ([www.eib.org](http://www.eib.org))

### *2.5. Special means of debt financing*

There are some further ways available to collect the necessary funds. These will not be discussed in details, only listed with some comments to make the possibilities complete:

- **Leasing**: special type of credit, when the company hire an asset instead of purchasing that (operating lease); or identifies an asset in which it wishes to invest and seeks a supplier of finance to buy it (finance lease). These can reach a significant level too, like leasing a plant, vehicle-fleet, properties, and machines.
- **Grants**: companies acting in industries considered publicly important, or investing in subsidized areas can receive financing from the state or from EU funds. These are sometimes non-repayable, but generally are providing more favourable conditions than those of market based.
- **Factoring**: offers a special way of financing, through selling future payments of customers for present cash (increasing cash at the expense of debtors). Rather short-term facility, but in some case it can be used in the financing-pool.
- **Credit guarantee**: Hitelgarancia Rt. was established in 1992 by the Hungarian state and Hungarian commercial banks as a well-capitalized company in order to support the access of domestic small- and medium sized enterprises (SMEs) to loans and bank guarantees by means of granting them unconditional payment guarantees (sureties). The scheme makes it possible to obtain loans / bank guarantees for those viable undertakings which are not in a position to present acceptable covers for getting a credit and, consequently, the bank - without the strengthening or supplementation of the cover available - would consider lending money too risky (more information can be found on [www.hitelgarancia.hu](http://www.hitelgarancia.hu)).

### 3. Equity financing

Here below I will comprehensively discuss this method, as the dissertation wishes to address the question whether listing is a good alternative or just a good idea?

What if a company has used up the available retained earnings and the banks provided the maximum available loans but there is still a need for money, or let's assume a company is foreseeing a very attractive business opportunity, that is requiring relatively high investments. It can also happen, that a company is not able to meet the banks' requirements (we know that banks are using the money of debtors – so the prudence requirement forces a limited risk taking), or the growth opportunity makes necessary to think in different dimensions (the new business would exceed the size of the existing).

This is the point where a company should start thinking about raising funds through equity offering. Either existing owners or new investors (public) can provide the necessary capital.

There are several forms of doing it, but I would like to deal with stocks (shares) only.

#### 3.1. Ordinary or Preference shares

The two basic types of shares are the ordinary share that is a simpler form of ownership and preference shares.

In the first case the owner is entitled for taking advantage from the success of the company through getting dividend or from the increasing value of the company (according to the percentage of the ownership). It is also important to mention that the share attributing residual claim (the owner entitled at last for the assets of the company, only after other employees, tax authority, creditors...) but the shareholder's liability is limited to the invested amount.

The preference share (has similarities with both bonds and ordinary share) is different in risk taking from the previous, as the owners of it have the right to the first slice (of predetermined size) of any dividend paid and also before ordinary shareholders in the liquidation row. Very often, less voting right is the compensation for the smaller risk. More recently they seem to have fallen from favour and have tended to be of very little importance. That is the reason for using share in latter parts will mean ordinary shares and I will note where there is a clear opportunity for alternatives.

### 3.2. Equity providers

The potential investor can be:

- Existing shareholders
- New investors (further classification is essential)
  - Acquisition
  - Private Equity / Venture Capital
  - Public offering
  - IPO

#### **3.2.1. Acquisition**

The owners of the company can decide on selling a stake in the company (or the whole). The reason behind can be the growth itself, when a company reaches a size, where the existing owner(s) realizes the limitations in managing the company, or threatened in the ability of defending the reached market position. The accumulated knowledge of the employees, the market position, the brands, the markets, customers are representing a value, sometimes difficult to conquer by new participants on that market. So it can be easier for the buyer to acquire an existing infrastructure and capitalize on it before moving ahead.

The owners can retain part of their previous holding, while the necessary funds are also available to finance investments. Multinational companies are the primary participants, but sometimes it can be difficult to find the investors and convincing them to act. It is also worth mentioning that during economic boom the appetite of multinationals are big, they possess high amount of capital looking for opportunities (and also willing to pay higher price), while during recession times it is difficult to make such deals.

#### **3.2.2. Private Equity / Venture Capital**

As PE/VC goes beyond a simpler shareholding role, I will discuss it in the next part among combined financing methods.

#### **3.2.3. Initial Public Offering (IPO)**

Similar to the next one, but the difference comes from the fact, that the company is not yet listed on the stock exchange before the transaction. This is a long process including the involvement of the public in providing the necessary funds to the company and initiating the floating of the shares on the 'floor'.

The whole process is well regulated to create a transparent transaction, where the IPO is approved by the Financial Supervisory Authority (called PSZÁF in Hungary) and the listing is subject to meet the rules of the selected Stock Exchange (in Hungary there are 2 sections for the companies with different requirements; further information regarding BET regulation can be found under [www.bet.hu](http://www.bet.hu), English version is also available).

### 3.2.4. Public offering

It is again not so much interesting because of the scope. Those companies are already listed can turn to the potential investors in the form of public share offering to get the necessary financing (existing owners are entitled to buy before new investors). The management are aware of how to do it, and usually investment banks are organising it.

The most important consideration should be the cost of capital, as the share capital tends to be the most expensive way of financing.<sup>(10)</sup>

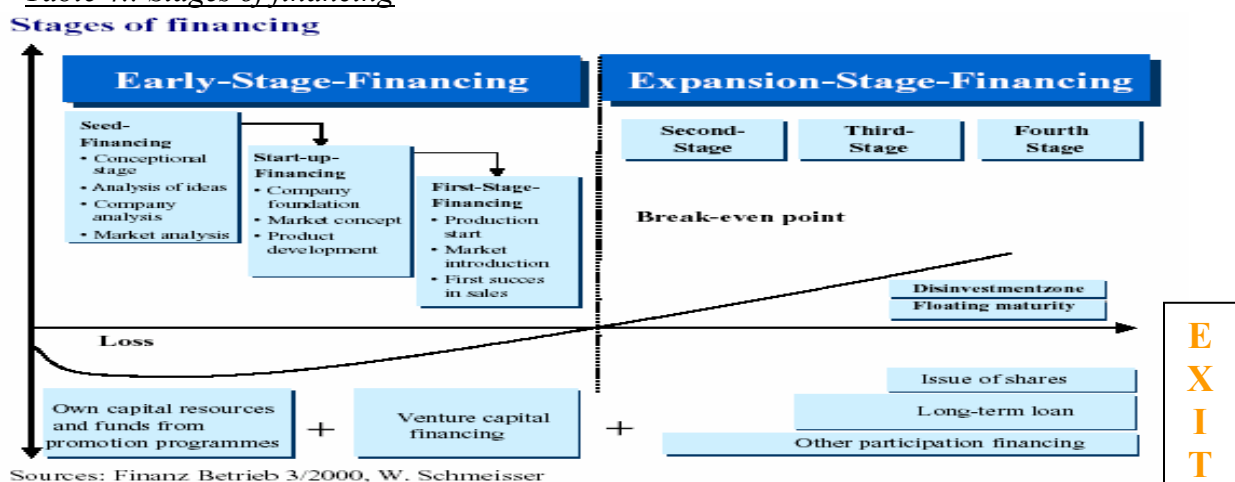
## 4. Combined financing opportunities

### 4.1. Private equity / Venture Capital

"Money and resources made available to start-up firms and small businesses with exceptional growth potential."<sup>(11)</sup>

These are mainly "semi-finished" or "embryonic" companies which involve private equity into the financing. It means those can be start-ups (just getting started based on a good idea, but with good outlook) or companies which have not yet reached a saturated position. They become owner of the firm, not a creditor! It can be venture (Venture Capital) or non-venture, while some writers distinguish Private equity and Venture capital, but herewith I do not, as there are only marginal and non-relevant differences.

*Table 4.: Stages of financing*



In general, these investors are acquiring a stake (either majority or minority) along with assurance of involvement in decision-making. In most of the cases they not only offering equity but also helping the creation of a good capital structure with also organising, negotiating, but not providing favourable debt equity and short-term facilities, as they are specialists of finance, as opposed to those of the existing management are good mainly in the business (frequently with rather technical orientation).

Besides financial advisory, they are contributing in management, marketing, sales or in other areas. The reason behind, they are focusing on industries (specific knowledge), or have some functional experts on board, who can provide professional advice.

Generally the transaction has five stages from the Venture capitalist point of view:

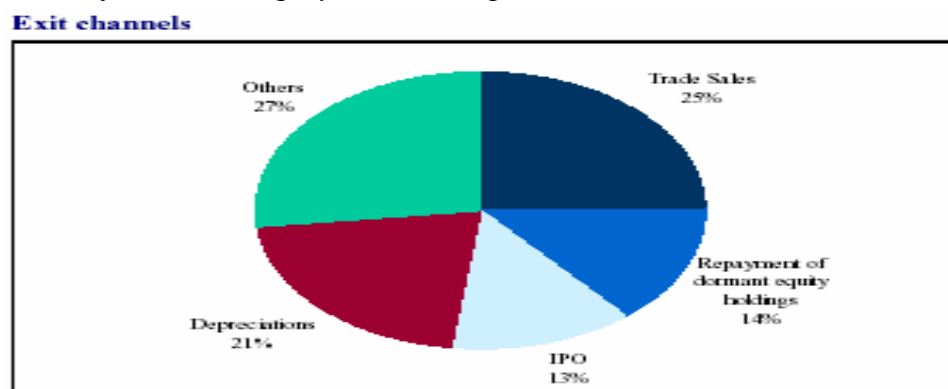
**Looking for investment opportunities — Valuation —  
Negotiation and signing the contract — Monitoring — Exit**

The close cooperation between the owners is essential, as the interest is common:

- ❖ Developing the company (investment, reorganization, managing)
- ❖ Meet strategic intent (as the financial need occurs to finance the growth!)
- ❖ And last but not least to increase its value.

The time-frame for such transactions are mainly 3-5 years, right after the equity provider is willing to realize the hopefully high return on the investment. There are several exit alternatives, from which in the US the IPO is the most common with 65% share, while in Europe it is different as it can be seen from the below chart:

*Table 5.: Exit channels for Private Equity/Venture Capital Funds*



Source: Fast Venture B. V. (Venture Capitalist)

#### 4.2. Structured finance

*"A service offered by many large financial institutions for companies with very unique financing needs. These financing needs usually don't match conventional financial products such as a loan. Structured finance generally involves highly complex financial transactions."<sup>(12)</sup>*

As the definition suggests, it's highly complex nature limiting the popularity of this form, and can be suggested for sizeable companies and in cases where the operation are covering wide geographical areas or it is used as a complex solution for special transactions (like air-line ticket settlement). It can take several forms like asset-backed, mortgage-backed, re-securizations, collateralized debt obligations (CDOs).

I would not suggest it for Hungarian corporation, as it would also require really professional financial background, which is not yet common, and the associated costs are really high due to the necessity of involving several experts (not only financials, but e.g. international lawyers too).

Those are interested in this form, I would suggest studying some available publications on the internet like [www.giddy.org](http://www.giddy.org), or contact institutions are specialized in this field (an example is Dewey Ballantine's Structured Finance Group, can be reached on [www.deweyballantine.com](http://www.deweyballantine.com)).

#### 4.3. Mezzanine

*"1. A type of equity financing used in takeovers. It uses preferred shares and convertible securities to make a target firm larger.  
2. Financing that combines debt and equity."<sup>(13)</sup>*

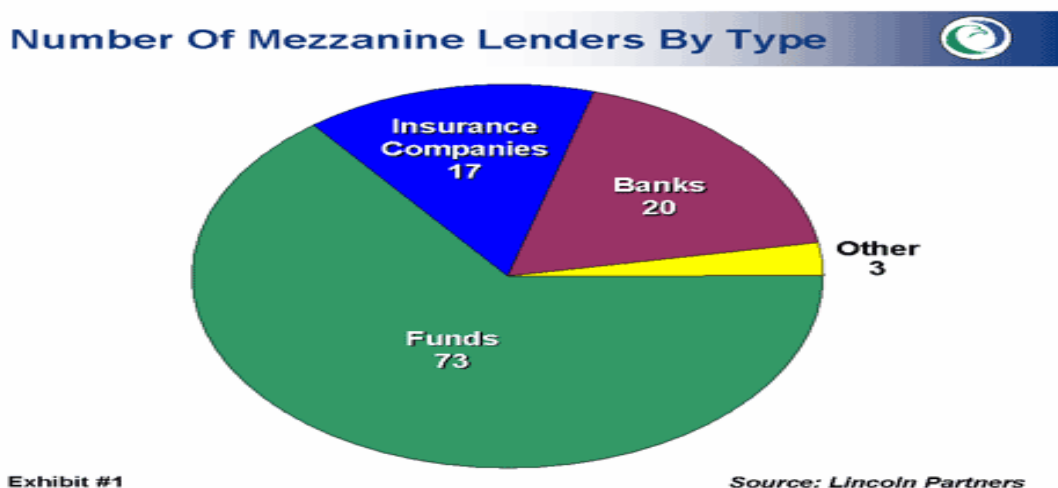
Existing lines of credit have been reduced. New loans from traditional lenders are harder to obtain. Access to the public capital markets is virtually non-existent and the economic downturn has been financially challenging for many businesses. Where then, in these times, does the typical middle-market company turn for capital? Increasingly the answer may be mezzanine financing.

A hybrid form of capital, the mezzanine financing is sandwiched between senior debt and equity on a company's balance sheet (this is the main difference from Venture Capital, where only equity is provided by the fund). Structurally it is subordinated or "junior" in priority of payment to senior debt, but senior to common stock or equity.

Mezzanine capital is typically used to fund a growth opportunity, such as an acquisition, new product line, and new distribution channel or plant expansion. Although it makes up a small percentage of a company's total available capital, mezzanine financing has become critical to middle-market companies in developed countries.

"The biggest benefit mezzanine debt provides is reducing the amount of equity required in the transaction," says Tim Shoyer<sup>(14)</sup>, Fleet Securities managing director of high-yield and mezzanine debt. "Mezzanine investors are looking for an 18 to 20 percent IRR (internal rate of return) compared to 25 to 35 percent for equity investors, so it's more cost effective."

*Table 6.: Number of Mezzanine Lenders By Type*



Unfortunately Hungarian providers are not yet available, but thanks to globalisation and Hungary's EU membership status, it can be easier to get access to foreign Mezzanine providers in the future.

#### 4.4. Special instruments

The development of financial culture created several hybrid instruments to satisfy some needs from both the investor or on the capital receiver's side.

##### **4.4.1. Convertible bonds**

Special bond security, that is not only paying interest but making it possible for the bond holder to decide on converting the debt into equity on a predefined date and price. The advantage for the investor is to make higher return if the share price goes up (because of

the profitability of the company or better outlook) as a compensation for helping to finance the company. The issuer is also taking advantage out of this form, as the interest paid is lower, because the investor is paying for the opportunity to convert it into share. It is especially attractive for smaller companies (or start-ups) because it offers a safer way (for the investor) to finance a company, while the capital can be increased as well.

#### **4.4.2. Option bonds**

Similar to the previous one, where it offers an option for the creditor to participate in raising the registered capital of the company within a period of time.

#### **4.4.3. Warrants**

Warrants are loan stocks that give the holder the right to subscribe for share at some time and price, in some predetermined quantity. They differ from convertible bonds only in that the warrant is not exchanged for equity as in the case of convertibles. In itself it also creates additional funds for the companies (firstly the income for the Warrant, later the participation in capital increase), however it is exceptional in Hungary.

#### **4.4.4. Others**

Finally I would like to mention a special type of private equity that is not really private. The reason is the provider itself, that can be a state funded organisation (mainly a venture capital fund) or an international organisation (e.g.: EBRD /European Bank for Reconstruction and Development/). There has been lot of examples in the previous 15 years where the latter types were involved in the privatisation process.

It is far more important to discuss the Hungarian means of opportunities. The reason for creating such organisations were to support to create a stronger SME sector, that is essential for a well functioning economy (in the globalised world it is dangerous to depend on some huge international corporations, those can leave the country quickly if they can find better conditions elsewhere, shocking the area of previous operation with high unemployment, falling tax revenues). Generally the state wanted to provide capital not only in the form of credit, but in form of capital and with better conditions compared to private equity providers.

According to some survey the biggest problem for the companies now, is not to get bank credit, but to access capital; so it is a reasonable idea to support them.

There are five separate organisations with different aims, size of available capital (official name is provided in brackets):

1. *For Supplier companies (Beszállítói Befektető Rt.)*

The aim is to create/strengthen a local supplier base that can meet the often-costly requirements of MNCs, finally exchanging import for local production.

2. *For IT companies (Informatikai Kockázati Tőkealap-kezelő Rt.)*

It is a program where the equity provider is a Specialised Venture Capitalist, with interest only in IT and Telecommunication.

3. *For small companies (Kisvállalkozás-fejlesztő Pénzügyi Rt.)*

Mainly specialized on smaller companies (the invested money was between EUR 120K – EUR 310K), with some preferred industries (export, service oriented; dealing with tourism, IT, energy-efficiency, environment, but finance and agriculture is not allowed). It is worth mentioning that there were banks among the founders of the organisation with the aim of creating business opportunities.

4. *For Capital exporters (Corvinus Rt.)*

The aim is to support Hungarian corporations in starting businesses abroad, allowing easier market acquisition or creating better competitive position due to favourable cost position (mainly CEE investments has been financed up to now).

5. *For Bigs (Magyar Fejlesztési Bank Rt.)*

Totally EUR 160 Million is available to finance bigger programs.

The primary source of the above information was the publication of István Binder. <sup>(15)</sup>

*Table 7.: State-owned Venture Capital Funds*

Name of the org.	Address	E-mail
<b>Beszállítói Befektető Rt.</b>	1085 Bp., Baross u. 22-26.	-
<b>Corvinus Rt.</b>	1065 Bp., Nagymező u. 46-48.	info@corvinus.hu
<b>Informatikai Kockázati Tőkealap-kezelő Rt.</b>	1085 Bp., Baross u. 22-26.	ikta@rfh-rt.hu
<b>Kisvállalkozás-fejlesztő Pénzügyi Rt.</b>	1053 Bp., Szép u. 2.	info@kvfp.hu
<b>Magyar Fejlesztési Bank Rt.</b>	1051 Bp., Nádor u. 31.	bank@mfb.hu

Source: Organisations' communication

## *C/ The role of the Stock Exchange in the Economy*

A well-functioning Stock Exchange is a measurement of the countries' development. It is not only indicating the health of the economy, but is also playing an active role in providing finance for the companies. As showed in the previous sections debt financing is only a fraction of the tools, more-and-more instrument, and method requires the Market. We also saw, that for Private equity providers (even International institutions, or state founded funds) the Stock Exchange is also needed as an exit opportunity. What's more, in the US - regarded as the most advanced financial cultural country - IPO takes more than 65% share out of exit alternatives.

When the BSE reopened its door in 1990, the founders declared the intention that the Exchange should:

- Promote efficient capital flow,
- Speed up privatisation,
- Close up international capital market's standards,
- Create investors confidence in the economy and market,
- Allow realistic valuation of assets, capital,
- And finally the creation of a controlled and open market mechanism.

So there is no question about it, Stock Exchange plays crucial role in the economy. It was especially important to mention, because Hungary has not yet developed enough, nor the political willingness is clear-cut in supporting it to fulfil its desired position. Politicians tend to forget, that strong economy does not exist without strong SME sector, nor without those locally based corporations are able to compete on the world market. Dependence on MNCs is risky, as the capital can move out of the country fast, if better conditions are available elsewhere. Obviously local players cannot do the same as local establishments, connections are fundamental for them.

Stock Exchanges from the economy point of view are assisting well the creation of such a strong sector. From the companies' point of view, there are several other reasons to consider it important. This will be described in this part.

## **Advantages of listing**

It is reasonable to discuss in details the pros and cons of listing from the companies' point of view. It will also establish the theoretical background of listing related questions before the interviews.

According to some definitions, the Stock Exchange is the most advanced type of market, where lot of market participants are represented; prices and information are widely available.

If we discuss the Market from a company point of view, we can list several reasons why listing is advantageous.

### *1) Advantage in Financing*

The most obvious advantage in financing is the fact that the company gets the required financing, when the investors are buying the shares. If we go further, there is an advantage because of the induced investor interest is higher, due to the prestige of the market (resulting lower capital cost, higher share price).

The company itself can also win better judgement, a position that is also easing the cost of financing (better rating, lower interest rates) or simply can access more funds (access to debt capital is also easier).

The market presence can give a long-term financial advantage as well, because it will be also relatively simpler to access additional financing if a good opportunity is given in the long-run (e.g.: acquiring a new company, stepping into a new business or simply accelerate growth.)

### *2) Advantage in Controlling the Company*

It offers further opportunities, like deciding on the nature of the investor. Sometimes a financial investor is preferred to retain control over the company, unlike selling shares to investors willing to participate in decision-making. It is especially important, when we consider the fact that money providers are tending to prefer investments where they are controlling the company due to safety reasons. In case of listing, it is possible to keep control with a low percentage

controlling stake, because other shareholders do not possess the same amount of shares alone, but usually a lot of individual investors are providing fund with relatively low percentage of ownership.

The floatation eases both solutions, because the company is visible, more transparent so the potential investors can make a 'safer' investment.

### 3) *Advantage in Liquidity*

The liquidity of the shares is increasing the safety for investors to sell the stake in the company and also help reaching a realistic price. Simply saying they are also braver to buy, because an exit opportunity getting easier compared to a simple ownership in a private company.

### 4) *Easing the Liquidation*

In case of the founder(s), some employees with shareholding, venture capitalists or other investors are willing to realise part of their investments they can do so far more easily than in case of a non-floated shares.

I would like to add the present difficult situation in Hungary, because there are only a few IPOs are foreseen, while the venture capitalists or the state founded formerly mentioned institutions are seeking ways to realize some earlier investments. The market is not yet developed enough, nor is there enough free capital available for such transactions.

### 5) *Marketing*

The listing itself is a good PR campaign for the company. Its significance is difficult to measure, but it creates several articles at the beginning and continuously in the media (not only financial media, but others are following the market happenings), while huge amount of possible consumers are also learning the product range and the company. It is not a direct advertising, but rather a continuous and efficient PR activity, indirectly influencing stakeholders.

But it is essential to understand, that increasing share price - in general - resulting an attractive and positive company image, while in the opposite case, the decreasing prices are harming the good picture. So during the IPO, the

organiser has to consider these issues too, as the success and price level has significant meaning for the investors and to the public.

6) *Continuous Interest*

Exchanges are also regarded as an information pool, where more-and-more people, investor are getting touch with the companies. (It also helps fair pricing.) This information is widely available through various media. Only imagination can limit the opportunities it can bring to the company (e.g.: new suppliers, customers; partners; new investors...)

7) *Continuous Provision of Reliable Data*

The Exchange itself is also controlling the way and content of information providing, helping investors to maintain high level of confidence towards communicated news.

Status of competitors can also have an influence, as supplier can prefer listed companies, due to a more reliable financial position.

8) *Forcing Excellence*

The market itself gives feedback on all decisions, assessing strategic decisions. It is something like a professional advising group around the company (of course with wrong interpretation sometimes), for free! It is good for the management or for the owners that they are forced to make changes in the structure, strategy to meet the expectation of the investors. The market is penalizing if the company tends to be satisfied with an average performance.

9) *Open New Ways for a Motivating Compensation-pool*

According to HR professionals, the most successful way of motivating is offering ownership to employees or rather to the management. The results are speaking for themselves: enhancing the company's long-term performance and increasing loyalty are definite advantages. It can be a part of the compensation.

The liquidity of the shares is easing such transactions.

The opposite side of the coin is showing far less disadvantages. Firstly the associated costs of an IPO or the listing itself are worth mentioning, but it can be offset by the

lower capital costs mentioned earlier. In the recent years another criticism gained territory in the media, when some corporate scandals were investigated (like the ENRON case). They argue that the market players are forcing the management into short-term goals to enable quick profit taking out of the increasing share prices. It is added that such short-term interests or rather the deployed “tricks of the management” with the aim of showing a better picture are undermining the long-term outlooks.

Finally it is important to emphasize the necessity of a preliminary consultation and consideration of the interests of the stakeholders (management, owners, employees, capital providers), the investigation of the strategy and the sources of finance, before deciding on the flotation. Exchanges are ready to help to consult on it, together with professional consultants.

## ***D/ Financial Strategy and Overall Corporate Strategy***

The same section of the Financial Management<sup>(16)</sup> lecture guides this part. “Financial strategies themselves are of little use unless they form an integral part of overall strategy” written in the above book. Given the above theory, here below I will summarize how financial strategy should support the overall objectives of a company.

Good financial strategies:

- Provide the financial structure, funds to achieve corporate objectives
- Measure outcomes of strategic options, aiding selection
- Consider finance as a source of competitive advantage.

Besides the traditional role of administration, meeting regulatory requirements (tax, statutory reports, annual reports, stock-exchange information providing) and internal decision supporting the above tasks are showing long-term strategic importance, unfortunately sometimes not really considered important.

Especially for growing companies these should be taken with great care, as success or failure can be subject of financial decisions, despite everything else are running well. (There are several examples of the failure of great products, inventions because of the

weak financial management ended up in bankruptcy. Examples are some mobile-phone operators stepped into expensive acquisitions or into 3G without sufficient financing.)

Financial strategies have different objectives:

- Survive as an independent business
  - Through maximising shareholder's wealth
  - Achieving low cost of capital (= optimising debt and equity financing)
  - Allowing good fund-raising capacity (selection from the mentioned tools)
  - Obtaining good credit rating (cheaper debts)
  - Maintaining a high share price
  - Being the predator, not the prey!
- To obtain optimal financing by:
  - Arranging sufficient finance to cover foreseeable needs and risks (in time, not earlier, nor later)
  - Distinguishing between long- and short-term requirements
  - Having the ability to raise capital at short notice if necessary, in large amount, at low cost, globally
  - Minimising cost of capital
- Achieving strategic flexibility:
  - Having an adequate information system and overall strategy to respond to acquisition opportunities or bids from other companies
  - Knowing the value of own businesses and possible targets
  - Having the ability to prepare contingency plans

Consequently, finance should be involved on the highest level in the strategy-making process, by emphasizing its responsibility in well serving the company's objectives, to allow the 'wheel running' and supporting the implementation of a flexible and responsive strategy.

The general scope of traditional finance (administrative and reporting role) is now supplemented with other tasks in supporting overall management in decision-making (with special focus on long-term strategic issues) and also serving the shareholders' needs. The later sometimes (especially in case of listed companies) in opposition with

the management, so interpreting the needs of the market and build that into the plans can also be an interesting new challenge for the Financial managers. The Enron case also taught that not only transparency but corporate ethics is an issue for financial managers.

## **Financing Decisions**

Financing decisions are crucial in the companies' life. Good decisions can result in a better competitive position, while failures are usually 'expensive'.

The section provided a wide range of financing alternatives available for growing companies. Making a choice among them is very difficult and requires not only experience but also deep analysis of future trends, competitive position and the strategy. Generally the Financial department should provide the available options, supported by suggestions and analysis. As I mentioned above, this requires more skills than traditional finance, so the involvement of consultants are strongly suggested (the AIM prepared a detailed documentation to ease the decision on listing, available at their website).

There are various readings available to assist analysis of the impact of financing decisions, providing indicators, methods to calculate the contribution of the selected method and its impact on the cost of capital. The books of Bodie/Kane/Marcus' Investments<sup>(17)</sup>, Brealey/Myers' Principles of Corporate Finance<sup>(18)</sup> or E J McLaney's Business Finance<sup>(10)</sup> are providing several deeper analyses based on financial mathematics (the scope of this Dissertation is limited to the alternative strategic decision making, not mathematical analysis, however that is also a very interesting topic.)

Based on a deep and widely covered analysis, the management should not only take the final decision, but the owners' participation is heavily recommended. Such a decision (like a listing on a Stock Exchange) has a long-term impact and can influence the nature of ownership and the ability of owners to control the company.

## *E/ Summary of the Section*

Following the growth theories of the previous section, here it was started with explaining what is strategy in general, in the context of growth. It was learned, that “Strategy is more than good-luck”, it is the way to reach the desired future outcome, the description of the steps towards success.

After the definitions, various financing alternatives were listed and discussed. Firstly the debt related types were introduced, followed by wide range of available equity financing methods. The first was not required too much discussion because it is simple and obvious for all related decision-makers, however some interesting special forms were introduced. The later required more attention, due to several inventions of the financial markets, sometimes in a combination with debts.

Special attention was paid to Stock Exchanges, to emphasize its importance in the modern finance world. It was also mentioned, why listing can be so important in the life of a company. This topic will be further discussed in the later parts.

Finally the way of decision-making was mentioned, together with the role of financial management and its impact on the companies’ future direction.

## CHAPTER 4 - RESEARCH PART

The following part of the dissertation will provide additional aspects of strategy and financing, firstly based on the Secondary Research and later with face-to-face, interactive discussions with company leaders and also from the investors' point of view.

### *A/ Secondary Research*

#### 1. International examples

The New York Stock Exchange, the London Stock Exchange or 'Deutsche Börse' /Frankfurt/ are well-known and largest Bourses in the financial world. However besides them there are several others especially important for growing companies. (Main figures of Stock Exchanges are included in [Appendix 4.](#))

Because of the importance of Markets in financing the growth, several institutions have created a platform where those companies are encouraged, who wishes to collect capital in an early stage. These platforms are requiring less pre-requisites and easier standards have to be met than those of the famous Stock Exchanges. The most important are the AIM (part of the London Stock Exchange), TSX Venture Exchange (Toronto Canada), Neuer Markt (Deutsche Börse Group, NM was incorporated into the main market).

*Table 8.: Market cap distribution of European growth markets, as at July 2001*

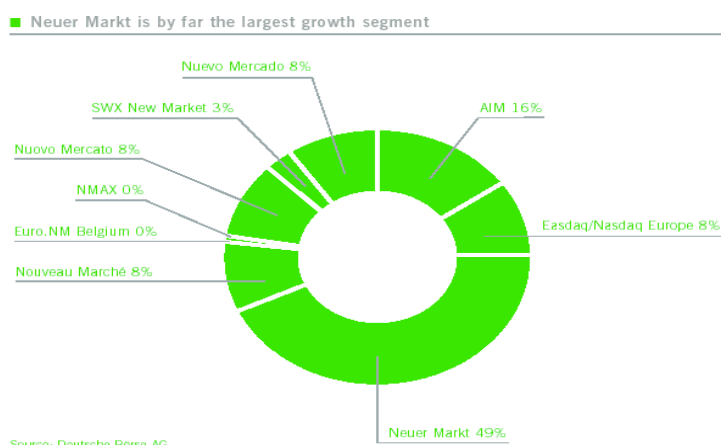


Fig. 1/7: Market cap distribution of European growth markets, as at July 2001

source: Deutsche Börse AG

### 1.1. AIM

The London Stock Exchange consist of two main parts according to its official web site:

- “Main market
- *AIM* – the Exchange’s global market for growing companies”.

*Table 9.: The main differences between AIM and the Main Market of LSE*

Main Market	AIM
<ul style="list-style-type: none"> <li>▪ Minimum 25% shares in public hands</li> <li>▪ Normally 3 year trading record required</li> <li>▪ Prior shareholder approval required for substantial acquisitions and disposals</li> <li>▪ Pre-vetting of admission documents by the UKLA</li> <li>▪ Sponsors needed for certain transactions</li> <li>▪ Minimum market capitalisation</li> </ul>	<ul style="list-style-type: none"> <li>▪ No minimum shares to be in public hands</li> <li>▪ No trading record requirement</li> <li>▪ No prior shareholder approval for transactions*</li> <li>▪ Admission documents not pre-vetted by Exchange or UKLA</li> <li>▪ Nominated adviser required at all times</li> <li>▪ No minimum market capitalisation</li> </ul>

Source: [www.londonstockexchange.com](http://www.londonstockexchange.com)

“It may be the most demanding thing that you’ve ever done... but also the most rewarding,” says the official publication of *AIM*, that is a presentation (available from:

<http://www.londonstockexchange.com/NR/rdonlyres/635E7643-52CD-4D71-B703-9EB4C6502E7F/0/1222.pdf>) to help companies understanding the whole process and explaining the associated steps:

- Decision Stage
  - Looking at the business (pros, cons of a listing)
  - Is the company right for a listing? (regulatory, market requirements)
  - Do the company and its management prepared? (investors relation, corporate governance)
  - Preparation work before flotation (advisers, changes in board and operations, taxation, valuation)
- Flotation Process
  - What becoming a listed company means (theory and costs)
  - Choosing advisers – and what they do (sponsors, lawyers, brokers, accountants, others)

- Countdown to flotation (documents and timetable)
  
- Life as a Public Company
  - Life as a Public Company (obligations, reports, shareholders relation)
  - The process of the listing (best practice, media and investor relation, monitoring, active management)
  - Summary, glossary, contacts

Besides the widely available publications (some practical success stories about already listed companies are also published, like LiDCO Group /[www.lidco.com/](http://www.lidco.com/)) they are also available for consultations. For me the handling of the whole issue underlined the importance of assisting companies in understanding their opportunities and showed how easy it can be to grow a company into a new 'era' (especially compared to the limitations of those Hungarian counterparts).

### 1.2. TSX Venture Exchange

To succeed, emerging companies need opportunities to grow. *TSX Venture Exchange*<sup>(19)</sup> providing Canadian companies with the early-stage stepping stones in their corporate lifecycles and gives early-stage business the opportunity to gain a solid foothold in public markets as a company works towards graduating to a senior exchange.

*TSX Venture Exchange* corporate finance professionals work closely with emerging companies to help entering the public markets. They can also introduce local lawyers, accountants and other consultants who can help bringing the company to market.

It offers to companies a flexible, two-tiered system. The tiers have minimum listing requirements based on a company's financial performance, resources and stage of development. The industry segments within each tier recognize the different financial and operating needs of companies in different industry sectors. Successful companies in search of mid-to-large cap financing can choose to graduate to senior markets.

Depending on company's needs, listing on *TSX Venture Exchange* can make good business sense:

- Company can access financing from \$500,000 to \$20 million

- *TSX Venture* listed companies raised \$2.37 billion in equity financing in 2000 and \$1.08 billion in 2001
- *TSX Venture* offers products and services specifically designed to meet the needs of early-stage companies
- Start-up companies gain national exposure
- Companies not only raise capital, but also learn how to manage their businesses and affairs under the public company regulatory framework before they move to senior markets.

They also offer a simple comparison chart to illustrate a step-by-step approach:

*Table 10.: Illustration of the different Market Segments in Toronto Stock Exchange*

	Net tangible assets	Pre-tax earnings
TSX Venture Tier 2	\$500,000 Cdn	\$50,000 Cdn
TSX Venture Tier 1	\$1 million Cdn	\$100,000 Cdn
Toronto Stock Exchange	\$7.5 million Cdn	\$200,000 Cdn

Source: [www.tsx.com](http://www.tsx.com)

A wide variety of information is also available at [www.tsx.com](http://www.tsx.com), that also offers wide information sources, figures and support how to start the process, besides contacts.

### 1.3. Neuer Markt

Germany has long been seen as one of the premier examples of a ‘bank-based’ financial system, a system in which banks are the dominant financial organization and loans (rather than publicly-traded stocks and bonds) account for the lion’s share of external financing of the firm. In the 1990s, however, the bank-based system has come under increasing criticism within Germany as unsuitable for promoting high tech. Interestingly enough, the same elements that were previously seen as strengths are now partially seen as weaknesses: the German banks’ preference for making loans to be established, capital-intensive companies, according to this view, starves new technology-based firms of needed high-risk venture.

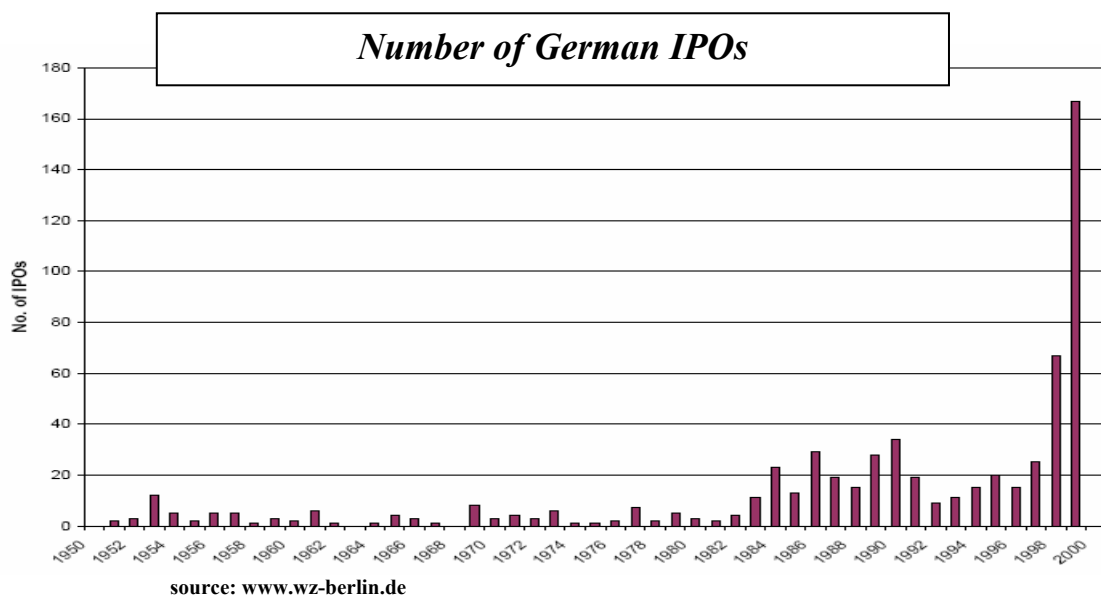
A special segment of the Frankfurt Stock Exchange called the *Neuer Markt* (New Market) was established in 1997 to address the above problem (later in 2003 it was

incorporated into the Frankfurt Stock Exchange, but still offering a special platform for emerging companies). It was primarily modelled on the US's NASDAQ, that is to serve the needs of both investors and young companies involved in high-risk new technologies. That time it was considered that the established stock market services traditional industry and the *Neuer Markt* finances the 'new economy'.

According to a research by Sigurt Vitols<sup>(20)</sup>; one surprising feature given the traditional conservatism of Germany's financial system, is the fact that quite a few foreign companies are coming to Germany to raise their 'risk capital'. 56 of the companies listed on the *Neuer Markt* (i.e. about one-sixth) were based outside Germany. A second quite surprising result is that Germany's *Neuer Markt* alone accounts for considerably more than half of the total market capitalization of Europe's new 'growth markets' or stock exchange segments for young, high-growth companies. Although these growth markets were established in other countries at roughly the same time and a number of them would presumably enjoy greater advantages, the *Neuer Markt* has become Europe's premier growth market far surpassing the pan-European growth market EASDAQ and the AIM.

In 1998, 1999 and 2000 there were 67, 168 and 152 IPOs in Germany, respectively. The *Neuer Markt* alone accounted for 61 percent, 79 percent and 87 percent of all German IPOs in those years, respectively. By the end of 2000 there were 338 companies listed on the *Neuer Markt*, with a high concentration in the sectors technology (20.1 %), internet (19.8 %) and software (14.8 %) published in the same study.

What is behind all these facts? The success of *Neuer Markt* can be explained with good marketing and also with the investors' appetite for IT companies (speculative behaviour), besides the already mentioned support of such exchanges. But the most important thing is it provided very good opportunity for growth companies to access funds to finance their growth strategies.

*Table 11.: Number of German IPOs till 2000.*

#### 1.4. Warsaw Stock Exchange

This Exchange is somehow the odd one out of the above row, because it is not primary for growing companies, but this is the main exchange of the country. However, because of the specialities of the country (relatively ‘new market economy’: Capital market traditions in Poland go back to 1817, when the Warsaw Mercantile Exchange was established. The Warsaw Stock Exchange began activity in its present form on April 16, 1991) it worth studying. Especially, because in the recent years it showed considerable development in attracting companies to be listed.

Equities may be listed on three markets: the main, the parallel and the free. The assignment depends, among other things, on the size and verified history of the company and its share value.

In March 2000 the WSE, following other exchanges, created a separate segment for Innovative Technologies (called SiTech). The criterion for qualifying a company to this segment is its field of activity: IT, Telecom or Electronic media (irrespective of the market they are quoted). It was simply a good marketing ...

The reality (the fact that a former socialist country is lagging behind those countries with advanced capital markets) forced other ways of development (unlike AIM or TSX) to create the background of professional market participants (the focus is not to teach companies, but to spread the knowledge country-wide):

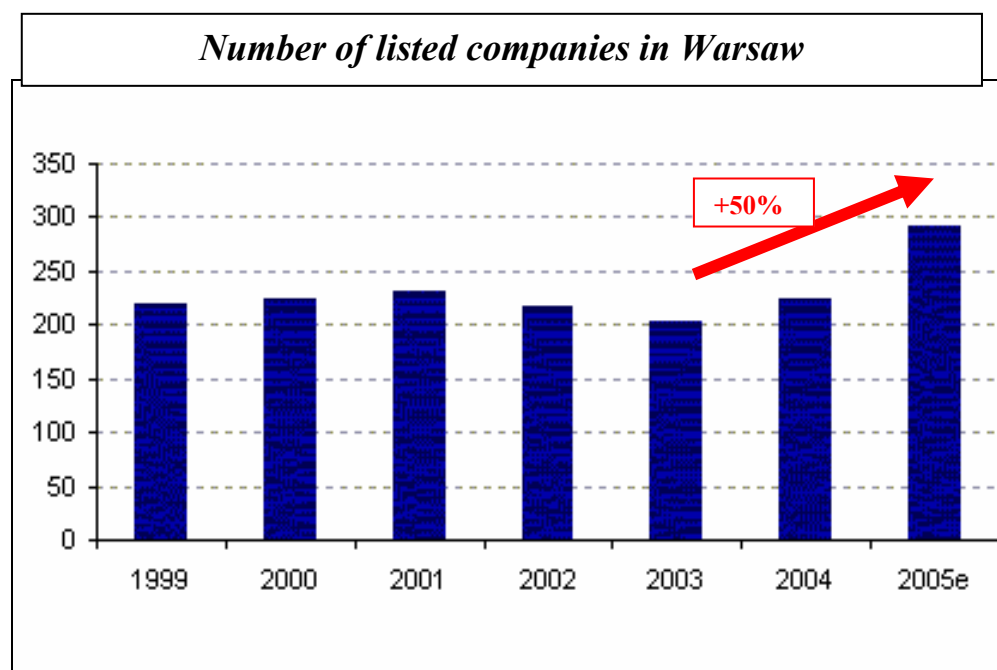
- Promotional and educational activity (participates and supports conferences, seminars; prepares educational publications and runs programmes for promoting the capital market)
- The Foundation for Capital Market Education, established in 2002, popularise knowledge on capital markets among youngsters through various games and competitions.

From another point of view, according to an Internet publication of [www.portfolio.hu](http://www.portfolio.hu) 68 new companies is willing to enter the market till the end of 2005, getting close to the total of 300. The concerned article arguing that the development of the market is backed by liquidity, as Polish Pension and other funds are taking high share on the market, while the general public is also quite active.

Adding to the article, it worth mentioning that there is also a push from those companies are willing to attract further funds to finance their business and from the state who want to privatise through the market.

The below chart suggests that their activity reached the desired goal:

*Table 12.: The increase in the number of listed companies in Warsaw*



source: Smith Barney

### 1.5. Summary

Consequently the formers' main aim is to assist growing companies to access capital or create exit opportunities for the owners (venture capitalists, founders) – specialisation, while in Poland the main focus is to create a well functioning capital market. Simply saying the later is an earlier stage of development (the same applies to Hungary, which is quite similar to the Polish situation). As this stage is completed successfully (I think it is close enough), the focus should shift towards the international example of specialisation through serving the needs of growth companies with more 'tailor-made' services.

As the Neuer Markt example showed, marketing is essential for the success. A good practical initiative can be the TCK (Market Compliant Companies' Club) founded by the Budapest Stock Exchange with the aim of collecting those companies together are interested in the listing. Furthermore, similar ideas like the AIM, TSX Ventures examples showed (assisting publications, practical guides, consultancy, eased conditions) could speed up the process. It can be also advantageous for the possible applicants to understand the role of the exchange in the still cloudy field of various financing alternatives. Unfortunately it is not only the subject of support from the exchanges, but also requires political commitment that is sometimes not clear-cut (in the forms of tax allowances, subsidies to cover partly the cost of the IPOs).

Finally referring back to the starting block of the previous section about the creation of a fundamental part of the economy (strong local company sector), I would like to mention some Hungarian success stories. OTP (Hungarian Bank giant), MOL (the oil company), Richter (pharmaceutical company) are good examples of growing firms (all are listed companies without any controlling owner), were able to meet the demanding investors' needs. They became the first Hungarian based MNCs (having activities mainly in the neighbouring countries) out of a state-owned, slow and 'comfortable' corporation. They are strong market players, managed well and financially healthy (even very profitable).

They passed the exam of the market economy successfully. Why should not Hungarians repeat the story again, this time with emerging companies?

## ***B/ Primary Research***

### **Introduction**

Primary research aims to provide additional facts and ideas based on the experience of market players. The discussion will be discussed in two ways:

- Experience of companies: as there were only a few companies entered the BET up to know, it would be impossible to make a statistical sampling or survey, so interviews with those few can provide the necessary information basis. Fortunately there are some IT companies with experience, from which two were selected for deeper analysis. The first was Graphisoft with several years of experience with capital markets and with global activity, while the other was Freesoft, who just entered the BET market. (It is important to mention, that the two companies are not limiting the scope of the Dissertation, regardless they are similar from the sector point of view.)
- The situation from the investors' point of view: right after the companies are shared their opinions, two capital providers' response will be added to see the other side of the coin.

The findings of the research will be presented in the following chapter.

## CHAPTER 5 - ANALYSIS AND MAIN FINDINGS

During the presentation of the section, here below I will follow the structure of the interviews, starting with strategy related questions, followed by the financing issues and completed with the main concern: the listing. Each point will be subdivided to reflect the difference between the views of the companies itself, and the opinions of the institutions. Consequently, particular examples will be analysed first, followed by a more generous statement about trends and likely future outcomes.

### *A/ Strategies*

#### **1. Companies**

The history and thinking of **Graphisoft** proved the classical growth theories (as discussed in the Introduction part), starting as a small company with just a few employees. They wisely realised their competitive advantage of being a flexible, client-oriented embryonic firm, with unique technological advantage (offering three-dimensional software solutions) and used it professionally to find their relevant market among the architecture firms (as they are also characterised by their small size). Small companies have shown more willingness to cooperate with companies having the same size. The good positioning of the company allowed a stable growth (as shown in the Greiner model) till it has reached the present size that can be regarded as the first Hungarian Software MNC. It is worth mentioning, that the founder was also brave in realising the necessary changes in structure, and left the CEO position for a professional, experienced person, but he is still acting as Chairman for the company. (It should be quite obvious in Anglo-American Corporate Cultures, but it does not yet very common in Hungary). The company is focusing now on the constructing industry, offering them the first software, which is able to model the complete constructing circle, supported with precise cost calculation. Furthermore, the solution is available for companies all over the world, in several languages (again very clear positioning) – and great success is expected.

So simply saying, I saw a very clear strategy: they want to be the best service provider in Software based designing and constructing, offering the solution in several language to extend their market. The implementation proved to be successful as well, however it was a bit conservative and the potential catalyst of a braver financing (leveraged-growth, capital accumulation) were not considered. This is the reason for not reaching a far-more bigger size, and more sounding success, however it might come in the future...

The **Freesoft** is rather a potential from strategic point of view. They are quite successful in the migration technology (transforming old software to fit integrated systems) that is confirmed by the cooperation with Oracle.

Their strategy stands on 2 pillars:

- Offering the migration technology all over the world, and
- Thanks to their strong financial position, they willing to take the lead in the expected consolidation of the Hungarian software industry, along with acquiring new technologies to supplement present services.

As the first one is speaking for itself, I would like to focus on the second pillar. The Hungarian IT industry consists of a large number of small companies, most of them suffering because of their size. They are not able to offer their services to bigger companies, as they have no capacity for that, or there is no trust towards them in the eyes of big customers. When they get work from them, the problem is the dependence.

The likely outcome of the present situation is, that most of them will disappear from the market, while the luckier ones will grow through this phase, will merge other companies or will be acquired. This process made Freesoft to decide what to do, and they decided to survive. They are not only intending to choose a non-conservative way, unlike Graphisoft, but there strategy is stands on the success of growth, so they should use financing techniques as a competitive advantage.

All in all, companies have a vision for the future, Stacey's Discovery – Choice – Implementation model<sup>(21)</sup> is followed, the question is how successful they will be in that.

## 2. Institutions

If we want to make a more generous picture about strategic thinking for Hungarian companies, we have to distinguish two groups:

- A large number of SMEs, representing the critical mass
- A few bigger companies have already managed to step forward from SME.

The later mentioned shows conscious thinking, but opportunistic behaviour can also be found. The continuously changing Hungarian circumstances (legal, political, economic) taught them to focus on short-term businesses, however it tends to change for the coming years. The question here is if they will be able to manage to focus on long-term aspirations or stick to their present size. A very good example among them is the **Concorde** itself (the interviewed company), as they were successful on the market, because they accumulated the necessary strategic thinking. They knew what they wanted to reach, and step-by-step they did that. When we discussed their business model, the followings were mentioned important:

- Clear vision, conscious thinking, well defined philosophy (= strategy)
- Flexibility (to meet market needs) and consistency (to keep the focus) in the quickly changing world

László Szabó, the CEO of Concorde Asset Management mentioned during the meeting, that ‘it would be better for the Hungarian Economy, if the leaders are not willing to change the world, but rather they would ‘feel the wind’ of changes.’ Learning to adapt to changing environment should be the most important asset of those Managers.

The first group is mainly characterised by the opportunistic thinking (short-term, ‘I do what brings me quick money’ way). Management knowledge is seldom among them.

## ***B/ Financing Alternatives***

### **1. Companies**

**Graphisoft** was very cautious throughout its development. Thanks to the good positioning and steady development, they were able to finance their operation from the retained profits. When they decided to involve outside capital to the business, the reason was not to grow further. Gábor Bojár, the founder was surprised on the fact how his colleagues were selling/buying the stake of Graphisoft among them (he considered

ownership as an important motivation from the beginning for his colleagues). He felt that the company worth far more, than the valuations made during those deals. He decided to turn to a Venture Capital Fund to prove the real value of the firm. As a result of the transaction, it was necessary to go for Stock Exchange listing, as an exit alternative had to be offered to them (and also for the owners).

**Freesoft** walked a different way. As it was written above, the strategy made necessary to access some capital. Here the strategy and financing is strongly linked (to reach strong financial position which allows the leadership role in the consolidation of the IT market), one necessitates the other. IPO had taken place right before the listing, to collect the funds. The source was the so-called FFF (family, friends and fools) institutional investors did not participate. The listing itself created liquidity to the shareholders brought a valuable marketing campaign (for free!) and allows the company to show to the wide public how they are planning to materialize their strategy. If the later will happen, it would be far easier in the future to organize further fund collection, even with the involvement of the institutional investors.

## **2. Institutions**

Let me start with a contradiction: liquidity is plentiful in the world; lot of money is waiting for good returns, while companies are claiming for the lack of capital available to them. How is it possible? The reason can be found in the above statement: the companies may not offer good returns. Those people are disposing of capital are not willing to waste money, just because they full with it. The money is looking for places where it can reach attractive returns, and refuse to take risks without compensation!

Following this short statement, let's go step-by-step through the various alternatives:

### 2.1. Retained profit

Most of the companies due to their size and relatively short history have not accumulated enough profits to finance their growth. The available profits are seldom enough to break away from the competitors; the size of the market is also a barrier (Hungary is a small country). Finally the owners would like to access some funds as well to finance their private life, which is also against the profit accumulation (the

success is not the only motivation, the founders want to earn some money as well – that is also supported by the general life-style, characterised by consumption, after the tight socialist period!).

Herewith it is necessary to disclose the IT specific story (which can be common in some other industries as well): some IT companies, mainly due to their low labour costs, show nice profits. But these costs are tricky, because the classical employment status is very expensive (about 30% of the total employers' costs are available for the employee, after deducting taxes). Most of the companies (mainly SMEs) found a way for tax-optimal way of employing their people, where - following the above calculation - 60% to 80% of the gross money is payable. When we look on the profits through these glasses, we can say that it is risky, even unacceptable for those want to provide funds, based on profitability.

Based on the interviews, I have to say, that this way of financing is crucial. Those companies are not able to create enough profits for the owner, cannot pay the interest rates and other costs associated with debt capital, or even cannot convince outside investors to invest into the company (as I wrote above, investors are obviously looking for the high and relatively safe return.) This should be the foundation of all businesses, especially because the dotcom crisis (the fall of share prices after the internet boom) taught investors to be more critical when dealing with start-ups.

## 2.2. Debt capital

When we consider debt financing, there are 3 main points needs deeper analysis:

- Banks and their behaviour
- Bond market and special means of financing
- Subsidized loans (EU and state subventions)

### 2.2.1. Banks

I have to raise my voice to criticize banks in Hungary. They are making huge profits (even higher than those based in developed countries), while there willingness to take risks is very low. It will not be popular among them, but I have concerns, that they acting like a cartel! Economic conditions (high interest rates, state subsidies) made them

comfortable, because they are living well, despite the relatively high number of them (where is the competition then?).

During the end of 2004 the base rate of MNB was around 12 %, while SMEs get loans for around 20 % (the FED's and ECB's base lending rate was 2 % this time). When we have a look on personal lending rates, we could see some around 50 %! So why should they fight for the risky businesses? The answer is simple: they should focus on the long-term, when the rates will drop (as it happened in half-a-year to the level of 8 % /regarding the base rate of MNB/). If they are not realizing the opportunity in financing SMEs, they will loose ground, when they are getting bigger (bigger Hungarian companies have no difficulties, as they can find the way to cheaper channels via foreign banks /with the same costs as their western counterparts/). It is expected, that they will realize it soon and the heavier competition among them will create cheap and abundant money supply for the companies!

The state also did some promising steps to improve the situation, as they offered credit facilities for the SMEs (through banks), providing guarantee behind (so called Széchenyi card program).

### 2.2.2. Bonds and alternatives

The bond market is relatively small; there are only a few players want to access capital on it. Junk bonds are missing, but it is not surprising if we consider high interest rates.

In case of the debt related alternatives (especially leasing, factoring), I would say the trend is favourable. More-and-more players entering this market, and companies are also realising the advantages in it. It would be even better, when the companies would understand the meaning of dead-capital (cars, property) and take competitive advantage out of the special means of financing, to leave the disposable capital to work in the business as it is usual in highly developed countries... This creates one more advantage: It is not only creating leverage, but force the management to be able to make higher profits (to cover the cost of it).

### 2.2.3. Subsidies

Finally I would like to discuss the various types of subsidies living its renaissance now. The EU membership opened the money-taps for the companies, and the politicians are also eager to offer funds through state channels. The available options covered deeply in other parts of this study (except for grants).

It is nice to offer considerable funds to SMEs to finance their business, but it is not sure that this is the most efficient way. The biggest concern around it: there is no guarantee on the reasonability. It means there is now strategy, concept behind the money-distribution. The time will show if it works or not...

### 2.3. Equity

In case of equity financing there are 2 main groups worth separation and deeper investigation:

- Institutional Investors (Private Equity, Venture Capital, various Funds...)
- FFF

#### 2.3.1. Institutional investors

Wide range of them is active on the Hungarian market, with strong financial background (international financial institutions are backing them). So it seems that everything is all right on the supply side, but if we look behind the surface, we might see, that they are not so optimal for the Hungarian market. The answer again is the size. Most of the Venture Capital Funds are interested in transactions worth EUR 1-50 Million and there is only little, like the Fast Ventures who wishes to invest from EUR 100,000. The reader or a people from a developed country might smile on this figure, but this is the Hungarian reality. Companies here are relatively small in their size, as the market is small.

When we consider those institutional investors are active on the capital markets (mainly Investment Funds, Banks, Insurance Companies, etc.) we are facing with the same problem. They are choosing only from the 4 (Mol, Matav, Richter, OTP) + 3 blue chips (Borsodchem, FHB, Egis), and neglecting others. They argue, “the same analysing and other capacity is necessary to follow others, while they worth only 1-10% of those Blues. It is simply not economic.” They also worried about the liquidity of the 2<sup>nd</sup>

league, but this creates a vicious circle. Institutions are not investing into them due to lack of liquidity and there is no liquidity as nobody dealing with them...

The Freesoft is a good practical example: they were the only newcomers on the BET last year, but they have not get any capital from institutions, despite the presentation of the management was regarded promising during the road show.

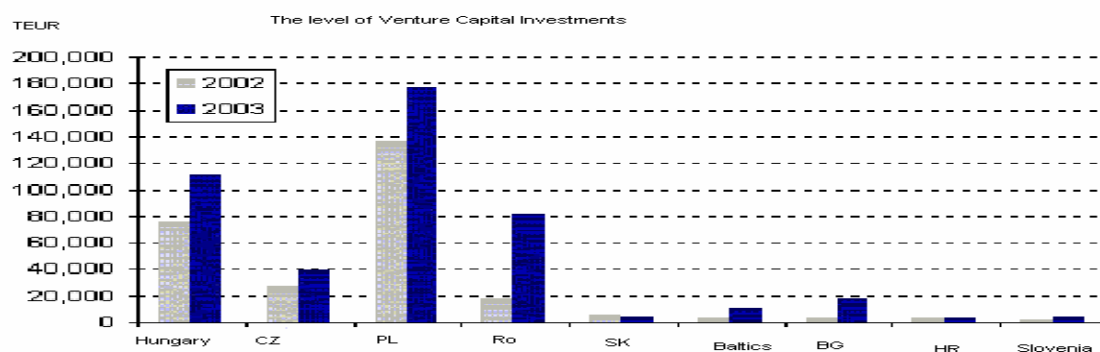
When we are considering companies left behind SME size, the interest is high. The reason is the number of them: quite a few. When they are asking money, they can select from wide range of alternatives, Institutions are hungry for them. The proven example was the Borsodchem, which company 'returned' back to the Blue Chips, after a Private Equity firm acquired it and sold back their shares later to institutional investors (they quickly forgot the loss they suffered during the takeover, when they were asked to participate in a Public Offering, which outlined nice future outlook for the company).

*Table 13.: Number of Venture Capital Funds in the CEE region, 2003.*

Number of Venture Capital Funds in 2003.	
Poland	18
Hungary	13
Czech Rep.	7
Rumania	7
Latvia	6
Slovakia	4
...	...
CEE total:	77

Source: [www.ebroker.hu](http://www.ebroker.hu)

*Table 14.: The level of Venture Capital Investments in the CEE region, 2003.*



Source: EVCA

### 2.3.2. FFF

Family, Friends and Fools, says the jargon of Institutional Investors. This is the only source seems to be available for SMEs and embryonic companies.

We saw above, that Institutions' motivation starts at a certain level, that exceeds the country average. So the critical mass should find their financing partners in this field, where the fools means those active private investors (mainly speculative investors), who has capital, which is looking for good investments. They are mainly socialised with Capital Markets (earned or just learned from the earlier happenings of the BET, or accumulated some money from various businesses) and showing more willingness to participate in risky transactions.

## *C/ Listing on the Stock Exchange*

Herewith, I will not follow the separation the findings are summarized together. As discussed in details in the Literature Review section, listing has several advantages, and some disadvantages. Herewith I also used the book of Mr Bojár (Graphisoft) <sup>(22)</sup>, who was very kind to provide me some parts of his manuscript.

During the interviews the followings were mentioned:

+ **Marketing advantage:** it creates a strong PR campaign, as the media happily writes about it (When a journalist offered an interview to Freesoft, he mentioned the question of money. The reply was: ok, how much would you pay?).

It has considerable advantage in dealing with customers and suppliers as the company is more reliable than those are doing business in the 'background' (especially within IT, where customers have fears of the missing future support).

+ **Forcing excellence:** those are active on the market will learn how to keep excellence, motivation, as the punishment of the market is painful and hard to forget (dropping prices are harmful for the owners). They will be more experienced in the future and will be better against their competitors.

+ **Tax:** this way of financing is also very attractive for those companies, where there are clear willingness from an FFF source to invest into, because in Hungary

there is 0 % capital gain tax is payable for transactions through the Stock Exchange (so not only liquidity is offered to the potential investors, but tax holiday as well!).

+ **Creates the opportunity for bonus programs based on ownership:** It is difficult to argue, that the most successful companies are not good because of high salaries, but having motivated people, with share-options (the employees are owners too!). Again, the tax holiday can be an issue, but with limitations.

+ **Shareholders (owners) can measure their wealth-creation;** even realize part of that for private purposes

- **Forcing short-term profitability** in expense of long-term aspirations (usually regardless of the nicer long-term outlook)

- **Costs:** there are several costs associated with the listing (however the state subsidize the initial costs) and the continuous floating (publication of news, reports; fees; auditing; annual meetings).

- **Transparency:** For some Hungarian company it can be a barrier as well. An example can be the Synergon (also listed on the BET as an IT company, which suffered heavy Tax audits and expensive penalties as the average salary per employee was shown below the minimum wage in the company's reports, reflecting tricky solutions as mentioned earlier). Transparency can be also an issue for other companies, as those analyst working for the investors are deeply analysing public companies, sometimes communicating important information, that can be harmful for competition point of view, or can touch sensitive points of the companies, like structure problems (the companies can face with critics, due to lack of management knowledge, etc...).

Finally I would like to mention the access to capital. This is not an advantage, nor a disadvantage. For most of the companies, it is not an issue at all, as there is a gap existing between supply and demand (as mentioned in the Financing part).

Something is happening, which is promising. The BET has decided to create the already mentioned so-called TCK Club and promoting those companies are involved and advising them on the steps necessary to be taken till the floor. Even more, they will show the good example, by deciding to list own shares. Others are also willing to take these steps in 2005; around 5 new listing is expected. BET also holds several forums both for private individuals, companies within the country (to teach them) and in abroad for foreign investors (to inform them about the investment opportunities in Hungary). It is not too much, but some more ideas will be given in the following section.

### ***D/ Summary of the Section***

It is a bit brave to make a general statement on strategy thinking based on some interviews (and several articles, reports), but it is not far away from the reality, if I say that professional strategic thinking does not an important characteristic of a young market economy. Fortunately, evolving with time, it will gain ground and will be among the crucial tools of managements.

From Financing point of view, we are also facing with the problem of 'young age', besides the small size of the Hungarian market. More-and-more opportunities are available for the companies, however some important are still missing (junk bonds, investment banks, risk willingness of banks towards SMEs); and the companies are also on the way to realize the competitive advantage in the right financing method.

The Budapest Stock Exchange is functioning, that is nice. Nowadays the BUX index beating the record every week, it is also good. But the main role of the BET is partially met only: does not mediate between capital providers and those looking for that. There is a gap in transaction size between the capital supply and demand.

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## **CHAPTER 6 - CONCLUSIONS AND RECOMMENDATIONS**

Several ideas were formed in the previous section, some criticisms have been mentioned. Here below some ideas are set out with the aim of speeding up the changes in creating a competitive market economy, which not only depends on the presence on MNCs, but on strong and developing local companies.

### ***A/ General findings***

In the previous section, I pointed out that the Hungarian market is small in size (10 Million inhabitants); the GDP is far behind the developed countries. It is always easy to find reasons for being unsuccessful, instead of searching for the solution.

Several Hungarian companies are not developed enough, but not too much time have passed since the collapse of socialism. We have to be patient, sometimes the development is not as fast as we might expect. Time, time and time... It will bring better conditions, all we have to do is to speed it up, focusing on the Strengths and Opportunities eliminate Weaknesses and prepare for the Threats. This way of thinking will be the guideline throughout this section.

### ***B/ Strategy***

However the short-term thinking can be surprising at first sight, but we should not forget, that most of the Hungarians learned Economics from the books of Marx and Engels and changing behaviour takes time. The coming 10-15 years will bring more academical thinking for businesses as well, they will learn how to cope better with market circumstances. It is a usual characteristic for young market economies. The real question for Hungary is, if it will be able to keep the leadership among their counterparts in the region, as it did happen in the past 10 years.

Hungary has its obvious strengths in the culture. The companies were quite successful during peaceful periods and later parts of socialism also allowed special forms of

entrepreneurship. The way of accelerating the process can be based on education (more practical education, focusing on business management). This can do a lot and there are good institutions existing to serve this need.

Let the companies evolve; learn from their mistakes they will do their jobs. Some say, that 'Experience is a total loss, unless you can sell it for more, than it cost you'. There is lot of information (specific news, media reports, the Stock Exchange itself, the listed companies' reports) available in the country, to learn from other's mistakes as well. There are well-published, nice success stories in the country, a lot can be used to form new strategies and more-and-more talented and well-educated professionals are available to participate in promising businesses. The time can be the solution in the change from the short-term way of thinking towards more long-term orientation, where learning how to adapt to changes will be more important, than just big dreams.

## *C/ Development of the Financial Sector*

### **State-participation**

Let me start with the so-much criticized state-participation. In general I agree with those people saying the state is not a good owner. But there are several fields, where its catalyst role is essential. There are some areas, where according to the history and achievements the potential is great. These are medicine related R&D, technical sciences and innovation. **Their incubation**, offering them concentrated support can help **the creation of competitive new businesses**. They can also rely on the existing successful companies, where the state should support the cooperation.

But a concrete strategy or suggestions should be based on a deeper analysis, studies and surveys (offer subsidies for creating these and adjust the bureaucracy to be able to drive the changes). **There should be a country-strategy defined, with clear vision where the country would like to reach considerable achievements**. It should be long-term, clear, and coherent and should meet market needs as well. There are satisfactory parts in the present system, so I am confident about the ability of further improvement.

The second suggestion has its roots in the property financing. A few years ago, there were no mortgage banks in the country, so it was decided to create a fully state owned Bank (FHB) to offer services to the property market (I wrote market as it has not only supported the private individuals who wishes to buy a new property, but property developers as well!). Today this bank is listed on the BET, and the remaining state ownership is expected to be privatised this year. The bank's activity (that also created healthy competition on the market) is measurable, a lot of new property projects have been implemented and the property market is now in a far better shape. So why not repeat it once more, now with an **investment bank**? There are some special state-owned banks in the country, along with other institutions (like the Hungarian Privatisation Agency) where considerable business, financial knowledge have been accumulated. The **concentrated capital** intervention, or rather **mediation** can help in creating better financing for companies. It should not only help offering state funds, but can help making the right choice from a wide range of financial services (like from a Menu in a restaurant) to feed the appetite of the companies. The services may include the following: **obtaining debt capital** (from various banks, sometimes in a consortia form to share the risk or through the bond market), **mediating between Venture/Private Equity Funds and also supporting the organisation of a Stock-Exchange listing**. Its advantage would not only be in the mediation between companies and capital providers, but the creation of easily comparable services and so extending competition. **Advisory function** (or mediating advisors) can be a possible further added value that can also help in the development of the companies' strategic, conscious thinking. Such an institution may call the attention of other market players for the potential, so a missing financial sector may be created. It is hard to measure the non-existence of such a Bank, but it can contribute with a great-deal to companies' financial problem solving.

The modification of the related legislation would be necessary. The law on **Venture Capital Funds are over-regulated**; more freedom in their acting would be welcome. Giving them as much freedom as possible is preferable, as they are professionals in doing such businesses and they should know how to invest their capital (we learnt above that they do not waste money). **Concerning the Financial and Economic legislation, I recommend some changes to reduce uncertainty among investors**. There have been some transactions where investors lost money, due to the loose regulation. The examples are: the ever most unfair acquisition trial in Hungary by Heineken for a stake in Brau

Union Hungary Rt (several articles are available about the topic); the acquisition of Forras (the price was only 60% of its own capital, which was mainly cash); or the pyramid games through property trusts (eg.: Baumag), just to mention the most interesting ones. More regulation where the dominant market players can harm wide range of investors can help the creation of confidence, hence more willingness of the public in participating in financial transactions other than bank deposits...

Not only the regulation itself, but also regulation-based institution should also take a more active part in defending and fighting for investors' interests (usually there is a mismatch between the power of individual investors and bigger market participants).

Finally, it is also necessary to make decisions regarding **structural changes**, create a better and accountable fiscal policy. I mean **reducing bureaucracy**, change the attitude of state institutions towards a **more service-orientated thinking**. **The level of budget deficit needs to be reduced significantly; tax mechanism should also need to change**. It is especially important as **the high interest rates make the economy more difficult to work, as savings are financing the state deficit (through high-yielding securities) and not the companies' investments**. These steps would allow a better functioning, more stable economic mechanism (free market economy), strong companies, consequently a healthier state and higher incomes (for all parties: individuals, entrepreneurs, companies and also for the state). Unfortunately it cannot be done quickly, nor are they popular in the short-run, but unavoidable!

### **Applicable Financing Methods for Growing Companies**

As I wrote in the Literature Review part, there are several existing methods of financing, however only a few are used by companies in their every day financing in Hungary, for the reasons mentioned.

There is no general rule for which is better or worse. **All companies should find the relevant for their business**. One thing is for sure: no one will get money for free (although it happens sometimes in Hungary). The companies should learn that doors would open up for the best; they will get all the help. So they should create their strategy, make the business model work and they should convince the capital owners about their ability in making the success story.

For SMEs, I strongly suggest to collect information about the possibilities, visit the bank first to see what they can offer. Apply for subsidies (there are several providers willing to advise on how to participate in the application process) and check the available Venture/Private Equity sources (also the state financed ones). At least they will learn a lot about their own business through the investors' eyes, they will get some good tips and will be more prepared for the later stages.

For example: a simple bank loan can be a clear-cut solution for building a warehouse, but it is also possible to have a built-to-suit solution, where the property fund is providing the financing. In case of growing companies, may be the external equity is the best way, especially when we consider the advisory role, management knowledge of Venture Capitalists. Sometimes the company can manage the financing in-house, using the assets in a better way (selling and leasing back non-productive assets)...

Simply saying: just one best way does not exist. It is far more complex and requires a special knowledge, as managing that particular business too.

The already mentioned **investment bank (or banks with well-trained advisors) where the companies have access to professional consultation** could be a further important asset. It would also force commercial banks to foster such special knowledge to remain competitive. Today, I also see some weakness in the advisory field, as **most of the financial advisors are only accountants**, and they are not really well versed in financing questions. Changing the present education system (which is obligatory and have to be completed every year) for them could help much provide them training in financing alternatives too. **Supporting the creation of an independent financial advisory business** would be also welcome; may be the present auditor system or chambers could serve as a base for them.

These changes would allow the companies to find the suitable, 'tailor-made' financing alternative; hence they will be able to make their business fortune.

## ***D/ Improving the Hungarian Bourse's Status***

During the whole dissertation I have regarded the listing as a special question. I wrote pros and cons based on theoretical information and experience. So I do not intending to make suggestions, as companies should be able to decide if the positives are more

relevant for them or the opposite. But in developed economies its advantage is unquestionable, or even unavoidable to make this step, but not in Hungary. I have to say, that the BSE is closer to the TSX Ventures and AIM in its role, than to LSE or NYSE. In Hungary nearly all companies are medium-sized, growing one, so the treatment should be similar (as it was described in the research part).

Herewith, I would like to point out the reasons and make further suggestions.

The situation is far from the optimal because of several reasons:

- **Liquidity:** it is not satisfactory for most of the listed shares; investors are active in the Blue Chips only. In Hungary the average size of a company is below the expectations of the capital owners (one reason is the relatively young market economy). There are several solutions to resolve it, like the BSE should make corrections in the fee-structure (consider some reduction and enhancing active trading based on international examples – for example paying for limit orders), support market-maker activity. Placing a mediator between companies and investors: like an Investment Bank, ETF (Exchange Traded Fund), Specialised Investment Fund, with the aim of collecting funds to finance smaller companies. Such a solution have several advantages: sharing risk as the portfolio is diversified, specialization as they know and follow their investments better and allow the participation in small but promising and yielding businesses. Banks would consider participating in it to find good investments and find new clients. Individuals would add it to their portfolio, while the companies would get the necessary capital and also the advantages of listing.
  
- **Marketing:** praiseworthy the BSE continuously organizing road shows to meet investors not only in foreign countries, but also within Hungary. This program should be extended like through the involvement of various media (like broadcasting an interesting TV program), as most people have some experience, but not enough and the structure of savings is also not healthy (bank deposit is dominant).
  
- **Dependence on foreign capital:** nowadays 80% of the shares are held in foreign hands. As László Szabó mentioned during the interview, it is no good, to make

decisions on Hungary in London or New York coffee bars. In Poland where the dominance is far less, there are rules for the Funds to force them to buy Polish shares. It would not be popular among Investment Managers, but this topic should be addressed somehow.

- **Transparency:** assist politicians to adjust legislation where necessary, cooperate with regulators (PSZÁF – the financial authority), support protection of interests (like TEBÉSZ – individual investors’ association, which is tough sometimes, but definitely acts on behalf of small investors, sometimes alone...), and allow access to more data for investors (some details like the traders and offers above five levels are invisible for private investors despite they are paying for the data, hence BSE gives competitive advantage to brokerage firms).
  
- **Good examples:** the Stock Exchange has several interesting characteristics, just to mention the mysticism around it. To make it more attractive to investors, good stories are needed. BSE should make stronger sales activity to convince those few not-yet-listed, but promising companies. Success stories spread quickly and attract new investors and new companies...  
Visiting foreign Exchanges, studying their model can bring further good ideas.
  
- **Listing BSE shares:** it is a really great idea to list the shares of the BSE on its floor. They might show the above-mentioned good example and might be the last but best sounding reason for companies to list their shares. They should consider:
  - Strategy: BSE is not merely a Stock Exchange, but also a profit-oriented business entity. They should draw up a wise strategy, implement that, without forgetting that they will be monitored and hopefully followed! The Bourse’s Management should act a bit more aggressively to make necessary changes to fulfil the needs of their stakeholders, as they did when it reopened its door and was the leader in the CEE region. Unfortunately it is just one Bourse in the region, and is neither the most advanced nor the fastest-developing one. A more innovative and motivated approach would be advisable to make a new success-story! Good example will form the thinking of other companies too...

- Marketing: as the state is supporting listing, they should find the way to involve the widest public. As I wrote, it is important because the general savings structure has to be changed, so starting with an investment into the country's Exchange can be an issue. Make it sound attractive; everyone should hear about it, then most of them would participate!
- Pricing: the owners' opinion is surely different, but this can be the most important element of success. Those people will participate in the transaction would make far more efficient campaign, when they are making money with the deal. The result: success might attract more companies, more investors (=CUSTOMERS) so higher return for the owners...

I could not imagine the bright future of the Hungarian Economy, unless BSE not fulfils its role, and the future cannot be else but promising, if it is implemented...

### ***E/ Summary of the Section***

Strategy, Financing and the Listing were discussed separately throughout the Dissertation, despite they are highly dependent on each other. Here below, as an example I put them together to answer the main question about listing and furthermore to emphasize, why this is so much important.

I assumed Financing as a possible competitive advantage for a company. But first the company should be competitive in itself, professional Management is consciously implementing a wise strategy, achieving a great success on the market, resulting outstanding profits. Such a promising company might look for capital to finance its further growth, to conquer new markets (can be both: product-wise or country-wise). They might consider Venture Capital along with debt related financing. Both parts require those institutions able to provide competitive and tailor-made solutions, which require a matured financial system, competition among service-oriented intermediary institutions.

Under ideal circumstances, there are investment banks available as they are more experienced in organising and advising highly complex financial transactions, where Commercial Banks can supplement it through providing their funds.

On the top of this process, stands the Stock Exchange, where the company is not only getting the further capital required to offer the exit opportunity to the Venture Capitalist, but can use it for motivational purposes or as a source of additional financing, besides the earlier mentioned other advantages.

The state has a limited role in a developed country. But in a developing one it has to take a more active role in creating and supporting the missing or weak segments to foster development. So politicians has crucial role, but well-known, respected experts should be active in convincing and influencing them.

Consequently the stand-alone question of ‘listing is a clear strategy or just empty words?’ can be misleading. The answer on such a question can be found if we take into account all elements of strategy-related questions; Microeconomics (companies, individuals); Macroeconomics (the Economy as a whole); and all financing related issues including the legislation, conditions, private individuals (their ability to accumulate funds) and the financial institutions.

It turned out to be a highly complex situation, so the solution should reflect it. Drafting a unified, comprehensive and integrated plan addressing all those elements the Dissertation covered should guide the improvement steps. The co-operation among all interested parties during the implementation is crucial in this process and the economy could reach a desired state of development and serving as concrete foundation strong and competitive individual companies listed on the Budapest Stock Exchange.

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## APPENDIX 1.

### *The history of the Budapest Stock Exchange*

- In 1864 the Pest Commodity and Stock Exchange was founded. There were only 17 shares listed this time and 84 shares 5 years later
- In 1872 there were 15 industrial and 550 bank shareholding companies were founded (after the only 2! in the previous year)
- At the end of the XIX. century there were 310 securities, that increased to nearly 500 till the First World War
- At the beginning of the XX. century was among the leading European Exchanges in grain (1,5 Million tonnes of annual turnover), played regional role in Stocks
- Was suspended during World War I. and 2<sup>nd</sup> half of the 1929-33 World Crises
- Closed again from December 1944. and August 1946. due to the War
- 25<sup>th</sup> of June 1948: it was closed again, as it was treated as the “citadel of the capitalist exploitation”
- On 19<sup>th</sup> of January 1988 Banks had a “trial trading day” to exchange bonds
- On 21<sup>st</sup> of June 1989 the Budapest Stock Exchange (BSE) re-opened
- ‘90s continuous development in turnover, No of listed companies. Some crises shocked the market (Asian crises in October-November 1997. when the BUX fell to 5561 points from the August’s height of 8483; during Russian crises it reached the 3775 points BUX level – halved of its value in 1 month)
- On 20<sup>th</sup> of November 1998. the first electronic trading day (MMTS)
- 20.01.2000. the index reached 10,000 (basis was 1000 set on 2<sup>nd</sup> of Jan 1991)
- On 30<sup>th</sup> of June 2002. the Court registers BSE as a shareholding co.
- In June 2004. Austrian Banks took over the controlling stake of BSE

## APPENDIX 2.

### *Economic Indicators*

*Table 15.: Main Hungarian Economic and Financial Indicators, 1991-2003*

#### Main economic and financial indicators, 1991-2003

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
<b>GDP volume index</b>	Preceding year = 100	88,1	96,9	99,4	102,9	101,5	101,3	104,6	104,9	104,2	105,2	103,8	103,5	102,9
<b>Consumer price index</b>		135,0	123,0	122,5	118,8	128,2	123,6	118,3	114,3	110,0	109,8	109,2	105,3	104,7
<b>Unemployment rate (ILO)</b>		-	9,8	11,9	10,7	10,2	9,9	8,7	7,8	7,0	6,4	5,7	5,8	5,9
<b>Current account balance</b>	EUR millions	223	235	-2959	-3300	-1266	-1408	-1812	-3026	-3531	-4380	-3613	-4900	-6488
<b>in % of GDP</b>	Percent	0,8	0,8	-9,0	-9,4	-3,7	-3,9	-4,5	-7,2	-7,8	-8,6	-6,2	-7	-9
<b>Direct investment inflow <sup>1)</sup></b>	EUR millions	1186	1142	2039	966	3399	2143	3165	2381	2489	2645	2575	3068	3439
<b>Exchange rate (average) <sup>2)</sup></b>	ECU	92,70	102,10	107,50	124,78	162,65	191,15	210,93	240,98	252,80	260,04	256,68	242,97	253,51

1) Equity capital

2) From 1<sup>st</sup> of January 1999., Euro

*Source: CSO, National Bank of Hungary,  
www.mnb.hu*

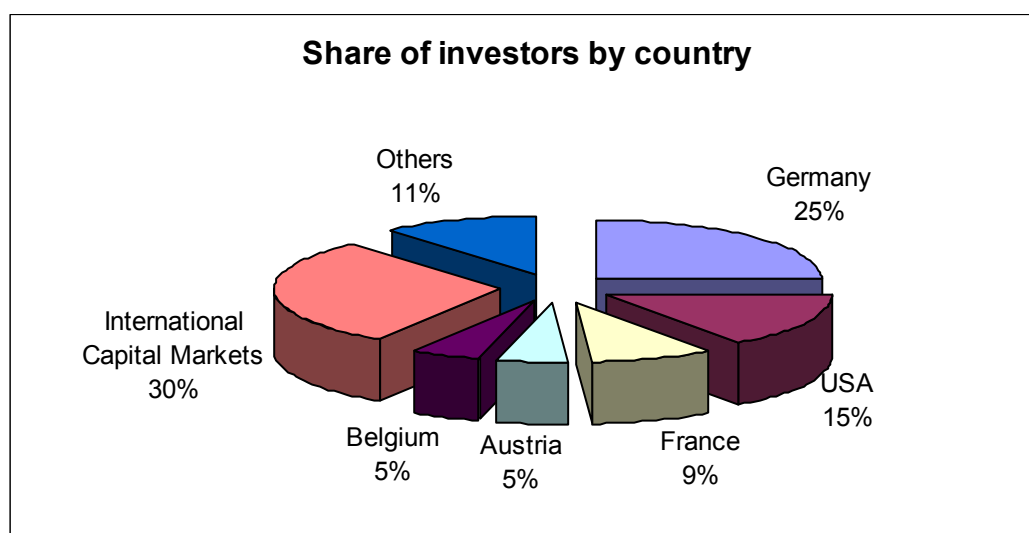
## APPENDIX 3.

### *Figures and Facts about the privatisation*

#### **Changes in the ownership between 1990-2002**

- In 1990 there were 1859 state owned companies with total assets of HUF 1670 Billion (USD 26,5 Billion)
- In 2002 there were only 167 remaining with total assets of HUF 767 Billion (USD 3,4 Billion)
- Total income amounted to HUF 1819 Billion (USD 12,9 Billion)

*Table 16.: Share of investors by country in the Hungarian Economy*



#### **Others**

- 45,5 % of the Assets were sold with the help of Capital Markets
- 30 companies became listed on the Budapest Stock Exchange
- There are only a few companies expected to be sold in the next years (remaining share of MOL /oil company/, FHB /mortgage bank/, Richter /pharmaceutical factory/, the Malév /national air carrier/, Mahart /national water carrier/)
- 37 companies will remain in state ownership (fully or partly)

## **Hungarian parliament declared the priorities of privatisation**

- Establishing and maintaining a functioning market economy, strengthening competition,
- Developing the domestic capital market, involving domestic and international capital and multinational companies, introduction of new up-to-date technology, business culture,
- Increasing the revenues of the state, reducing its role in the economy,
- Establishing domestic ownership of assets, supporting the development of domestic entrepreneurs,
- Maintaining and creating jobs,
- Promoting acquisition of assets by employees and management,
- Increasing the number of small domestic investors, offering appropriate assets in exchange for compensation vouchers, completing the compensation scheme.

## APPENDIX 4.

### *Figures about the World's Stock Exchanges*

*Table 17.: Figures about the World's Stock Exchanges*

source: <http://www.world-exchanges.org/WFE>



**NUMBER OF LISTED COMPANIES  
(Domestic & Foreign)**



*Total, excluding investment funds*

Exchange	End 1995	End 1996	End 1997	End 1998	End 1999	End 2000	End 2001	End 2002	End 2003
<b>Americas</b>									
Amex	791	751	710	711	650	649	606	571	557
Buenos Aires	149	147	136	131	125	125	119	114	110
Mexico	185	193	198	195	190	177	172	169	237
Nasdaq	5 127	5 556	5 487	5 068	4 829	4 734	4 063	3 649	3 294
NYSE	2 242	2 476	2 626	2 670	3 025	2 468	2 400	2 366	2 308
Sao Paulo	544	551	545	535	487	467	441	412	391
TSX Group *	1 258	1 323	1 420	1 433	1 456	1 394	1 299	3 791	3 599
<b>Europe - Africa - Middle East</b>									
Budapest	NA	NA	NA	NA	NA	59	56	48	49
Deutsche Börse **	NA	NA	NA	662	851	983	983	934	866
Euronext	NA	NA	NA	NA	NA	1 216	1 195	1 114	1 392
Istanbul	205	228	259	278	286	316	311	289	285
Ljubljana	17	45	78	90	130	149	151	135	134
London	2 502	2 623	2 513	2 423	2 274	2 374	2 332	2 824	2 692
Warsaw	65	83	143	198	221	225	230	216	203
Wiener Börse	148	142	138	128	114	111	111	129	125
<b>Asia - Pacific</b>									
Bursa Malaysia	526	618	703	731	752	790	807	861	902
Hong Kong	542	583	658	680	708	790	867	978	1 037
Korea	721	760	776	748	712	702	688	683	684
Mumbai	NA	NA	NA	NA	NA	NA	5 795	5 650	5 644
National Stock Exchange India	NA	NA	NA	NA	NA	NA	1 041	916	911
Singapore	272	296	334	358	408	480	492	501	551
Taiwan	347	382	404	437	462	532	586	641	674
Thailand	416	454	431	418	392	381	385	398	418
Tokyo	1 791	1 833	1 865	1 890	1 935	2 096	2 141	2 153	2 206

NA : Not Available

\* TSX Group : as from 2002, data include Toronto Exchange and TSX Venture

\*\* Deutsche Börse : excluding market segment "Freiverkehr" (unofficial regulated market)

Exchange	End 2000	End 2001	End 2002	End 2003
<b>Americas</b>				
Amex	82 717,4	60 223,3	45 690,6	92 877,2
Buenos Aires	45 839,3	33 384,0	16 548,6	34 994,7
Mexico	125 203,9	126 258,4	103 941,2	122 533,0
Nasdaq	3 597 085,9	2 739 674,7	1 994 494,0	2 844 192,6
NYSE	11 534 612,9	11 026 586,5	9 015 270,5	11 328 953,1
Sao Paulo	226 152,3	186 237,6	121 640,5	226 357,7
TSX Group	766 204,3	611 492,8	570 223,5	888 677,7
<b>Europe - Africa - Middle East</b>				
Athens	107 502,5	83 481,3	66 040,0	103 764,5
Borsa Italiana	768 363,4	527 467,3	477 075,4	614 841,6
Budapest	11 908,5	10 367,0	12 988,9	18 868,2
Deutsche Börse	1 270 243,2	1 071 748,7	686 013,5	1 079 026,2
Euronext	2 271 727,5	1 889 455,1	1 538 684,4	2 076 410,2
Istanbul	69 658,9	47 149,9	34 216,7	68 379,2
Ljubljana	3 099,6	3 461,3	5 577,9	7 134,1
London	2 612 230,2	2 164 716,2	1 856 194,4	2 460 064,0
Swiss Exchange	792 316,4	625 908,7	547 020,4	727 103,0
Warsaw	31 428,6	26 155,0	28 849,2	37 404,5
Wiener Börse	29 935,2	25 204,3	33 578,1	56 522,5
<b>Asia - Pacific</b>				
Hong Kong	623 397,7	506 072,9	463 054,9	714 597,4
Japan (Tokyo)	3 157 221,8	2 264 527,9	2 069 299,1	2 953 098,3
Korea	148 361,2	194 470,1	216 116,6	298 248,1
Bursa Malaysia	113 155,3	118 980,7	122 892,4	160 970,3
Mumbai	NA	NA	130 390,2	278 662,8
National Stock Exchange India	NA	NA	112 453,9	252 893,4
Singapore	155 125,6	117 338,0	101 553,7	148 502,6
Taiwan	247 596,9	292 872,2	261 311,2	379 060,4
Thailand	29 217,4	35 950,4	45 405,9	119 017,2