FDI trickling in

Despite the announcement of two large foreign direct investment projects in the automotive sector in September, experts do not expect FDI volume to improve significantly any time soon.

BBJ GABRIELLA LOVAS

Sadly, the news flow of major announcements on new foreign direct investments (FDI) during the past few months was due to carefully planned timing rather than a major pickup in FDI activity. These kinds of investments have a long "in the pipeline" period of several months, thus leaving investors wide elbow-room for timing their announcements. And timing matters, as good news on FDI is clearly positive for GDP growth and the Hungarian forint, as well as the employment outlook.

REVVING THE ENGINES

Major sectors that attracted the largest volume of FDI include financial services, real estate and business services, trade, transportation and storage, transportation equipment and electronics manufacturing. FDI in the automotive sector accounts for 23% of all foreign direct investments in manufacturing. Within just three days in September, two large car makers, Audi and Opel, announced expansion plans in Hungary.

German car maker Audi said that it will invest €900 million to expand capacity at its base in the Hungarian city of Győr by 2013. The investment will create 1,800 jobs and could add 2% to Hungary's GDP when completed. Audi's base in Győr will be the source of a total of 15,000 jobs, both at the plant and at suppliers, and the expansion will raise the annual number of cars produced at the base to more than 125,000.

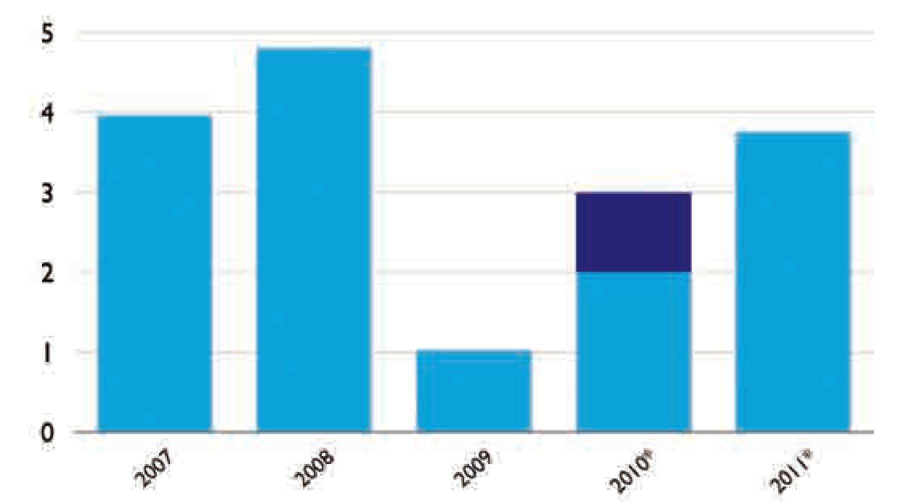
On top of the €900 million investment, Audi has spent €23 million to buy a 200-hectare plot on which to build the new capacity. Audi has invested a total of €3.89 billion in Győr since establishing its unit in Hungary in 1993. The plant started assembly work in 1998 with a staff of 200. Today it employs 5,700 people.

Meanwhile, Opel will spend €500 million to expand its engine plant in the Hungarian city of Szentgotthárd. The expansion will create 800 jobs in the short-term and another 200 later on. The Ministry for National Economy said that Opel would be awarded a HUF 7.5 billion state subsidy for the investment, which is expected to be recouped within three years. The new capacity will start production by November 2012. The expansion will double Opel's total investment in Hungary and will create 2,500–3,000 jobs for Opel suppliers.

TAKING STOCK

In 2010, FDI inflow is expected to reach €1.5 billion in Hungary, investment and trade promotion agency ITD Hungary told the Budapest Business Journal. In the first half of 2010, FDI inflows further decreased compared to 2009; however, mid-year data can be misleading and do not reflect real processes, ITD noted. In 2009, FDI was only €1.02 billion, which represented a 70% drop from €4.8 billion in 2008. Experts forecast a recovery in 2011, and Hungary may again receive an annual average of €3.5–4 billion in FDI in the medium-term.

FDI INFLOW (€ BLN)



***ITDH FORECAST ** EXPERT FORECAST** *Source: ITD Hungary, MNB, experts*

Since the democratic transition more than 20 years ago, Hungary has to date attracted FDI totaling more than €65 billion (this is referred to as FDI stock). With approximately 10 million inhabitants, this represents the second highest per capita rate in the Central Eastern European region, after the Czech Republic.

The stock of FDI showed a steady increase between 1995 and 2007. While there were no major capital withdrawals from the country in 2008, FDI stock still decreased, due to the central bank's new methodology in FDI data collection and the weakening of the forint. In 2009, FDI stock was slightly up again to €66 billion and currently stands at €65 billion.

AT YOUR SERVICE

Almost one-third of FDI goes to the manufacturing sector in Hungary. Services gained ground at a slower pace after the transition, partly because privatization in the sector started later than in manufacturing. However, today the service sector is the largest investment destination, with its share double that of the manufacturing sector, at 63%. The shift in the distribution of capital inflow results in lower annual FDI in the short term, ITD said. The other target sectors are energy (4%) and the real estate purchase of non-residents (2%), while construction and agriculture account for 1% of the total each.

Hungary received a large number of service center investments in the past five years. Outsourcing could be a major driver of FDI during the crisis, as an answer to cost reduction measures. The relocation of different services into service centers in Hungary will increase FDI in the sector in the short-term. Lately, Hungary has attracted more medium- and smaller-sized investments than large ones, due the increasing number of projects realized in the services sector.

WHY HUNGARY

There was much competition to take on the new capacity needs of Audi within the Volkswagen group, but Győr won out because of its infrastructure, its flexible and competent workforce and the favorable wage structure in Hungary, Audi's Chairman of the Board of Management Rupert Stadler said. Hungary was chosen even though the wage structure in China is 30% more favorable, he noted. Audi wants to raise its annual car sales by 50% to 1.5 million by 2015, which will require more capacities. After looking at several cities in the US and several countries outside the US, and talking with other companies that have made investments in Hungary through ITD, medical technology company Kinetic Concepts Inc. (KCI) has selected Hungary as the location of its shared service center, KCI president and CEO Catherine Burzik announced in September. Several hundred jobs are expected to be created over the next few years, as KCI transitions transactional activities in the areas of finance, administration and human resources to the center.

"We see how strategically located Budapest is, which is very attractive to us," Burzik said. "We also felt very welcome here; we saw that there was a very business-friendly environment. Everybody has at least a college degree, many had university degrees as well as administrative and information technology skills. And importantly, because we are dealing with so many different countries, with so many different languages, almost everybody we have speaks multiple languages."

KEEPING THE FLOW

Due to their geographical proximity and historical links, and similar to other CEE states, European countries have accounted for the majority of foreign investments in Hungary, at 75% of the total. Germany is by far the most important country of origin with a 22% share of all FDI, followed by Austria (14%) and the Netherlands (13%).

The United States has been the largest non-European investor (4%). In many cases, however, investments going through the Netherlands and other European countries also originate from the US. Among Asian countries, Japan and South Korea have played an increasing role in FDI.

Currently, ITD Hungary is in talks with 28 potential investors on projects with a combined investment volume of more than €4 billion and the creation of altogether 12,000 new jobs. Most projects are in manufacturing sector, followed by tourism, shared service centers, logistics and research and development. ITD aims to close talks with more than half of the investors, thus ensuring the creation of 7,000 new jobs this year, the agency said.

In 2010, ITD has facilitated 25 FDI transactions so far, totaling €9 billion in value and creating 5,700 new jobs. The table below contains only 18 of the 25 investments, as seven have not been made public yet.

Jeremie |

After vetting hundreds of potential investment targets, fund managers have started to select the first companies to invest in under the European Union's Jeremie program.

BBJ GABRIELLA LOVAS

The Jeremie (Joint European Resources for Micro to Medium Enterprises) program is designed to improve the financial status of SMEs by providing early-stage equity financing. The Hungarian capital market is relatively underdeveloped in this sector, with larger transactions dominating. Only a few market players were previously involved in financing SMEs in their seed and start-up stages.

"For innovative companies in the early stages of their lives, the availability of public funds for private sector investments with preferential conditions is a very important development," Dr. Judit Karsai, senior researcher of the Hungarian Academy of Sciences, told the Budapest Business Journal. In 2010, the number of transactions in this segment is expected to radically increase, as the eight fund managers selected to participate in the program make their first investment decisions.

The value and number of traditional venture capital investments provided for start-up, early stage and growth businesses was quite low in 2009, with only 12 transactions in the total value of €214 million, meaning an average transaction of €17.8 million. Besides the effects of the global crisis and the small size of the Hungarian market, the slow activity on the venture capital market was also due to the higher risks of investing in the region as well as the low number of business angels, according to Karsai: "Venture capital favors a stable economic environment and outstanding growth opportunities, which are currently lacking in Hungary."

The much awaited launch of the Jeremie program was delayed by the prolonged process of selecting the fund managers, the expert noted. This was quite distressing, as the funds have been available since 2007, although she added that the other participating countries are lagging even further behind. Eventually, eight fund managers were picked from 18 applicants to manage HUF 45 billion in funds as part of the so-called New Hungary Venture Capital Program. The new Jeremie funds were launched earlier this year after the approval of financial watchdog PSzÁF. ■

ELIGIBLE COMPANIES

- qualified as a micro-, small- or medium-sized enterprise
- registered head office in Hungary
- early (seed or start-up) or growth stage
- founded no more than five years prior to the investment decision
- net annual turnover not exceeding HUF 1.5 billion in any business year

In addition:

- promising business plans
- attractive, developing industry
- likely to meet elevated return expectations
- no means to tap bank resources (e.g. lack of capital, the nature or risks of the proj ect, lack of collateral)
- ready to share ownership of the company

kick-starts VC

Under the program, a total HUF 31.5 billion in funds from the EU (85%) and the Hungarian state (15%) went into a "fund of funds" managed by Venture Finance Hungary Plc, which in turn divided it among the eight new funds, with an additional HUF 8.5 billion kept in reserve. These funds, which also need to raise 30% of their total from private sources, select the SMEs to invest in. Private financing may come from private capital funds, independent financial investors registered in Hungary or abroad, as well as from business angels.

"The key to the success of the program is the 30% private financing, which ensures a market-based approach in the selection of the investment targets," Karsai said. The selected fund managers, which have several years of experience in the market, will thoroughly look at the prospective businesses and ensure that the money will not disappear without oversight. While the government sets the framework for the program, it cannot interfere in the selection process, she added.

The eight funds set up range from HUF 4 billion to HUF 7.36 billion, with a ten-year duration. According to the yield limitations, private investors are entitled to the entire upside reward exceeding the hurdle rate, which is the benchmark yield on the 10-year government bond. This means that public investors are not entitled to profits above this rate. Funds will be returned to the "fund of funds" at the time of the exit from the investments.

It is not only money that the selected companies gain through the investment, but they will also have access to the expertise of the fund managers, Karsai said. Start-up businesses will probably need help in finding the right suppliers and forming their customer base, as well as in hiring management. Venture capitalists have experience in building a company from scratch.

The Venture Capital Program operates within the framework of the EU's Jeremie program. Hungary's government has earmarked HUF 175 billion for the entire program to help SMEs take out loans between 2007–2013. Within that, HUF 45 billion was set aside for the venture capital program. ■

JEREMIE FUND MANAGERS

Fund Manager	Fund size (HUF million)	Public (HUF million)	Private (HUF million)
Biggeorge's-NV EQUITY Zrt	4,000	2,800	1,200
Central-Fund Zrt	5,000	3,500	1,500
DBH Investment Zrt	5,000	3,500	1,500
Euroventures Capital Zrt	4,000	4,000	0
Finext Startup Zrt	7,630	5,000	2,360
Morando Zrt	6,506	4,550	1,952
PortfoLion Zrt	6,800	3,944	2,856
Primus Capital Zrt	6,200	4,340	1,860

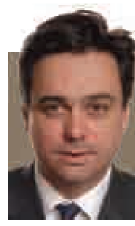
INVESTMENT TARGETS OF JEREMIE FUND MANAGERS

Fund Manager	Investment decisions made	Projects in pipeline
Biggeorge's-NV EQUITY Zrt	services (HUF 80 million)	1. healthcare 2. healthcare (combined HUF 300 million)
Central-Fund Zrt	1. design and construction of earthquake resistant panels (HUF 50 million) 2. trade of chemicals (HUF 350 million)	6 undisclosed prospects
DBH Investment Zrt	1. developer and manufacturer of industrial automation systems (HUF 315 million) 2. biotechnology company (HUF 340 million) 3. healthcare equipment manufacturer (HUF 200 million)	n.a.
Euroventures Capital Zrt	-	1. biotechnology 2. tourism 3. industry
Finext Startup Zrt	1. service industry 2. software application 3. software application (combined HUF 1 billion)	1. IT 2. retail 3. food and agriculture (combined HUF 900 million)
Morando Zrt	-	1. renewable energy 2. IT
PortfoLion Zrt	1. biotechnology 2. electronics 3. IT (combined HUF 800 million)	1. communication 2. IT (combined HUF 750 million)
Primus Capital Zrt	1. Comforce Kft (telemarketing, call center services, HUF 170 million) 2. 3D Histech Kft (healthcare, HUF 400 million) 3. Adfit Kft (HUF 190 million)	2 undisclosed prospects

[EXPERT OPINION]

BANK TAX AND CONSTITUTION

The first instalment of the controversial tax on financial institutions had to be paid by 30 September 2010. Despite all criticism pointed out by the business community and some international institutions, the law establishing this tax was adopted by the Parliament this summer. If the financial institutions still want to challenge the tax, they would have to lodge a complaint with the Constitutional Court. Could such a complaint be successful?



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BACKGROUND

The recent global financial crisis and the costs of the banks' rescue packages implemented in several countries have led governments to define how the financial institutions could contribute to the financial effort they largely benefited from. The EU members agreed on the introduction of a European bank tax in principle, certain countries, like Germany or France, have decided to levy such a tax at a national level before. By voting a law establishing an exceptional tax on financial institutions (the "Tax") on 22 July 2010, which entered into force on 28 September 2010 (the "Law"), Hungary seems to be in line with the current movement promoting the taxation of the financial sector. However, its choice remains atypical. First of all, although Hungary launched a banks' rescue package, the amount of money actually dedicated to bailing out banks was low (HUF 30 billion, or €100 million) in comparison with the financial effort provided by other countries and moreover concerned one single bank (FHB). It is therefore difficult to justify the introduction of this Tax on grounds of the need to make the banks contribute to expenses incurred by their own rescue (the Ministry for National Economy expects that the state will raise HUF 187 billion, or €660 million, from the Tax, i.e. six times the amount spent to the benefit of the sector). Furthermore, the Tax rates are much higher than those being considered in other countries.

A BRIEF DESCRIPTION OF THE TAX ON FINANCIAL INSTITUTIONS

The Tax is to be paid by credit institutions, insurance companies and other financial institutions having a permanent establishment in Hungary, irrespective of the form under which they pursue their activities (company or branch). The tax calculation depends on the category of financial institutions concerned. The Tax due by credit institutions in 2010 amounts to 0.15% of the 2009 adjusted balance sheet total rising to 0.5% for the tax base above HUF 50 billion, the Tax due by insurance companies is 6.2% of the 2009 corrected premiums, and the Tax due by financial enterprises is 6.5% of the 2009 profit from interest, fees and commissions.

QUESTIONABLE COMPLIANCE WITH HUNGARIAN CONSTITUTIONAL LAW

The complaints on which the Constitutional Court might be called upon to rule are the infringement of three constitutional principles:

The principle of non-discrimination

The Law distinguishes between financial institutions providing services in Hungary depending on whether they have any permanent establishment in the country or not, since only the former are subject to the Tax. However this difference in treatment may be considered justified by overriding interest, and hence comply with the Constitution. The exemption of non resident financial institutions purports to avoid any double taxation which they may suffer from, inasmuch they are subject to an equivalent tax in their resident countries.

The principle of a contribution to public revenues proportionate to the level of income and wealth of the taxpayers

The Constitutional Court has already asserted that the law-maker enjoys substantial freedom to decide on the nature and the level of the taxes. However, pursuant to the principle of a contribution proportionate to the level of income and wealth of the taxpayers, taxes must not be abusive and confiscatory, nor create a situation hindering the taxpayers from pursuing their activities. This, therefore, is a matter of appreciation and certainly it could be difficult to prove that the Tax could have such an impact, even though the burden the Tax could represent for the financial institutions and its counterproductive effect on the Hungarian economy have widely been criticized.

The principle of non retroactivity

The Law sets up in 2010 a tax which is based on the revenues of the financial institutions received in the course of 2009 and reported in their annual report closed on 1 July 2010, the latest. The Tax thus alters retrospectively a situation consolidated before the enactment of the Law, since the Law was promulgated on 13 August 2010, and may be therefore deemed "retrospective".

CONCLUSIONS

The possible outcome of a constitutional complaint is quite uncertain. The strongest argument, i.e. an infringement against the principle of non-retroactivity, allows the Tax to be challenged on formal rather than substantial grounds, since the law-maker could pass another law with exactly the same content, but with another schedule that more evidently complies with the Hungarian constitution.

For a more detailed version of this article see www.bbj.hu