Management Challenges in Privatization Acquisitions

in Transition Economies

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Management Challenges in Privatization Acquisitions in Transition Economies

Abstract: *Large-scale privatization was at the core of economic reform in most transition economies, except China, in the 1990's. Privatization creates special challenges for multinational investors acquiring firms in the process. Such acquisitions differ from conventional acquisitions due to the constraints imposed on strategic action by the privatization context, the depth of subsequent restructuring, and the necessary sensitivity to the local context and the societal changes associated with systemic transition. This paper reviews privatization experiences in Central and Eastern Europe and the former Soviet Union with the aim of identifying key issues for managers operating in transition economies.*

Key words: Privatization, restructuring, mergers & acquisitions, transition economies.

Introduction

One of the most significant socio-economic challenges at the onset of the new millennium is the transformation of post-socialist organizations to organizations that can meet the challenges of the predominantly capitalist world economy. Multinational enterprises become directly involved in this transition process when establishing operations in one of the former socialist economies, especially when acquiring local businesses. They face a distinct institutional environment, which pre-determines the strategic opportunities for businesses and limits transferability of Western business strategies and organizational concepts (Peng 2000, Hoskisson *et al.* 2000).

Hence, strategies observed in transition economies differ from those in developed economies, and strategies applied successfully in one country may fail in another. Corporate strategies in transition economies and other emerging markets can therefore be explained only by incorporating the specific institutional context in the analysis. This creates challenges that are fundamentally different from Western experiences for managers of both local firms and foreign business partners.

A special challenge is the acquisition and subsequent integration of formerly state-owned enterprises. Acquisitions frequently fail to achieve the declared goals, even within or between mature market economies (e.g. Scherer and Ravenscraft 1987). Management scholars have analyzed the challenges of post-acquisition management, notably conflicts of corporate culture (e.g. Cartwright & Cooper 1993), trade offs between strategic and cultural integration (e.g. Birkinshaw *et al.* 2000) and between speed and synergies (e.g. Empson 2000). In transition economies, these challenges are even more daunting as acquisition managers operate in an unstable institutional context, and become entangled in the social and cultural aspects of the transformation from socialism to capitalism.

Few studies have analyzed privatization acquisitions from a strategic management perspective (Uhlenbruck and DeCastro 1998, 2000). This paper presents an eclectic perspective of privatization-related acquisitions in transition economies, outlining the managerial challenges at different stages as observed in Central and Eastern Europe (CEE), drawing on and complementing the widely dispersed literature on privatization and foreign direct investment in transition economies.

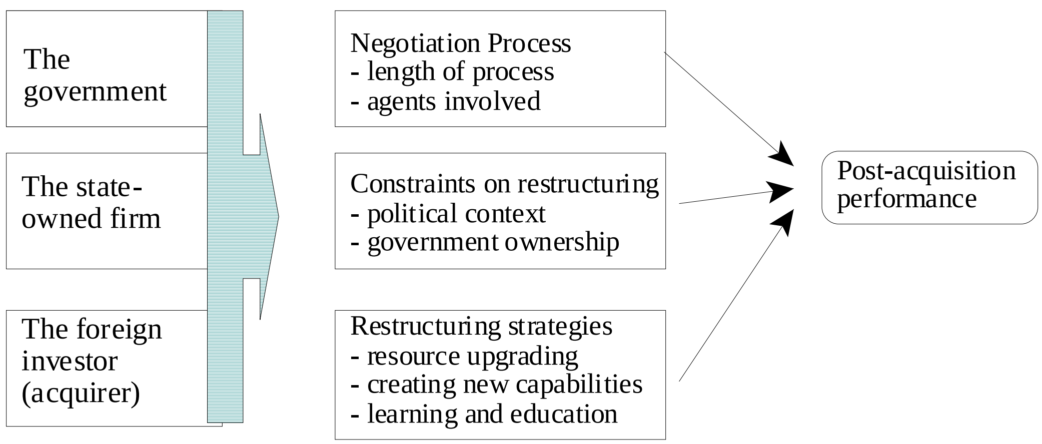
The paper takes the perspective of the acquiring firm and is addressed to both managers and scholars interested in this process. I first explain the concept of privatization acquisition and outline the process from the negotiations to the restructuring and integration of the firm. Next, I discuss the privatization process, which may create lasting constraints on post-acquisition strategy. Then, I analyze the transformation of the acquired firm in relation to the associated resources transfers and learning processes. The main insights are presented in form of propositions, each complemented with the implications for managers involved with privatization from a foreign investor perspective.

Privatization acquisition

Many multinational firms pursue local markets in CEE, while others, fewer in number, aim at utilizing lower factor costs, especially low cost technical staff close to key West European markets (Meyer 1998). Investors expect considerable long-term growth in demand, especially as the income of the middle class, their prime customers, grows faster than the average, as measured by GDP (Batra 1997).

When entering these new markets, an acquisition can be a key strategic move, providing local brands, market knowledge and distribution channels. Other local resources sought by foreign investors include network relationships with both businesses and governmental authorities and, in some cases, specific assets such as human capital in software engineering or in air and space technology. Hence, acquisitions can be an attractive form of entry into emerging markets if investors require complementary assets held by local firms, or if institutional barriers slow the establishment of Greenfield operations make them costly (Meyer & Estrin 2001).

Figure 1: A Process Perspective on Privatization Acquisitions



Until recently, acquisitions to access the aforementioned resources in CEE have only been possible as part of the privatization process. The success of such a privatization acquisition depends on the characteristics of the two firms as well as government policy, as modeled by Uhlenbruck and DeCastro (1998). In this paper, I take the analysis one step further, focusing on the acquisition process and on parameters that can be influenced by managers negotiating and implementing a privatization acquisition (Figure 1).

Ultimately, acquirers are interested in establishing an affiliate that creates value for the acquiring firm. The success or failure of an acquisition should therefore be assessed based on performance in terms of value creation for the new parent firm. This value may accrue in form of profits, but it also includes intangible contributions such as knowledge sharing or increased market share, permitting larger scale economies elsewhere in the corporation.

Post-acquisition performance depends on both pre- and post-acquisition processes and events. Earlier literature has emphasized that successful post-acquisition integration requires firms to develop an appropriate strategy even before the contracts are signed (e.g. Haspeslagh and Jemison 1991, Ashkenas et al. 1998). In the case of privatization acquisitions, the negotiation process is often complex, lengthy and involves different stakeholder groups. This may not only lead to contractual commitment concerning the acquired firm, but it may also cause a deterioration of the target firm during the process. Hence, the privatization process sets the stage for the subsequent strategies.

Actual restructuring strategies have been discussed in more detail than the often political pre-acquisition activity (Antal-Mokos 1998). Yet, for investors taking over formerly state-owned firms, issues of resource upgrading, creation of localized capabilities and management of the learning and education process have proven to be particular challenging.

Buying from a Privatization Agency

The Negotiation Process

Investors acquiring a privatized business unit are confronted with national politics. From their perspective, it is a case of 'mergers and acquisitions'; yet buying a firm from the government results in a number of peculiarities, starting with the negotiation process. With under-developed stock markets, the valuation of firms is difficult. Moreover, the local partners are manifold and have diverse objectives, which may not always be compatible with those of profit-oriented investors. Multiple stakeholders, including local governments, management and workers' councils, have *de jure* or *de facto* influence on the negotiation outcome (Bak & Kulawcuk 1997, Antal-Mokos 1998). The resulting complexity of the negotiation process has been shown in many case-based studies:

- Governments not only maximize their financial revenues, but also pursue broader social objectives (e.g. Wortman 1990, Estrin 1994). Consequently, privatization negotiations generally involve wider issues such as investment plans and employment guarantees. Especially in East Germany, firms were often sold for a symbolic price if the investor was committed to investing and developing the local business (Brückner 1997).

- Formally, potential buyers negotiate with the privatization agency. Yet a large number of agents inside and outside the firm try to influence the agency through formal or informal channels. In many cases, this degenerates into internal 'politicking', where agents pursue individual goals to the detriment of the organization. In some cases, potential foreign partners become entangled (Antal-Mokos 1998).
- Frequently, managers and/or workers' councils have attained considerable influence, *de facto* or *de jure*, especially in Poland and in many former Soviet Union countries. In many cases, they could convert their *de facto* control into formal ownership by opting for privatization modes that gave them preferential access to shares (e.g. Åslund 1995, Blasi et al. 1995). Workers' councils may take an active role in the negotiations and can derail a deal if they perceive it as a threat to their interests (Bak & Kulawczuk 1997). In partially privatized firms, insiders may hold substantial equity stakes that enhance their bargaining power, which they could use to negotiate their own job security.
- Drafting contracts is a challenge where the legal framework is still in flux with many basic elements not yet established. Investments have to be structured to account for such risks by building on self-enforcing contracts based on personal trust (Thornton and Mikheeva 1998, Starr 1993). Moreover, the lack of necessary business and legal terminology in local languages makes the preparation of formal documents cumbersome.
- Last but not least, local negotiators initially lacked experience in negotiating with foreign businesses (Antal-Mokos 1998), though the hiring of professional consultancy firms as advisors to privatization agencies has mitigated this problem.

The complexity of negotiating with multiple stakeholders is illustrated in case studies of failed foreign investment negotiations in Poland (Bak and Kulawczuk 1997).[1] Following a tender, *Compania ROCA*

Radiadores of Spain had been selected by the Voivod (provincial governor) for exclusive negotiations concerning the takeover of ZWS in Wroclaw, Poland in December 1995. However, employees and management favored the alternative proposed by a Dutch investor, and thus tried to undermine negotiations with the Spanish firm. Employee protests were widely reported in the local press, culminating in escalating demands for higher wages. The Spanish wanted to negotiate purchase of controlling interest in the firm with the Voivod, who was representing the state as owner. However, they found themselves confronted with three parties interfering in the negotiations: the Voivodship bureau, the management and the trade unions. The Spanish negotiators observed that "the management of ZWS were more busy having conflict with ROCA and the Voivodship bureau than running the company" (Bak and Kulawczuk 1997, p. 46), which they found unacceptable. After 6 months of arduous negotiations, ROCA withdrew. By then, the market position of ZWS had deteriorated markedly.

Similarly, Konvolutfabrikken Danmark of Denmark became embroiled in lengthy negotiations concerning acquisition of KZWP, a paper products manufacturer in Krakow, Poland. They negotiated directly with the management, but on all crucial issues the management referred to the need to obtain the Voivod's approval. The Polish side repeatedly presented additional demands and reopened previously agreed items. The negotiation process dragged from 1991 to 1995, at which time the Polish firm's market position and its equipment had become so obsolete that the original investment strategy was passé (Bak and Kulawczuk 1997).

Consequently, potential acquirers need to be prepared for a potentially costly and lengthy negotiation process. As time passes, the competitive situation changes due to events both within the target firm and in its environment. As the firm 'in privatization' cannot react pro-actively while future ownership remains uncertain, its market position may erode. Moreover, tangible and intangible assets may deteriorate as insiders extract assets, key people leave, or the organization fails to invest in maintenance orcontinuously improve qualifications and technological infrastructure. These events in turn affect the firm's prospects after privatization has been completed. Hence:

Proposition 1: The more different agents are involved in the privatization negotiations, the weaker post-acquisition performance will be.

Proposition 2: The longer the privatization process lasts, the weaker post-acquisition performance will be.

Several practical implications arise for managers from these features of the negotiation process. First, sufficient resources and time have to be allocated to the negotiation phase. Second, relations with stakeholders other than the state agency formally in charge have to be developed to anticipate, pre-empt and manage potential conflicts. Third, investors should anticipate events with possible negative consequences during the negotiations when assessing potential acquisition targets and reassess the target firm's resources continuously during the process.

Restructuring Constraints

Even after the takeover is completed, the privatization experience shapes the organization. Privatization aims to break the link between governments and firms, but this break is rarely complete. Political and social forces typically continue to influence and constrain post-privatization strategies (Uhlenbruck & DeCastro 1998, 2000). The governmental influence may be direct, based on property rights retained by the privatization agency. Yet even where no explicit rights have been stipulated, political agents set regulatory policy, and they may exert moral suasion and political pressure.

Privatization is generally part of a broader process of deregulation and institution building. The future development of privatized firms is therefore highly interdependent with institutional change in their environment and public policy. Governmental agencies, often not the negotiating unit, thus influence the post-privatization institutional setting. Industrial regulation and competition policy have a particularly profound influence on market structure and, therefore, on post-privatization performance (Uhlenbruck and DeCastro 1998). The regulatory frame is key to privatization negotiations where the privatized firm holds a monopoly position, or where privatization is related to industry liberalization, like in telecommunications (Ramamurti 2000).

Also, apparently unrelated policies may affect restructuring. For instance, the divestment of social assets (kindergartens, health care facilities, etc.) depends on the ability of other providers, municipal or otherwise, to provide these services. At the same time, governments may support privatized firms by securing financing or through guarantee procurement, tax breaks, or restrictions on import competition (EBRD 1999).

Governmental influence may, moreover, be exerted indirectly and informally. Public opinion and, in consequence, political agents, frequently take a strong interest in formerly state-owned firms. This may trigger governmental intervention if the new owner's actions are not thought not to be in the country's best interest. In addition to the social objectives, politicians and bureaucrats may pursue personal objectives and engage in various form of rent-seeking behavior. This leads to high levels of corruption, such as that seen in Russia (Transparency International 2001), which foreign investors are well advised to avoid (Puffer & McCarthy 1996).

A prime example of a politically important yet sensitive foreign investment has been VW's acquisition of Škoda in what is now the Czech Republic. VW negotiated with the highest government levels and, in return for commitments to maintain and develop the Škoda brand and to support the development of a local supplier industry, the Czech government offered special incentives, including measures to limit import competition (Becker 1997, Meyer 2000). Even so, VW experienced major challenges concerning its dominant market position from the later established competition authorities, who appeared to use high profile VW- Škoda as a pilot case (Becker 1997, p. 400). Another conflict arose with the downscaling of previously announced investment plans. Although these investment plans were not legally binding, the downscaling caused a major conflict with local authorities and eventually led to the negotiation of an addendum to the joint-venture contract (Becker 1997, p. 409). In both incidences, VW faced major public relation challenges in communicating with the Czech public. Yet overall, the cooperative relationship with the authorities appears to have been essential for the successful restructuring of Škoda. In VW's other major joint-venture in a transition economy, in Shanghai, China, the synergistic relationship with the local authorities is also considered a major success-factor (Peng 2001).

In less well-known cases, politicians have also used moral suasion. They may, for instance, wish to prevent major layoffs, as illustrated in the following case: Hungarian *Gyôri Keks* had been privatized successfully in the early 1990's by *United Biscuits* of the UK, which invested substantial resources in the upgrading of production facilities (Estrin et al. 1997). *United Biscuits* sold *Gyôri Keks* in 2000 to French multinational *Danone*. When Danone announced closure of the plant in March 2001 as part of a global restructuring program, public protest led to government intervention. Although there were no legal grounds to force *Danone* to keep the plants open, *Danone* felt compelled to negotiate with the highest government levels, and in mid-May withdrew its plan to close the facility. While government intervention may also occur in other cases of threatened job losses, the perception of this former state-owned firm as a national icon contributed to the publicand the government's perceived need to intervene.

Such company-specific intervention is rare in Hungary, where market institutions are relatively advanced. However, in Russia and some other countries of the former Soviet Union, governmental intervention is frequent, even on relatively minor issues (McCarthy, Puffer & Naumov 2000). This is based on long traditions of the paternalistic Russian state interfering directly with the economy and is likely to persist for some time.

Hence, post-privatization restructuring does not occur in a social vacuum, but is interacts with other political and social processes in the country. Acquirers who can create positive interaction between the firm and its political environment may therefore benefit in the long-term.

Proposition 3: Goal congruence between the acquirer and public policy in the host country averts political conflicts and has a positive effect on post-acquisition performance.

Proposition 4: Cooperation with local governments and socially responsible behavior reduce the likelihood of potentially disruptive interventions and have a positive effect on post-acquisition performance in the long term.

For managers, these propositions imply first and foremost that they have to be aware of the social consequences of their corporate activity. Conflicts with political agents can create various indirect costs for the privatized firm. Where legal and regulatory frameworks are not yet fully developed, unsolicited interference by politicians in former state-owned firms remains a possibility. If goal congruence can be achieved, this can considerably smoothen relations with governments and other political agents, benefiting performance.

Ssecondly, the relationship with the local community is important in preventing conflicts. Showing social responsibility in the local community, implementing effective corporate communications, and establishing a friendly relationship with key political agents on the basis of high ethical standards can support corporate development. However, foreign investors have to distinguish legitimate social concern from individual rent-seeking behavior. To this end, businesses have to monitor the political processes in the host municipality and country, just as they follow market trends.

Government Ownership

More salient is the governmental influence found in the rights retained in the privatization process. The privatization contract[2] can create a principal-agent type relationship between the government and the acquirer beyond the privatization (Stark 1992, Uhlenbruck & DeCastro 1997). Deal terms can, for instance, prohibit closure of the operation or stipulate employment guarantees, investment commitment, partial local ownership, or that the management team be staffed with nationals (Brückner 1997).

This influence is most explicit where governments retain a minority share. The frequently observed ‘staggered divestment’ (Perotti & Guney 1993) allows privatization agencies to have a temporary influence on post-acquisition management. Many privatization acquisitions were first announced as joint ventures, including high profile cases like GE-Tungsram in Hungary and many of ABB’s new affiliates across the region. VW initially acquired 31% of Škoda in 1991, with an option to increase its share to 70%, which was realized in 1995. Still, most investors attained management control and envisaged the acquisition of full ownership from the beginning. VW, for example, appointed three out of five Škoda board members from the outset (Becker 1997).

As a temporary arrangement, a minority stake plus management control offers advantages to both partners. Governments obtain some control over the firm's restructuring and can thus promote externalities for the local economy, while capitalizing on the probable appreciation of the share value as the transition economy becomes less uncertain (and avoid embarrassment over initial underpricing). Governments may also be reluctant to transfer control over firms deemed strategic or those trading with governmental institutions (Wright *et al.* 1993) for both political and economic reasons.

Investors normally aim for full control of acquired businesses to not only to reduce transaction costs but also to enforce faster turnaround of former state-owned enterprises (Aulakh & Kotabe 1997). In this respect, the foreign investor may not like the possible government interference in strategic decisions, but would appreciate the risk sharing and the lower amount of capital to be raised at the outset. If the acquirer attains management control, the influence of the government on operational management is limited. Moreover, privatized firms are dependent on public policy anyway, such that a minority government stake may be less significant than is often believed.

Furthermore, the interests of the government, especially those of regional or local authorities, may become more aligned with those of the acquiring firm if they share the profits. This should reduce undue bureaucracy and regulatory interference, while providing access to important public and private networks. Such informal networks are vital for businesses in transition economies, especially in Russia (Puffer *et al.* 1996, Holden *et al.* 1998) and China (Peng & Heath 1996).

Hence, minority government ownership can have contradictory effects. In mature market economies, firms in mixed ownership may generate lower profits because governments aim at social rather than financial returns. At the same time, the private partner faces weaker incentives arising from the lower profit share and may benefit from some form of transfer pricing. However, this logic may not hold in transition economies and other emerging markets, where political capital is crucial for business. Managers themselves assess performance of firms with residual government ownership more negatively (e.g. Lyles et al. 1996, Luo et al. 2001). However, Uhlenbruck & DeCastro (2000) find that firms with residual state ownership actually perform *better* in terms of sales growth. Hence, institutional constraints bear on corporate strategy, yet the competing effects do not allow a prediction of the dominant impact on the firm's performance:

Proposition 5a: Minority state ownership improves the alignment of corporate interests and government policy, which may improve post-acquisition performance.

Proposition 5b: Minority state ownership imposes constraints on corporate strategy, which may negatively affect post-acquisition performance.

The managerial implication is that - until more conclusive empirical evidence becomes available - the possibility of residual state ownership should be considered without prejudice. The likely future role of government and of political agents has to be analyzed and forecasted. If a government unit is a shareholder, valuable networking assets may be found. However, managers interviewed stress the importance of appointing the affiliate's CEO and controlling 51% of equity, possibly via a friendly partner holding the equity balance. Moreover, the acquisition contract should clearly stipulate the control rights held by the government and exactly who represents the government.

Restructuring Strategies

Firms have very different 'dominant logics' in socialist and capitalist societies (Newman 2000). In socialist regimes, the overriding objective is plan-fulfillment. The incentives created by central planning led, however, to severe distortions, such as the production of large volumes of standardized, low quality products, lack of concern for consumer demand, and disregard for externalities of any kind, especially for the environment. With the objective of ensuring full employment, firms employed far more people than necessary to achieve their output target, as labor costs were not a constraining variable. Employment relationships were effectively based on lifetime employment and enterprises provided many of the social needs of both current and retired employees. Enterprises were reasonably efficient in allocating the available resources, yet they failed dramatically in innovation, i.e. in introducing new production technologies and forms of work organization (Berliner 1976, Kogut & Zander 2000). Managers pursued political and social objectives, but had few incentives or opportunities to act as business leaders or entrepreneurs in a Western sense.

Consequently, transformation has to re-program an organization geared to the rules and performance criteria of the central plan economy to act by the rules of a market economy and be assessed by capitalist criteria. This requires not only radical re-configuration of resources, skills and capability reservoirs, but also of organizational structures, processes and cultures. The need to simultaneously address these multiple dimensions of transition adds to the complexity.

Typically, restructuring started with *defensive adjustments* aimed at survival under hard budget constraints, e.g. laying off workers or shifting the product mix (Brada 1996, Carlin 2000). To improve productivity, many firms started their lives in capitalism by shedding redundant assets and laying off employees on a large scale. Deeper *strategic and organizational restructuring* has to build a new, competitive business. For this purpose, firms have to acquire new resources and reorganize existing ones to improve 'internal consistency' and 'strategic flexibility' (Uhlenbruck *et al.* 2003). State-owned firms typically perform poorly on these intermediate performance criteria, so that enhanced consistency and flexibility are good indicators for distinguishing firms on the way to successful restructuring. However, empirical evidence points to continuity rather than radical change and few domestically owned firms have been able to implement strategic restructuring (Brada 1996, Wright *et al.* 1998, Newman & Nollen 1998).

Foreign investors acquiring a formerly state-owned firm have to initiate and implement strategic restructuring. They are well positioned to initiate change through their experience in leading competitive businesses and to provide a vision and strategy for the restructuring. Many foreign investors have been more successful than local owners, leading strategic change by developing new products, investing in new production facilities, entering into new markets and establishing marketing operations, new brand names and distribution channels (Newman & Nollen 1998, Fahy *et al.* 2000). Crucial tasks include providing complementary financial and human resources, restructuring the organization and promoting learning processes throughout the firm.[3]

Resource upgrading

To implement strategic resource re-configuration, privatized firms have to acquire complementary resources through investment in both complementary assets and organizational learning (Uhlenbruck et al. 2003). This includes, for instance, investment in different management capabilities, new business functions like finance and accounting, and upgrades of production facilities. In marketing, firms have to adopt new structures, systems and processes, organizational culture and human resources (Batra 1997). Also financial restructuring tends to be a high priority. Some missing resources, such as licenses, may be acquired, yet others have to be developed internally, or, at the very least, adopted to local circumstances. Foreign investors have a competitive advantage in implementing such upgrades, as they can transfer resources internally, particularly finance and managerial knowledge resources.

However, post-acquisition restructuring is deeper than many anticipate. Investment often exceeds the initial investment and the project may take on features normally associated with Greenfield investment, which differ from conventional acquisitions. In these frequent 'Brownfield' investments (Meyer & Estrin 2001), acquirers replace all but some very specific resources in the acquired firm. A small set of crucial resources may have motivated the acquisition in the first place; yet other assets may be unsuitable to create a competitive affiliate and thus have to be replaced. In pursuing such assets, acquirers may be drawn into deep restructuring processes, requiring major resource transfers - from top management time to finance.

For example, Beiersdorf of Germany, maker of 'Nivea' cosmetics, acquired Pollena-Lechia in Poznan, Poland in 1997 because the firm owned the rights for the 'Nivea' brand in Poland (Blaszejewski et al. 2002). Pollena-Lechia was, in many ways, still operating as it did before 1990, with excess staff, outdated production facilities and IT systems, and essentially no pro-active marketing. Even in 1997, retailers would collect the products directly from the production ramp. The Beiersdorf management added a structure of its own, made to meet the new marketing strategy of the Western-quality Nivea brand. The new marketing, human resource, and information and logistics departments pulled in selected personnel from the old firm, but operated largely independent of the old structures. “The double structure was kept in place until it became clear that the Nivea re-launch had been successful. Then the bubble of former Pollonia-Lechia was allowed to burst” (Blaszejewski et al. 2002). A generous redundancy program was offered in the summer of 1998, which most employees in the old structure joined, leading to a quick dissolution of the now redundant operations. In 2001, Beiersdorf added a new state-of-the-art production facility to its operations in Poznan.

The need for additional resources to transform privatized firms is illuminated by the fact that investment is the only strategic variable that Uhlenbruck & DeCastro (2000) found clearly associated with better performance. Research on joint ventures in CEE also suggests that support from the foreign partner is crucial (Lyles *et al.* 1996, Fey 1995). Hence:

Proposition 6: Post-acquisition performance is positively related to post-acquisition resource transfers from the acquirer to the new affiliate.

That post-acquisition restructuring requires resources may be common sense to Western managers. However, resource needs in transition economies appear to be frequently underestimated. Due diligence normally includes a comprehensive evaluation of post-acquisition restructuring and resource-needs. In the case of privatization-acquisition, the assessment has to pay special attention to training and knowledge transfer needs, to obligations taken over with the privatization deal, such as employment guarantees, and to business units of the acquired firm in which the investor has no primary interest.

The Learning and Education Process

Management in capitalist companies requires fundamentally different capabilities than in socialist firms. Technological skills in socialist countries were high due to a good general education in natural sciences, especially in mathematics and engineering. However, managerial capabilities were insufficient due to both the change of institutional context and the neglect of social sciences (other than ‘Marxism-Leninism’) by the socialist education system. This situation creates special challenges for knowledge transfer and managerial learning.

The required new capabilities often transcend the experience-horizon of individuals used to the central-plan system. Child (1993) distinguishes three levels of knowledge upgrading. At the *technical* level, new and specific techniques have to be acquired, such as methods for quality measurement, engineering techniques or the construction of samples for market research. At the *systemic* level, new systems and procedures have to be adopted, which requires integrative learning emphasizing co-ordination, relationships and the establishment of links concerning, for example, co-ordination of integrated production systems or production control and budgeting systems. To master these systems, former state-managers may have to unlearn acquired routines and replace them with new ones. Moreover, modern management practices, such as empowerment, may function only if attitudes and value systems held by individuals in the organization change too (Michailova 2002).

At the *strategic* level, senior managers have to change their cognitive framework for doing business and conducting management tasks . They need to reassess their business success criteria and the factors contributing to that success. This requires an understanding of technological and managerial processes in such depth that managers can engage in innovation, select and adapt technology, and take strategic decisions. Beyond new skills, entrepreneurial personalities have to emerge, able and willing to take risk and accept responsibility (Luthans et al. 2000).

The missing knowledge is often highly tacit, therefore requiring direct interaction between the learner and the provider of the knowledge. Yet, knowledge transfer is inhibited by cultural and institutional barriers (Jankowicz 1994, Kostera & Wicha 1996) as few Western managers and trainers have personal experiences with the previous socialist regime. Recipients learn and, in particular, internalize new knowledge by connecting new ideas and information with their prior knowledge and experiences, i.e. experiences in the socialist society (Soulsby & Clark 1996). Most academic observers stress the need to contextualize the contents and methods of training in Eastern Europe (e.g. Jankowicz 1994, Child & Czegledy 1996). To be useful for recipients in transition economies, transferred knowledge has to be applied in this context and built upon local foundations. Positive change in managerial practice is more likely if continuities with the values and decision-making processes are preserved (Vlachoutsicos & Lawrence 1996).

However, a fundamental discrepancy separates Western training methods and the expectations of Eastern employees. Many Western 'trainers' took, especially in the early 1990's, an ethnocentric perspective, believing in the superiority of the Western way of doing things, while being disrespectful, or unaware, of local traditions, cultures and accomplishments (Hollinshead & Michailova 2001). At the same time, training programs face the dilemma that formalized delivery methods, as preferred by many participants, cannot achieve the training objectives , i.e. inducing managers to think for themselves on a strategic level (Hollinshead & Michailova 2001). Especially where personality traits or value systems are affected, the learning process cannot be accomplished by conventional training methods, but requires experimental learning and critical self-reflection on the recipients' side.

For example, ABB trained its staff in over 50 acquisitions across Eastern Europe to enable local management to act independently within the decentralized structure of ABB. The intensive training started even before the acquisition was formally completed to prepare managers for the market economy and, specifically, the principles of management in ABB. Crucially, "middle managers were trained primarily in communication, problem solving, negotiation and leadership skills, as well as in finance, accounting, marketing and production management, using game, lectures and case studies" (Obloj and Thomas 1998, p. 393). This training provided a basis for a knowledge drive and a clear acceptance of continuous change, and it enabled managers to develop initiatives and strategies within the ABB network. For example, "they started to experiment with new production methods and in many divisions they adopted team-based production systems they observed working successfully in other ABB companies" (Obloj and Thomas 1998, p. 395).

For those taking over a state-owned firm, knowledge transfer to the affiliate is thus a core element of the transformation process. The literature suggests that investors empowering the local organization to learn and to absorb, integrate and apply new capabilities in the local context will be more successful than those that transfer processes directly and unadapted to the transition context. Hence:

Proposition 7: Post-acquisition performance is positively related to knowledge sharing that connects received knowledge with local institutions, cultures and traditions, rather than an unidirectional transfer of practices and procedures developed in a different context.

For managers, the learning and knowledge transfer literature provides clear insights. Knowledge transfer has to take account of local capabilities, cultures and traditions, revitalizing hidden capabilities and adapting contents and methods of training to the local context. This refers to both the substance of knowledge transfer and the methods of delivery. Experiential learning is widely recommended and case studies of firms in transition are now available. Moreover, Czarniawska (1997) suggests that sharing concrete experiences would be more helpful than abstract models.

Individuals that relate to both modern management and post-communist reality can bridge the cultural and systemic gap. Soulsby & Clark (1996) report that local consultants with Western training and émigrés returning to their roots have been highly appreciated by local managers, though there is also anecdotal evidence to the contrary such as returnees being perceived as "didn't make it in the West". In Central Europe, the intellectual and cultural gap between Western and local managers is narrowing, yet finding individuals capable of communicating effectively in the former Soviet Union is still a considerable challenge.

Creating New Capabilities

To build competitive advantage in transition economies, importing resources from the parent does not suffice. Rather, indigenous capabilities have to be created, connecting those of the parent with local ones. The acquired organization is a living organization with its own dynamics, history, resources and organizational culture. New capabilities are developed in an evolutionary pattern on the basis of the firm's knowledge, organizational culture and, possibly, individual value systems.

Radical environmental change induces evolutionary change in organizations, rather than an overnight reincarnation. Evolutionary scholars are concerned that the reforms in transition economies have been too preoccupied with removing institutional legacies for the sake of freeing the competitive forces of markets along Western models (Kogut, 1996, Spicer *et al.* 2000). This results in the wholesale importation of Western concepts, rules and institutions at both the national and organizational level. Few efforts have been made to develop new solutions better adapted to the transition context, which is, unlike mature economies, characterized by weak and unstable institutions and, consequently, high economic uncertainty (Newman 2000, Meyer 2001). Thus, neither the inherited routines, nor those adopted from Western partners and consultants fit the environment.

At first sight, foreign acquirers may see little value in the inherited organizational routines and cultures of the acquired formerly state-owned firm. Many firms undoubtedly had excess slack. Still, excessive reliance on cost cutting may undermine the firm's ability to develop new strategies (Grabher & Stark 1996). A certain degree of slack can be an important resource for innovation, for managerial learning and for transformation.

Moreover, investors risk losing valuable local capabilities if they concentrate on transfer of their established best practice and neglect development of variety by fostering indigenous capabilities (Meyer & Lieb-Dóczy 2003). Rather, Kogut (1996) encourages firms to focus on learning through experimentation, and the internal development of new routines and capabilities adapted to the specific context. This would enhance the firms' capabilities to operate successfully and to react to external shocks in the present environment. Initial support for new local practices may enable them to develop their full potential before they are exposed to (internal) competitive selection. Arguably, local initiative and experimentation has been crucial to the diverse yet overall successful restructuring strategies in ABB's Eastern European companies (Obloj and Thomas 1998). With time to adjust, affiliates may develop new indigenous capabilities, become more competitive by the new, market-based rules of the game, and contribute to the joint knowledge pool of the global firm.

New practices can be built on existing attitudes and value systems, selectively preserving what is worthy, and using experimentation to discover new best practices suitable for transition economies (Kogut 1996, Spicer *et al.* 2000). Overly ambitious change imposed on an organization may be counterproductive because, as Newman (2000) argues, the relationship between institution-level change and organizational change can have an inverted-U shape. Too radical change can create barriers to second-order learning and leave agents without suitable learning templates. This suggests that change may best be implemented in stages, allowing for the development of new solutions evolving in the local context, supported with knowledge transfer by the parent.

Proposition 8: Enabling the acquired organization to adapt, experiment and develop its own capabilities will generate better long-term performance in the acquired firm than the indiscriminate transfer and superimposition of Western best practice.

Integration managers must be aware of the depth of the required changes and establish realistic goals. If they act as facilitators of change and allow for an evolutionary process, they can nurture development of new capabilities, and eventually utilize them for the global organization. Transformation management may target a range of possible outcomes, rather than a point-target, to allow for evolutionary dynamics. Societal changes can support this process, although this too requires flexible interaction with the transition environment.

Conclusion

Privatization acquisitions are shaped by the institutional context, as the process determines the organizational arrangements for the affiliate. Managers design corporate acquisition and post-acquisition strategies under the institutional constraints imposed by transition. Hence, they need to understand the dynamics of the privatization process, which in turn conditions the post-privatization institutional context. Affiliates with inheritances from a state-owned firm are sensitive to the political context and have to manage their relations with authorities and with the public carefully. I suggested that, for example, a minority stake of local authorities might smooth this sensitive relationship in some cases.

When integrating a former state-owned firm, the acquirers have to instill new purpose into the organization and facilitate change along multiple dimensions. They may have to engage in deep restructuring and considerable resource transfer, and the acquisition may be only a small building block of the new affiliate, a ‘Brownfield investment’. Often, a major challenge is to break the continuity in ways that do not destroy valuable capabilities or positive change processes already underway.

Privatization in Eastern Europe has manifestly advanced since the early 1990’s and privatization is no longer the only way to acquire local firms. Many of the issues raised in this paper remain even when acquiring a notionally private firm: The state still holds minority stakes in many firms, while other firms are controlled by a complex web of stakeholders (Meyer 2001). A new phenomenon is therefore acquisitions of firms that have a history as state-owned firms, but were privatized in the 1990’ by local owners who may or may not have initiated strategic restructuring. Evidence, such as Danone in Russia (Florent et al. 2000) or Beiersdorf in Poland (Blazejewski et al. 2003), suggests that negotiation and restructuring challenges in these cases resemble those of the privatization acquisitions reviewed in this paper. However, it remains for future research to explore these types of acquisitions systematically.

While this work has focused on Eastern Europe, the management implications may well apply to other emerging economies going through major deregulation and privatization, such as Egypt and India, and in the near future perhaps China and Vietnam. I would like to encourage research in these countries about the similarities and differences of corporate strategies, such as those analyzed in this paper.

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Endnotes:

[1] Unsuccessful cases are rarely reported in detail, although they are frequent, as businesses naturally prefer to present their success stories. Case evidence of 'politicking' in the privatisation process is also presented by Antal-Mokos (1998). He reports 'juicy' details, but the names of the firms are disguised.

[2] The term "contract" is used here to refer to both contracts signed by the acquirer with local agents as well as legal acts that form foundation of the privatization process, e.g. tender documents.

[3] This does not apply, naturally, if the underlying objective of the acquisition has been to eliminate a competitor rather than to build a new operation.