FOOD PROCESSING AND FOOD PACKAGING IN HUNGARY, 2007

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CONTENTS

1. Hungary

1.1 Key facts

- Location**:** East-Central Europe
- Official name**:** Republic of Hungary
- Head of State**:** László Sólyom
- Head of Government**:** Ferenc Gyurcsány
- Area**:** 93030 km2
- Capital**:** Budapest
- Largest towns**:** Debrecen, Miskolc, Szeged, Pécs, Győr
- Time zone**:** GMT + 1 hour
- Population**:** 9,956,108 (July 2007 est.)
- Ethnic groups**:** Hungarian 92.3%, Roma 1.9%, other or unknown 5.8%
- Religions**:** Roman Catholic 51.9%, Calvinist 15.9%, Lutheran 3%, Greek Catholic 2.6%, other Christian 1%,
- Climate: temperate; cold, cloudy, humid winters; warm summers
- Geography**:** landlocked; strategic location astride main land routes between Western Europe and Balkan Peninsula as well as between Ukraine and Mediterranean basin;
- Terrain: mostly flat to rolling plains; hills and low mountains on the Slovakian border. Highest point: Kékes (1,014 meters). Lowest point: Tisza River 78 m
- Main rivers and lakes**:** Danube, Tisza, Lake Balaton, Lake Velence Natural resources**:** bauxite, coal, natural gas, fertile soils, arable land
- Environment**:** large ongoing investments to upgrade Hungary's standards in waste management, energy efficiency, and air, soil, and water pollution to meet EU requirements
- Currency: Forint (HUF)
- Composition of GDP: agriculture: 3.3%; industry: 32.5%; services: 64.2%

1.2 International environment

While the growth rate of the world economy slowed somewhat in 2005, it looks like growth generally rebounded last year in the major economic centres of the world and global growth may have reached levels above 5% once again. it also means that the world economy continues to expand faster than last ten years' average. Following a peak in 2004, the growth dynamics of the United States have slowed down in the past two years, however; the US economy remains to be one of the most important driving forces of the world economy. While 2006 H2 figures cast shadow on the most recent performance of the US economy, the year as a whole still saw growth at 3,3%, and medium-term prospects continue to be positive – especially when the expectedly one-off effects of housing market failures will be over. While Western European growth rates are still somewhat behind those of the United States – and even further behind the quickly converging economies of Asia – the economy of the European Union gained momentum last year. The growth rate of the enlarged EU reached 2,9%, which is well beyond previous expectations, and the highest since 2000. Growth rates of new Member States acceding to the EU in 2004 still – by far – exceeds the average growth rates of old Member States.

In line with prevailing former trends oil prices on the world market increased further in the first half of 2006 and the price of (Brent) crude oil peaked close to 80 dollars per barrel in the summer months. However, due to a sudden drop in the beginning of autumn, prices returned to levels (60 dollars) similar to that of the beginning of 2006 Following a further sharp drop in January 2007 to 50 dollars, price level is stabilising again around 60 dollar per barrel.

The trend of dollar strengthening that characterised the year 2005 reversed in 2006: from the cross rate below 1.20 dollar/euro in the beginning of the year the euro strengthened to levels above 1.30 dollar/euro by the end of the year. 2007 began with a strong dollar rebound, which proved to be temporary: the exchange rate has been at 1.31-1.32 in recent weeks..

1.3 Economic growth

According to preliminary figures the Hungarian economy was characterized by decreasing growth rates during the year, which, however, still almost reached 4% in 2006. Reflected the impressive growth experienced in Western Europe: gross domestic product grew by 4.9%, while the composition of growth remained basically unchanged, in the middle of the year, however, growth has lost momentum. It decelerated to 3.8% in the second and third quarter due to base effect, decreasing (governmental and manufacturing) investments and moderate consumption dynamics, and growth rate fell to 3.2% in last quarter of the year. After the slowdown of investments in 2006 the positive balance of external trade (according to national accounts) remained almost the only driving force of growth. The volume of investments dropped by 2% in 2006 mainly due to the decreasing investments in manufacturing (-5.1%) and real estate, renting and business activities (-4.1%), which couldn't be wholly offset by the somewhat slower (5.6%) investment growth of the transport, storage and communications sector.

Partly as a result of budget consolidation measures the growth rate of household consumption expenditures decelerated to 2% in the first three quarters of 2006, while public consumption fell by 5%. Quarterly export growth has continuously outpaced import dynamics for two years now and the positive gap expanded even further in Q2 and Q3 2006. This led to the balance turning positive in the last two quarters, according to current price figures of SNA foreign trade of goods and services. Net export position rose to 2% of GDP in the first three quarters of 2006; a considerable improvement over the -2.2% figure recorded in the same period of the previous year. Thus net exports has become the main component of GDP growth, adding 4.4 percentage points to it in Q1-Q3 2006. Concerning the production side of the GDP, growth in the services sector wasn't far behind the total GDP-growth, agricultural output – however – fell by 7.4% and that of construction dropped by 2%, while industry proved to be the most dynamic sector of the national economy in the first three quarters of 2006 (industrial added value grew by 9.2% in January-September). Industry remained to be characterized by dynamic growth in 2006 as well. The volume of industrial output increased by 10.1% in comparison with previous year’s level, which is 3 percentage points higher than the 2005 growth rate. The sector’s primary source of growth remained rooted in the two-digit expansion of exports, although the upturn of domestic sales (after a prolonged period of stagnation) did not run out of momentum either (this seems to be changed in the last two months however).

1.4 Competitiveness

Due to the outstanding industrial value added data, industrial productivity increased by 11.1% in the first three quarters, which is considerably above the 8.2% increase in industrial nominal wages. Other Visegrád countries have witnessed similar processes; however, as opposed to Hungary, the domestic currencies of the three countries have become stronger against the euro. Therefore, while the unit labour cost expressed in euro—which is appropriate for an international comparison—has decreased with a rate of over 10% in Hungary, ULC practically stagnated in Czech Republic and Slovakia and rose markedly in Poland in the first three quarters. While export sales prices expressed in HUF increased by only 5.2% in the first three quarters of 2006, the Hungarian forint weakened by as much as 7% and domestic sales prices increased by 5.9% on the most important markets of the European Union. The sales prices on the internal market of the EU 27 increased while the export prices of Hungarian industrial products (expressed in euros) fell, this way resulting an improvement in the market position of Hungarian industrial products on the European Union market: the producer price based real exchange rate deflated by the domestic industrial sales prices of the EU27 has shown a more marked depreciation in of 2006 as compared to the currencies of the other Visegrád countries.

1.5 Labour market

The slow, but steady rising of unemployment, which started in spring 2004, picked up in 2005 and in February 2006 reached its recent peak. Albeit unemployment rate improved somewhat beyond the usual seasonal effects in the spring, the favourable tendencies failed to prevail in the second half of the year. Employment rate however – although very slowly – started to creep up and these developments translated to considerably increasing participation rate. Labour market participation rose by 0.5 percentage points in 2006 to 55%, but this level is still extremely low in international comparison. Although the unemployment rate standing at 7.5% is fairly low, together with the slightly improving employment figure – 50.9% – they point to a fairly unfavourable labour market performance.

The number of employees dropped in the first two months of 2006, but due to the slowly improving figures of the following months the institutional labour statistics showed stagnating figures last year. The number of employees in the private sector rose by 0.6% on average, while the public sector headcount shrank by 2,2%. Thus the favourable restructuring trend seems to prevail in 2006 as while, albeit at a rather low pace.

Nominal gross average monthly earnings of full-time employees increased by 8.1% nominally on national level in 2006. Net dynamics fell behind that of gross by 0.6 percentage point, thus net real wages grew by 3.4% on average, compared to the same period of previous year. It has to be noted that due to the modified tax legislation which came into effect on the 1st September, the net real wage growth in Autumn dropped to -1.5% and the figure for December turned out to be positive only, due to surging bonuses.

The new recommendation of the National Consultation Council on nominal gross wage dynamics for the private sector is 5.5-8% in 2007. The recent agreement for the public sector contained a partial pre-payment of the 13th monthy salary of 2008 in the second half of this year, while the budget planned a 2.5% increase. These factors suggest a rate of 6-6.5% on annual terms, but it is possible that planned reorganisation of several institutions would affect public sector wage dynamics. Altogether, annual gross nominal wage dynamics is expected to hit 7-7.5% in 2007 on national level. Net real growth however will plunge compared to previous years – due to increasing tax and social security contributions and the accelerating inflation. Thus annual net real wage growth is expected to be between -3.5-4%.

1.6 Equilibrium

In 2006 the dynamics of foreign trade accelerated significantly in both directions. Although dynamics fluctuated significantly – especially in the second quarter –, the whole of the period was characterised by export dynamics being 2,7 %-point higher than that of imports. Y-o-y growth rates in EUR terms stood at 16.6% and 13.9% respectively, which resulted in EUR 1 964 million foreign trade deficit – EUR 940 million lower than the revised data for 2005. Export and import volumes rose by 16.8% and 12.6% respectively last year, while nominal figures reached EUR 58,4 billion (close to 66% of GDP) and and EUR 60.3 billion (more than 68% of GDP). Although we expect the surplus of export growth to narrow this year, some additional improvement of the trade balance would not come as a surprise.

The deficit of the current account amounted to EUR 4 062 million in January-September 2006, which is 566 million euros lower than in the same period of previous year. The deficit decrease was largely attributable to an improvement (EUR 510 million) in the balance of goods. Balance deterioration was observed only at the income (the deficit increased by EUR 366 million, to EUR 4,5 billion). The surplus of services increased by EUR 145 million, to EUR 785 million and the balance of current transfers improved by EUR 277 million, to EUR 262 million. The deterioration of balance of income was largely attributable to the increase of deficit on income on equity while the deficit on income on debt increased only slightly (by EUR 62 million) and the balance of compensation of employees improved by EUR 15 million as compared to 2005 levels. Within services the travel surplus increased by EUR 289 million, while the deficit on other services increased by EUR 144 million. The actual (net) external financing requirement amounted to EUR 3 704 million, which is EUR 492 million lower than in the same period of previous year.

In January-September 2006 the total amount of foreign direct investment inflow into Hungary amounted to EUR 3 737 million, which is EUR 610 million higher than in the same period of 2005 and the highest amount ever. Of the total amount of foreign direct investment inflow EUR 1 962 million took the form of equity capital, of which the MOL-E.ON gas business sales transaction generated EUR 478 million. In 2006 and 2007 and in the medium term around EUR 4 billion of total FDI inflow annually is expected. Although the foreign direct investment of Hungarian enterprises abroad in January-September 2006 (EUR 753 million) lags behind the amount of the same period of previous year, considering the acquisitions of certain domestic corporations closed in the last quarter Hungarian FDI export is expected to have reached signifi cant – even record – levels in 2006.

After falling to historic lows in early 2006, consumer inflation started accelerating in the second half of the year. Due to the cut of the 25% VAT rate in January, the 12-month consumer price index fell below 3% (reaching its lowest level at 2.3% in the spring), then it started rising again. From September, inflation jumped over 6% as the consequence of the increase of the 15% VAT rate and the adjustment of regulated energy prices. In December, headline inflation stood at 6.5% (average annual rate of inflation was 3.9% in 2006), and the consumer price index rose further in early 2007 (7.8% in January).

1.7 Financial markets

During the January-March period of 2006 the BUX index has increased by more than 14% and reached the 24 000 point historic height by the end of February. However this period was followed by a general drop on the global financial markets. After a 10% correction of the BUX stock prices began to rise again and the stock-index reached the 25 000 point historic height in May. As a result of the drop explained by international effects by mid-June the BUX has lost 25% of its one month earlier value. In the second half of June – in line with the positive international atmosphere – the Budapest Stock Exchange started to work off the result of the recession. By the end of the summer the stock index reached 22 000 points. All together the BUX showed positive direction in 2006, the BUX index has reached almost 25 000 points by the end of the year. The uncertainty has remained on the stock exchange and the BUX index's performance is relatively moveless followed by a 7% drop in Januarry. Since that the BUX moved in a narrow band (between 23 200 and 24 200 points). The central bank has raised the rate in June (it was the first after 2003) and this was followed by four additional times by a total of 200 base point rise. Accordingly the current level of the interest rate is 8%.

After the ambitious begin on the forint and government bond market in January 2006, recession and than uncertainty was coming on these markets. In the first two months of 2006 bond yields have been stabilised around their September level. In the first half of March a sudden fall was developed in the investors' mood thanks to the negative changes on the developed markets. Financial markets have suffered losses in May again, yields have grown dynamically. Since July – except some slightly increase in September and October – yields have decreased. Yields have been slightly increasing at the beginning of the year in the case of the 3-month-yield level it was 0,2%, the 10-year-yield has increased in an average of 0,3%. The exchange rate of the Hungarian forint showed the same attitude that of the bond yield. At the beginning of 2006 the exchange rate moved within a relatively narrow 250-260 HUF/EUR band. In the beginning of March the forint, however, – among other currencies of the region – has started declining, during the March-June period it moved between 260- 270 HUF/EUR, in July-October it was fluctuating between 270-280 HUF/EUR. In the beginning of October forint started to strengthen and due to the continuous appreciation by the end of the year forint has gained a 10% value against the euro. Since January however the exchange has not change significantly – except a slightly drop at the end of January – and it has settled between 250-255 HUF/EUR.

2. Introduction

After the fall of Communism in 1989, the Hungarian food and agricultural sector began a transition from a state controlled economy to a market economy.

As in other transition economies, Hungary's market reforms required enormous adjustment costs to agriculture and the food industry, which included privatisation of land and capital, elimination of consumer subsidies, contraction of consumer demand (that accompanied the 1991-93 recession), and increased production costs.

Hungary's agricultural sector and food industry accounts for approximately 7,5% of gross domestic product (GDP). Agriculture alone employs around 5,0% of the labour force. Principal crops are wheat, corn, sunflower seed, sugar beets, and potatoes. Pork and poultry are Hungary's principal livestock products.

2.1 Market trends

Hungary's agricultural sector shrank considerably during the first half of the transition. Between 1989 and 1995, gross agricultural output declined by 36 percent, with most of the decline, taking place in 1991 and 1992. Agriculture's share of GDP in 1996 was half the 1990 level. The output is still diminishing especially in the animal production.

A significant raise in consumption along with increasing wages supports the opportunities for foreign companies to compete on the Hungarian market for food.

Along with the large and increasing number of tourists visiting Hungary the higher wages and salaries create a still increasing catering market, with possibilities for high quality products.

Agriculture in Hungary is a major regional producer of corn (5-8 million metric tonnes per year), wheat (3-6 million metric tonnes), and sunflowers (close to 1 million metric tonnes in a good year). Total grain acreage in Hungary is about a third of the size of Poland’s, although Hungary's yields are higher, except for rye. Feed demand accounts for 80 percent of Hungary's corn crop and a third of the wheat crop.

Net exports for both corn and wheat are positive, but vary from year to year, depending on weather and world market conditions. Hungary is a net importer of protein feeding stuff - primarily soybean meal—but a net exporter of sunflowers. Soybean meal is higher in protein and has fewer nutritional restrictions in animal feeding. Hungary appears to have a comparative advantage in sunflower production, relative to major soybean-meal-producing countries such as Brazil and the United States.

During the transition, Hungarian livestock and poultry producers reduced inventories in response to increased production costs and lower consumer demand. Between 1988 and 1998, cattle inventories declined by 44 percent, hogs by 34 percent, and poultry by 18 percent. Hog inventories have not even been stabilized today, so both cattle and pig numbers continue to decline. This year also poultry production is affected negatively by the arrival of the avian flue.

Inventory fluctuations in the mid-1990s have been comparatively measured, correlated with weather-related changes in feed prices. Hungary continues to be a net exporter of both beef and pork products. However, when Hungary joined the EU in May 2004, higher costs associated with Hungarian products continued to squeeze producers' profits, as well as Hungarian shares in domestic and foreign markets. After contracting in the early transition, poultry production in Hungary has expanded since 1994.

Consumption of beef and pork appears to have stabilized, though at levels far below those of the Communist era. Hungary remains a net exporter of poultry products, although exports are small, suggesting that Hungarian consumers prefer the relatively low-priced protein of poultry.

2.2 Fish

The fact that Hungary has no access to the sea, makes the country an importer of saltwater fish. That the country is landlocked however does not mean that there is no fishing industry. A large number of fish farms supply the consumers with freshwater fish. The market for imported seafood in Hungary is around EUR 12 to 15 million. The consumption is still low (3 kg. per capita) but rising along with increasing incomes, tourism and the spread of hypermarkets and distribution centres. The most important way of distributing seafood in Hungary is in the catering sector, around 80% of all imported seafood is sold to hotels and restaurants.

2.3 Market size indicators

Hungary's food processing sector has been entirely privatised, through the start-up of new companies and the sale of shares in the former state-owned companies. Foreign investment has played a critical role in the development of this sector. Overall, the share of foreign ownership in Hungarian agribusiness is 30 percent; it is over 50 percent in the food and beverage industry. Some industries within Hungary's food processing sector, such as vegetable oil and tobacco production, are 100-percent foreign owned. Foreign ownership is nearly as high in other sectors, such as turkey production (90 percent) and meat processing (around 50 percent).

Privatisation of the food industry, however, has not necessarily meant higher incomes for producers. Producers complain that in some sectors the state monopoly has simply been replaced by a private monopoly.

3. Statistics

A REGISTERED FOOD PRODUCTION COMPANIES FOR SECTOR*

Definition	Number of companies			
	2003	2004	2005	2006
Production of food, bevarages and tobacco products	**2 662**	**2 731**	**2 746**	**2 741**
Food, beverages	2 655	2 725	2 740	2 738
Meat processing ,preserving	257	257	265	249
Poultry processing, preserving	81	93	98	92
Production of meat and poultry products	62	62	65	58
Fruit and vegetable processing	191	191	197	198
Milk products	63	61	59	59
Sugar production	5	3	4	4
Sweets products	94	92	95	98
Distilled alcohol beverage production	51	47	50	49
Wine production	160	169	175	184
Beer production	35	29	27	27
Soft drink production	105	132	132	135
Tobacco products	7	6	6	3

*) Companies with more than 4 employees

Source: Central Statistic Office

NUMBER OF EMPLOYEES IN FOOD INDUSTRY BY SECTOR *

Definition	2003	2004	2005	2006
	number of employees			
Production of food, beverages and tobacco products	**125 729**	**115 879**	**113 443**	**106 991**
Within this:				
Food, beverages production	123 668	114 185	111 897	106 100
Within this:				
Meat processing, preserving	14 973	11 820	12 555	10 575
Poultry processing,preserving	15 824	13 924	12 057	12 434
Meat and poultry products	4 712	7 147	5 024	6 197
Fish processing	161	170	68	55
Fruit and vegetable processing	12 256	11 016	10 153	9 064
Milk products	8 911	8 523	8 292	7 875
Milling industry products	5 797	4 835	4 356	3 326
Fodder production	5 189	5 070	4 985	4 228
Other food products	39 742	36 410	39 251	37 530
Bread and frash pasta products	22 190	22 138	24 501	23 135
Preserved floury products	3 136	2 937	3 137	2 855
Sugar production	1 411	1 250	1 394	1 247
Sweets products	5 146	4 885	4 560	4 698
Distilled alcholic products	1 531	1 343	1 394	1 383
Wine production	4 226	3 917	3 997	3 925
Beer production	3 075	2 666	2 309	2 228
Soft drinks production	4 401	4 546	4 749	4 651
Tobacco products	2 061	1 694	1 546	891

*) Companies with more than 4 employees

Source: Central Statistic Office

VALUE OF INVESTMENTS*

Definition	2002	2003	2004	2005	2006+)
	million HUF current price				
Total food, bevearges and tobacco products	**108 002**	**96 943**	**112 168**	**101 693**	**113 074**
Within this :					
Meat and fish processing	8 629	10 351	13 615	7 745	9 765
Poultry processing	9 179	4 350	7 528	9 843	6 442
Fruit and vegetable processing	11 544	10 084	7 380	6 836	14 519
Milling products	9 364	7 807	10 735	7 999	6 946
Fodder products	2 512	2 923	6 713	7 384	10 902
Sugar production	7 116	5 981	5 805	6 188	3 092
Sweets products	2 426	2 334	2 679	2 231	1 507
Alcohol and alcoholic drinks	3 803	2 741	4 031	3 749	3 351
Wine production	1 756	1 477	2 997	4 328	2 863
Beer products	4 810	3 969	5 635	4 902	2 220
Soft drink production	6 866	5 378	6 756	4 642	3 849
Tobacco products	7 669	5 598	6 949	6 470	5 911
	4 517	6 666	3 252	3 358	2 758

*) Investments of companies and budget- funded institutions

Source : Central Statistics Office

4. Hungary Food & Drink Industry SWOT

Strengths

- The food-processing sector is among the most modern in Eastern Europe, with a strong focus on exports
- The food-manufacturing sector has attracted significant foreign investment, and the leading companies now include both local and international operators
- Hypermarkets provided the highest sales value per outlet, at an estimated US$44.78mn in 2005, followed by discount stores at US$3.49mn per store
- Hungarians purchased just under a third of their daily grocery provisions in hypermarkets last year and the trend points to consumers increasingly spending their money in big stores

Weaknesses

- The saturation of the retail market has discouraged major players including Wal-Mart
- and Aldi from entering Hungary as originally planned in 2006 Income inequality is increasing and local consumption patterns vary significantly according to income
- The beer industry is currently facing falling sales as a result of increased imports and excessive taxation. Beer sales fell by 11% in 2004 with taxes constituting around 40% of the price of Hungarian-brewed beer
- Growth in the meat and dairy markets is slower than in some CEE countries. Animal products experienced an increase of 1.9% in terms of producer prices in the first 11months of 2005 compared to the same period the previous year. However, production only reached 2.02% between 1999 and 2004

Opportunities

- Healthy eating trends are boosting the value of previously relatively untapped markets such as cereal snack bars and bottle mineral water. Innovation opportunities are now rife in healthy categories
- The average number of unemployed people in Hungary was 305,700 in April to June 2006, resulting in an unemployment rate of 7.2% according to the Central Statistics Office (KSH). The unemployment rate fell from 7.3% in the previous three-month period but represented an increase from 7.1% y-o-y
- Prices of Hungarian farmland are estimated to be a quarter of average prices in the EU, offering wide appeal to investors from other EU countries
- Changing consumer habits and increasing car usage suggest that modern retail outlets will continue to expand their market share
- Sub-sectors set to experience significant growth rates as a result of rising disposable incomes, include confectionery, beer and soft drinks, with foreign multinationals having invested large sums in recent years

Threats

- The Hungarian competition authority is coming down hard on retailers it believes are misleading consumers. It has fined Auchan and Tesco for misleading advertising campaigns. In July 2006, the French supermarket retailer was fined more than US$230,000 in relation to statements regarding certain products being the cheapest on the market
- Economically, Hungary does not perform as well as politically. The ‘twin’ deficits represent a major threat to economic stability, and the domestic currency, the forint, has already fallen significantly this year against the euro as a result of falling investor confidence
- Hungary’s ability to attract foreign investment is subject to increasing competition from lower-cost markets such as Bulgaria and Romania

5. Developments

5.1 Industry Developments

- The organic movement has evolved into a major driving force in the global food and drink industry for the 21st century. In 2005, the global organic food and drink market reached an estimated value of US$40bn (EUR32bn), and Europe holds a 45% share of this total. Generally, there is a growing perception that organic food is of a better quality compared to standard produce in the CEE region. However, the premiums associated with organic farming methods bump up the unit price for the end consumer, and in many parts of the CEE region, where consumer spending on food is declining as a percentage of GDP, this is a major hurdle.

- Countries that have already joined the EU are hotspots for organic food producers and retailers. EU accession has sparked major growth in Eastern Europe, and placed the region as a key player in the lobal organic marketplace. Organic farmers in CEE now have ready access to the Western European market valued at EUR12bn in 2004. It is believed that farmers in the more developed markets spent years preparing for EU accession, in order to reap the benefits of this profitable trend as soon as possible. Organic farmland in the three largest accession countries – Poland, Hungary and the Czech Republic – grew by 150% between 1999 and 2003. The Czech Republic leads in the CEE region, and among the accession countries, in terms of organic farmland. Six percent of Czech farmland has been converted to organic methods, which equates to more than 255,000 hectares. This exceeds the UK's position, which is the second-largest market for organic food behind Germany, with just 4.5% of farming certified as organic. Hungary follows the lead of the Czech Republic with 114,000 hectares of dedicated land, ahead of Slovakia with 55,000 hectares and Poland with 49,000.

- The Slovak Agriculture Minister filed criminal complaints against Tesco for selling bad foodstuffs in Q206. This follows an investigation last year which found that the company was routinely selling meat well past the expiration date after simply re-labelling it, and resulted in fines to the company of EUR25,000, a mere drop in the ocean for a corporation of its size. In response to public pressure due to the high levels of public hostility towards such large foreign companies, the Slovak government decided to take action, launching criminal proceedings. The issue of selling out-of-date meat has been found to be endemic to the region, as similar scandals have erupted in Poland and the Czech Republic. This is due to the highly competitive nature of the CEE food retail market, where many stores generate losses, take years to turn a profit, and therefore look for ways to cut corners, with producers (or in this case consumers) often paying the price.

- Lidl has agreed to remove canned meat products from Hungarian shelves following complaints from Greenpeace that it contains genetically modified organisms (GMOs). Tesco has also agreed to a similar course of action if the producer provides evidence that GMOs have indeed been used to produce three local meat products.

- A reduction in VAT rates has been counteracted by increases in excise duties on alcoholic drinks (to HUF220,600 from 192,000). The retail price of beer and sparkling wine noticeably increased due to these increases at the start of 2006.

- Demonstrations against the falling prices of milk and milk products took place in August 2005 outside two Auchan hypermarkets in Budapest. No solution to the farmers' queries has been reported and further demonstrations are expected.

5. 2 Company Developments

- In July 2006, **Central European Distribution Corporation** completed its purchase of alcoholic drinks company **Bols Hungary**. The US company acquired 100% of Bols share capital from **Remy Cointreau** and **DELB**. It also bought the Royal Vodka trademark, which is the number one selling vodka in Hungary, for US$19.6mn. CEDC is also the largest vodka producer in Poland.

- **Pécs Brewery Rt**, a Hungarian brewer owned by Austria's **Ottakringer Brauerei AG** has announced plans to spend HUF1bn (US$4.72mn) in expanding its production capacity. Pécs will install new equipment, worth HUF630mn (US$2.97mn), to produce canned beer, which is expected to increase production to 460,000hl this year from 421,000hl in 2005. Bearing in mind the high taxes on beers, Pécs Brewery has also decided to spend HUF260mn (US$1.23mn) on product innovation, including the introduction of a non-alcoholic energy drink. Company sales rose to HUF5.2bn (US$24.4mn) last year, up from HUF5bn (US$23.5mn) the previous year.

- According to **SABMiller**, the number two alcoholic drinks company in Hungary, innovation will be imperative to growth in this sector over the next few years. The London-listed brewer, which operates in six markets in CEE, told representatives at a press conference in April 2006 that it expects its volumes to grow 'in the mid-single digits' over the 'next few years'. Alan Clark, SABMiller's European managing director said that he believed rising disposable incomes would encourage beer drinkers to trade up to premium brands, particularly in the on-trade.

- The assets of **Parmalat Hungaria Rt** were purchased by dairy company **Alföldi Milk Kft** in 2005. It is beneficial for the company to maintain the brand name Parmalat as it is well recognised in Hungary. Alföldi Tej produces 250mn litres of milk a year and aims to keep the Székesfehérvár workers of Parmalat, applying for job-retaining subsidies.

- Hungarian wine distributor **Monarchia Matt International** (MMI) has secured a two-year financing agreement worth US$3.6mn with US venture merchant bankers, **Capstone Business Credit LLC**. MMI distributes wines throughout the US and in Hungary but wishes to expand to Holland, Austria and other countries within the EU. The deal with Capstone, which includes US$1.2mn of purchase order financing and US$2.4mn of factoring services, will enable it to meet the demands of such an expansion drive. Capstone can ensure a more predictable level of cash flow for the business, giving the company more power in negotiations with suppliers and allowing it to price its products more competitively.

- Hungarian meat processor **Délhus Rt** announced its intention of moving its pig slaughtering operating from its Pécs facility to the plant of its recently acquired sausage manufacturing unit **Pick Szeged**. Operations will be transferred at the start of 2006, allowing Délhus to utilise Pick's facilities, which have an annual slaughtering capacity of 650,000 pigs. Délhus increased its stake in Pick – Hungary's leading sausage maker – from 31.2% to 98% in mid-September 2005. However, the acquisition of a controlling stake in Pick does not mean a winding down of activity at the company's Pécs site. Délhus is to invest HUF750mn (US$3.6mn) in constructing a new processing and packaging plant at the site, which will create around 100 new jobs.

- Polish food and beverage manufacturer **Maspex Wadowice** has acquired the Hungarian mineral water brand Apenta from beverage firm **Apenta Asvanyviz es Udirtoital** for an undisclosed sum. The acquisition is expansion-driven Maspex's third purchase in Hungary and the company's 11th in total. Maspex is to produce and distribute the Apenta brand through another of its recent Hungarian acquisitions, **Olympos**.

- German coffee producer **Tchibo** is to close operations at its Czech and Hungarian production plants and transfer part of the two facilities' operations to Poland, in an effort to consolidate the group's business activities. In order to accommodate the increased demand, Tchibo's Polish subsidiary **Tchibo Warszawa** has invested PLN6mn (US$1.9mn) in installing a new instant coffee packaging line at its Marki facility, near Warsaw. The new line was operational in Q106 and produces instant coffee to be sold both domestically and in the markets of Slovakia, Hungary, Romania and the Czech Republic.

- Western Hungary's **Konyari Winery** is to invest HUF520mn (US$2.5mn) in the establishment of a new processing and bottling plant. The new facility, which will be half funded by the country's Agricultural and Rural Development Orientation Programme, will have the capacity to produce 6,000hl of must and 600,000 bottles of wine annually. The plant is not expected to turn a profit for eight to 10 years, showing Konyari's faith in the future growth of the industry. The Balatonlellebased company's commitment to its growth was further demonstrated last year when it invested HUF370mn (US$1.8mn) in constructing a new grape processing plant.

- Hungary's two leading bakeries have merged to form a new company called **Transdanubium ZM Z Rt** in an effort to fend off international competition. Both companies had been seeking ways to improve efficiency and reduce margins, which the newly established merged company will allow them to do. All production will be transferred to just one site, most likely the Zalaegerszeg plant. Distribution and marketing activities will also be co-ordinated, although both brands will retain their current names.

- The State Financial Institutions Supervision (PSZÁF) of Hungary has authorised a bid by Heineken of the Netherlands to acquire Brau Union Hungária Brewery. Heineken, through its subsidiary **Brau Immobilien**, has offered some US$93.78 per share, about one-third more than it previously offered in 2003. A court had ruled that Heineken's earlier offer was too low and that it had to raise its bid. As PSZAF discussed and evaluated the offer price – calculated with discounted cash flow methodology – with the help of outside experts, Brau's board did not request further checks of the price by third-party professionals, according to Brau's statement. Heineken had made two earlier attempts to buy the public shares. Heineken already controls Brau Union Hungaria's parent company, **Brau Union AG**, and in October 2003 the Dutch company acquired a 93.2% stake in Brau Union Hungaria. The brewer's board is appointed by Heineken.

- Friesland announced at the end of 2005 that it planned to close its dairy plant at Békéscsaba from March 1 2006 onwards. Production will be focused at its dairy plant in Gyöngyös. According to company statements the move does not affect its 25% share of the Hungarian market. The company has invested more than US16mn in its dairy facilities in Hungary over the past three years.

- Hungarian food canners, already struggling to survive following EU accession in May 2004, fear industry repercussions if the EU adopts proposals to reduce import duties on various canned produce. According to The Hungarian Canning Industry Association, the industry, which was valued at more than EUR475mn in 2005, would be diminished by around 50% were the EU to reduce customs duties by 3.5% on a variety of canned products, particularly canned sweetcorn from Thailand. Corn canning constitutes around 50% of the domestic industry, rendering it vulnerable to cheaper Thai imports, which can be bought for 30-50% less, due to less expensive labour costs and a more favourable exchange rate for Thai producers, who trade in dollars and not euros. The EU planned to cut duties by July 2005, in line with the Generalised System of Trade Preferences, an initiative described by the head of the Commission's delegation to Thailand Klauspeter Schmallenbach, as a 'key instrument to help developing countries stimulate their exports to the EU'. EU accession, which also heralded the end of Hungarian state subsidies in agriculture, has pressured the industry still further by increasing vegetable prices. It was reported last year that a total of 100 canning companies would face closure as a direct result of rising prices. Hungarian food producer **Globus** recently announced that higher vegetable prices had significantly contributed to an 86% decrease in net profits, which fell to EUR1mn during the first three quarters of 2004, despite a 23% increase in domestic sales during the same period.

5. 3 Market Overview

The Hungarian food-processing sector is the most modern in Eastern Europe and its export revenues are vital to Hungary's overall trade balance. International players have invested significantly in privatised companies active in sugar production, vegetable oil processing, confectionery and snacks. In other sectors, privatisation has taken place at a slower rate and foreign involvement has usually taken the form of small- to mid-sized joint ventures with domestic majority ownership. This applies, for example, to the milling, baking, pasta and poultry industries. Food prices went up by 0.9% in monthly and 5.3% in annual terms in April 2006, which compares with a respective 1.2% and 5.1% growth in March 2006.

A major hurdle for domestic food and drink companies in 2006 is the increasing number of hard discounters and aggressively priced private labels, which threaten sales of smaller brands. These small players must also contend with the huge marketing activities and budgets of international competitors offering new, innovative and premium brands.

Bird flu is expected to return and make an impact on the Hungarian food industry in Q406, although consumers are getting accustomed to reading about the latest food scare to reach their kitchen tables. The government has been reassuring the public that bird flu poses no risk to humans. The largest food scandal to ever face Hungary happened a year ago, when tainted paprika from Brazil – imported via Spain – was mixed with a Hungarian variety. The scandal caused controversy and the government had to allocate significant resources to calm the domestic and foreign outcries.

Prices of Hungarian farmland are estimated to be a quarter of average prices in the EU, offering wide appeal to investors from other EU countries. However, this is likely to change now Hungary has joined the EU and the EU Commission has agreed to allow Hungary to impose a seven-year moratorium on land sales to foreigners. However, in May 2004, the Hungarian parliament passed an amendment allowing foreigners already active in Hungarian agriculture for a minimum of three years to buy land.

Growth in the meat and dairy markets is slower than witnessed in some other CEE countries. Animal products experienced an increase of 1.9% in terms of producer prices in the first 11 months of 2005 compared to the same period the previous year, according to the Central Statistics Office (KSH). However, production only reached 2.02% between 1999 and 2004. The price of slaughter pigs rose by 5.5% in January to November 2005 compared to the previous year, while the price of poultry for slaughter fell by 3.6%. The price of cattle for slaughter increased 19.6% over the same period. Joining the EU has meant producers have faced far greater competition in their domestic markets, while arguably they lack the products, investment and know-how to compete effectively in the wider EU arena, at least for the short to medium term. In Hungary, agricultural production continues to rely heavily on small farms, for example, small farms, with no more than five animals in stock at a time, account for nearly 25% of production.

Between 1999 and 2004, milk production fell by 7.09%, while the producer price of milk went up 2.7% in the first 11 months of 2005 compared to the previous year. Production of eggs in Hungary increased by 4.64% between 1999 and 2004, despite the producer prices falling by 3.6% in 2005 y-o-y.

Overall, the food and drinks sector is dominated by multinational operators and is very competitive and highly export-oriented, with an average export share of 20%. For some industry sectors, including canning, meat, dairy and poultry, this share is even higher. The strong export orientation is due to the increase in the number of companies with new, more efficient production facilities and a decline in domestic consumption, which led to excess production capacities, significantly increasing the pressure to export. Within the group of Central and Eastern European countries, Hungary is the only net exporter of food products. The most important export products are fruit and vegetables, meat, poultry, confectionery and dairy products. In 2005, the value of food production was around EUR9.5bn, representing around 18% of total industrial production.

By the beginning of 2012, **BMI** expects that more than two-thirds of Hungarian households will be earning more than US$15,000 a year, and one-third will earn more than US$25,000. However, the food industry is expected to reach stagnation in volume terms. The soft drinks market is one of the few exceptions to this rule, as Hungarians follow consumption patterns currently witnessed in Western Europe. In the soft drinks sector, a few well-known and heavily promoted brands share the market with an increasing number of minor product ranges. Sales of carbonates in particular are dominated by multinationals **Coca-Cola** and **PepsiCo**, while domestic manufacturers hold stronger positions in the bottled water and fruit juice sub-sectors. In July 2005, **Coca-Cola Hungary Kft** agreed to change its marketing and business

activities in the country to avoid a fine from the EU competition office, after being accused of abusing its dominant market position. The parent company opted to negotiate with the competition office rather than face mandatory fines – a technique that the competition watchdog itself prefers. The soft drinks giant has promised to no longer offer discounts to retailers that meet a certain sales volume. It has also pledged not to sign exclusive contracts with retailers and to allow the stocking of competitor drinks in up to a fifth of the space in its branded refrigerators. In the alcoholic drinks sector, domestic operators dominate sales with their traditionally favourably priced products, due to the price consciousness of Hungarian consumers. This has made it difficult for foreign manufacturers' products to successfully penetrate the market.
Following Hungary's EU accession in May 2004, direct competition from EU markets began to increase and domestic manufacturers have been forced to invest in the quality, packaging and image of their products. In order to benefit from the opportunities that EU membership offers, manufacturers have found it increasingly necessary to join forces to promote products abroad, especially in the case of local wines and spirits.

Organic food is now produced on 2% of Hungary's agricultural land as demand increases and consumer awareness of pesticides and additives grows due to media attention on healthy eating. Price is the major barrier to growth, however, as Hungarians are renowned for being extremely cost-conscious. In April 2004, poultry processor **Master Good** established Hungary's first organic poultry processing plant, with a large share of production aimed at European export markets. Construction of the new facility was partfunded by both the European Union and the Hungarian government.

6. Distribution system

After the poltical changes of 1989 the structure of commercial distribution has changed radically also because of the increasing purchase power and because of foreign investments which launched a significant development process. The previous system was based on state – owned distribution chains and shops which was replaced by a private system adopted to Europen standards.
One of the main characteristics of Hungarian commercial activity is the high turnover of operators in the various sectors which needs a precautionary approach from exporters.

Regarding consumption goods, the importer often takes care of distribution, as well through a network of dealers.

Considering that in 2000, the main consumption goods were sold in 25 thousand sales points, the distribution among the various channels is the following :

• hypermarkets : 16% of the money spent by Hungarian families for the purchase of consumption goods went to 32 hypermarkets ;
• discount stores : 300 sales points of this type obtained 12% of family spenings (these stores offer a wide range of products at lower price);
•supermarkets : in Hungary there are 1000, belonging to different chains, these get 17% of spendings .

These three distribution channels count only 1.400 sales points (5,6% of retail stores) while they collect 52% of the total sales volume. The remaining 48% is divided between 23.600 stores, open – air markets and other channels.
15% of sales of consumption goods is realized in shopping centers but this number can easily double int he following 10 years.

The growing number of hypermarkets is the most indicative data emerging from the analysis of the Hungarian distribution channels.

The distribution system is oriented towards big retail chains substituting at least partly the small traditional shops.

The saturation of the western markets and first of all the lack of regulation of the distribution sector - unlike the rigid regulations in force in Europe – allowed the big foreign chains to enter Hungary …

Today, retail trade is in a strong development and it determines the growth of shopping centers.

Shopping centers are open on Sundays, as well, inside there is always a hypermarket, a large scale of small clothes shops, multimedia and service points, a space dedicated to gastronomy, often amusement arcades and movies – they have become places where Hungarian citizens like to spend the weeend.

These centers are in a way similar to American shopping malls with hypermarkets, multiplex cinema, consumer electronics, restaurants and many small shops and sepcilaized services.

The phenomenon of the rapid growth of hypermarkets on the other hand, has caused the creation of purchase groups of local retailers in order to obtain lower costs and consequently offer competitive prices. According to analysts, non organized retail trade does not have a future and in the following years it will be necessary to create more and more forms of associated trade. The sales volume in supermarkets, discount chains, small self-service shops and markets has remained the same throughout the past years since the growth of hypermarkets has reduced the number of small shops and open air markets.

Small retail shops will always reamin of certain importance because of their proximity to residential areas and the loyalty of customers but the mix of their products might change. Supermarkets will still gain ground they have not been influenced by hypermarkets.

At the moment , the distribution system in Hungary is divided in the following way :
•Hypermarkets : sales points with at least 5.300 square meters surface, the most important chains present int he country are TESCO, CORA, METRO e AUCHAN;
•Superstore: sales points with 700 – 5.300 square meters surface (Kaiser's, Match, Smatch, Spar, Interspar e Billa);
•Discount: chains present in the country are Profi, Jéé, Penny Market , Discount Plus and Lidl;
•Commercial centers : these have a surface of more than 5.000 square meters. At the moment there are 31 only in Budapest and other centers will be built in the near future;
•Department stores : situated on at least 1.000 square meters, these do not sell food products and have big parking areas;
•Retail parks : various department stores can be found within the area;
•Supermarkets : surface varying between 400 and 2.700 square meters, the 80% of their income is from the sale of food products.

The importance of shops with an area of more than 1.000 square meters is continuously growing, as the number of shops between 400 – 1.000 square meters is also increasing especially in smaller centers. Survival is more difficult for shops belonging to the 40 – 400 square meters category which are not able to compete with the big chains.

The small shops will also face hard times, but they can maintain their role for daily purchases.

What us to be expected for the following years :

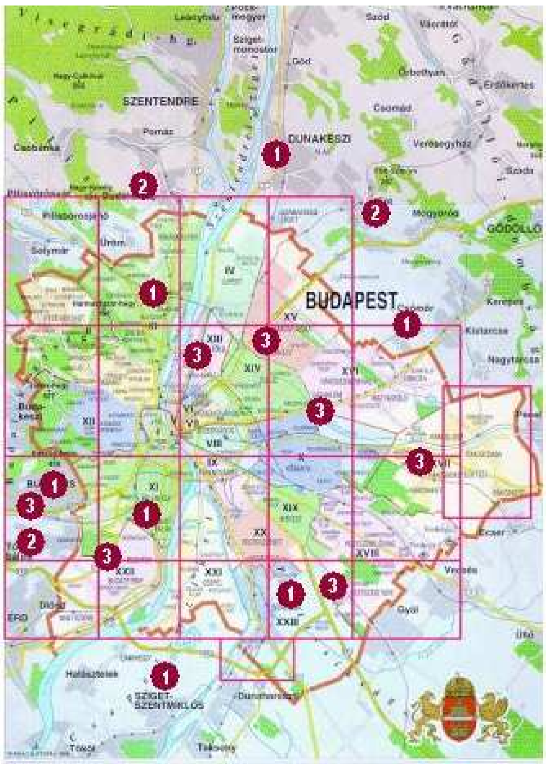
• the discount chains with stores between 400 – 1.000 square meters will have increasing success and the number of stores will grow;

•the importance of Cash & Carry stores (eg. Metro,Interfruct and Alfa) will remain considerable;

•the supermarkets with their wide range of products will gain more importance in distribution in budapest and later int he country, as well. The slogan „everything under the same roof" is getting more and more popular in Hungary;

•specialized stores will have to organize themselves in cooperatives, there are two examples ont he market constituted by the Coop group and CBA, run by individual enterpreneurs and havin gin common the purchasing and marketing activities.

E-commerce still represents a limited reality in spite of its rapid and significant growth. On line sales are only a very small fraction of the total retail sales also because of the relatively high costs of Internet connection.



1. Auchan
2. Cora
3. Tesco

6. 1 End of 2006 rankings : the Top 14

The following ranking contains the top 14 companies regarding retail and wholesale trade of consumer goods (Source:Nielsen) . The list contains the 14 biggest companies according to turnover in 2006. The data is supplied by the companies , where data was missing, Nilesen made anestimation.

1. TESCO-GLOBAL: 2.057,489 million Euro
2. CBA: 2.036,687 million Euro
3. METSPA (Metro+Spar): 1.874,728 million Euro
4. CO-OP HUNGARY: 1.512,859 million Euro
5. REAL Hungaria: 1.180,030 milion Euro
6. PROVERA CSEMEGE: 834,966 million Euro
7. AUCHAN: 760,507 milion Euro
8. REWE Group (Penny Market Kft.): 500,896 million Euro
9. PLUS: 385,779 million Euro
10. LIDL: 336,536 million Euro
11. INTERFRUCT: 189,486 milion Euro
12. DM-DROGERIE MARKT: 162,632 million Euro
13. ROSSMANN: 140,053 milion Euro
14. HELIKER: 41,025 million Euro

7. Packaging industry in Hungary

In the process of product sales, the determining role of super- and hyper markets has transformed the relation salesperson – customer into product – customer. According to certain analyses, packaging has less than 2 seconds to catch the attention of customers and motivate them to buy. Therefore, development engineers keep searching for more complex, unique and attractive solutions from the technical and from the esthetic point of view, as well. Packaging manufacturers have to satisfy market needs and this means continuous innovation.

7. 1 Manufacturing investments, technical developments

In the Hungarian and in the international context the use of paper materials dominate, its role is determining in consumer, multipack and shipping packaging, as well. Dunapack Paper and Packaging Co. is the most important Hungarian company in paper packaging production. It has several subsidiaries and has extended its activity also to ten Central-European countries, and therefore its developments can be considered tendencies in the sector.

In the past period the technical background (machinery) for currugated cardboard boxes have been developed in more plants of Dunapack Zrt. Ont he bases of the increasing requests the company has made investments in printing, cutting and gluing mchines as well as less visible background developments. In case of multipack and shipping cardboard boxes quality multicolour (shading) printing is more and more demanded. Flexography printing technology
makes possible quality printing in case of cardboard boxes, as well but only if there is a high number of raster platens and and a printing machine able to print 4-8 colours and lacquering.

With the improving appearance of boxes, the contstructions have also become more complicated. This required the purchase of the latest design softwares and the machinery background for replacing stitching with gluing.

Stora Enso Packaging Ltd. has begun its activity in Hungary in August 2001. In the past six years it has become a determining player on the market regarding quality packaging printed with offset technology on B,E,F and N corrugated cardboard boxes.

The competitive appearance of their products are due to special technologies as relief printing, part and total UV lacquering, printing on metallized paper special lacquering technologies and foil windows. Their success is proved by the fact that besides their plant in Páty they started the preparation of a new investment in Komárom. The investment will amount to about 18 million euros and will start int he beginning of 2008 to be completed within the same year.

Regarding aerosol bottles the two leading Hungarian companies are Mátrametál Kft. and Szenna Pack Packaging Kft. The most important user of this special technology is cosmetic industry which is particularly sensible to fashion and requires and uses the latest solutions in production and packaging technologies . The aerosol bottles with special, designed shape have appeared in the nineties and had great success because they were able to grasp the attention of the target group and have proved useful also to maintain the interest of customers towards introduced brands .

The increasing demand from customers motivates both companies to carry out development almost parallelly. At Szenna Pack a new production line was put into operation in 2006 that has several specialities, it can produce bevarage bottles with relief printing and environment – friendly piston bottles . In these bottles the active ingredient and the propellant are separated, do not touch each other and its main advantage is in waste collection because the environment – friendly – in most cases propane – butane – gas is not polluted with the product. Mátrametál Ltd. located in Sirok has also carried out investments in the past years and in August 2007 it has upgraded one of the printing machines with a unit for 9 colour printing. These investments will enable the company to produce 0,33 and 0,5 l beer bottles, as well.

It is particularly true for the packaging industry that the development of costly production technologies is not enough, they have to pay special attention to environmental aspects, as well. The inner surface of aluminium bottles have to be treated in consideration of the filling material (product) which today is possible with materials containing solvents. According to the ministerial decree on the limitation of the emission of volatile organic compounds of certain activities and equipments, all intersted companies had to reduce their emission within 1 October 2007. To satisfy these requirements, Szenna Pack Ltd. has already installed, Mátrametál Ltd. will shortly install the equipment for burning the volatile substances used for the production of aerosol bottles and tubes – first of all the lacquering of inner surfaces and printing of outside surfaces - .