Building a Distribution System in Eastern Europe: Organic Growth in the Czech Republic

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I. Introduction

Building distributions systems in emerging markets like those of Eastern Europe offer many opportunities and challenges. In an environment of changing customer expectations and evolving distribution infrastructure, firms can develop new business models that generate rapid growth. In this paper, we examine the organic growth of an office supply firm in Eastern Europe. The distribution firm, Papirius, developed a strong business over its twelve-year history tracked in this article (1993-2005). This article first chapters the company through 2000 where it faced some major decisions about its growth and the defendability of its markets. It then examines the outcome of those decisions through 2005. The success of this firm provides many important lessons for distributors in emerging markets.

II. Early Company History

In the spring of 1993, two 18-year-old college students (Petr Sýkora and Jan Èerný) wondered how they might make some money between classes. One of them had a friend that worked for a paper wholesaler, and so they decided to try their luck as sales representatives. After a week of

[1] This article was written with research assistance from Daniel R. Justicz and Jay A. Altizer.

work, they finally landed their first client, for a toner cartridge. When they tried to fill the order, however, they realized that the wholesaler didn't have the cartridge in stock. Afraid to let down their very first client, they searched around Prague and found the product elsewhere. As they had very little money, they bought the product on credit and hopped on the metro, stopping only to buy some snowdrops as a gift for the customer. Smiling at the box of snowdrops, their customer thanked them heartily for their on-time delivery.

Customers

Net Sales in Million Kc

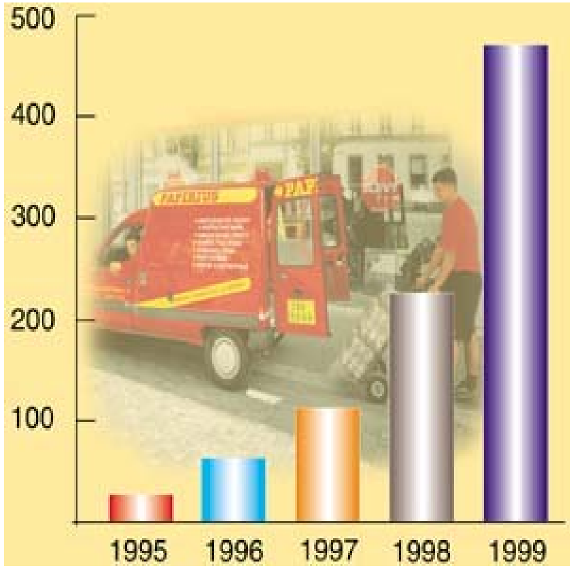

Figure 1: Papirius Growth in the first five years.

With this experience in hand, the two of them fronted 10,000 Kc (cca. $275) of capital and started their own business called Papirius. After some time, they were able to borrow a car, and a few months later they bought their first fax machine. Shortly thereafter they bought an old Skoda for 20,000 Kc ($550) and hired their first employee.[2] Their "customer first" approach, while commonplace in Western Europe and the USA, struck a chord with Czech consumers. Both their overall sales and customer base grew at compound annual rates in excess of 100%[3], with 2000 sales exceeding 800M Kc ($22M). By 2000 they were one of the largest players in the office supply market competing with many small local players with limited offerings.

The company's growth was financed entirely by internal cash flows (see Exhibit A1) and the initial founders' equity contribution of 10,000 Kc until early 2000, when the company opened a line of credit with a local bank (Ceska Sporitelna). Jan and Petr had repeatedly declined offers of equity investment from foreign and domestic investors, choosing instead to retain their independence and financial control. While there was a cultural bias against the use of debt in the country, their decision to wait so long before seeking financial support from a bank was in large part due to the inability of local banks to understand the operations of a rapidly growing distribution business. The economic climate of the Czech Republic throughout the late 1990s made investment capital scarce and expensive.

[2] Adapted from the "How it all began" section at www.papirius.cz.
3 Ibid.

The Czech Economic Climate

Initially the darling of Eastern Europe, the Czech Republic began a period of economic stagnation in 1996. Most economic observers attributed the economy's sluggish performance in the late 1990s to structural issues that have impeded the country's transformation from the centrally planned economy that existed prior to 1989. As noted in 1999 by *World Trade Magazine*,

> Even three or four years ago the Czech Republic still looked like a bright spot, but now it's clear that privatization has been mishandled and that banking laws and creditor protection remain week. The political logjam means none of these problems is being addressed. The only encouraging sign is last year's increase in FDI to $1.8 billion, which should at least underpin some productivity growth.[4]

The initial period following the 1989 "Velvet Revolution" was dominated by two issues: the country's separation from their sister state Slovakia after more than 70 years of joint statehood and the coupon privatization scheme championed by the conservative government of (Economic and then) Prime Minister Václav Klaus.

Coupon privatization involved distributing shares in non-strategic state-owned companies directly to individual citizens. While seemingly a capitalist's dream, the plan had two major shortcomings. First, the existing laws formulated under a totalitarian regime were inadequate to protect small shareholder rights. Second, individual investors seeking financial security either

[4] *World Trade Magazine*, Andrea Knox, July 1999.

sold their shares to or placed the shares certificates and voting rights in the hands of banks that remained majority state owned. These facts, coupled with inadequate “Chinese Wall” provisions, often meant that banks with significant shareholdings in money-losing companies often loaned money to these companies in an effort to support their equity investments. The results were disastrous for the economy. Not only was scarce capital loaned to companies that would never repay the money, but massive bureaucratic enterprises were also effectively given stays of execution, delaying much needed reform and redistribution of human capital in the Czech economy. The backdrop of a massive state-sponsored bailout of all the major commercial banks clouded the start of the new millennium in the Czech Republic. The minister of trade was trying to get a restructuring program going, but it was not clear how it would be done or financed. Many wondered if the government would be willing to endure the pain.[5] Throughout 2000, a major effort was underway to dress up the banks for privatization. But this process was riddled with revelations of scandal. The headline on the July 4, 2000 *Prague Post* was like many others that summer declaring “Discovery of massive-debts and a criminal investigation follow high-level housecleaning.” This painful economic climate made it difficult for a young business, like Papirius, to access the capital needed to fund growth. And banking was not the only institution going through upheaval. The same day’s paper also headlined turmoil in the state-controlled television network, where independent thinking journalists who pressured Prime Minister Klaus for openness, quickly lost their jobs. Even with these challenges, many felt optimistic about positive economic changes ahead as the Czech Republic worked toward joining the E.U. in 2004.

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[5] Ibid.

Expanding Outward from Prague

With poor opportunities in the capital market, Jan and Petr had to carefully choose their internally funded growth initiatives. By the summer of 2000, Papirius supported a catalog of over 3,500 office-related supplies and delivered anywhere in the Czech Republic within 24 hours. While the item selection was modest by western standards (an typical Office Depot store stocked over 8000 skus with over 14,000 skus stocked in fulfillment centers for business delivery), it surpassed private stationary stories and the local wholesale competitors who focused on specific supply segments (like paper). Moreover, the overnight delivery concept was new in the Czech Republic. The relatively large item selection and the fast, reliable service was a winning combination for Papirius' core small-business customers.

The firm started their operations by servicing only the Prague market. By early 1995, they expanded into Brno, the Czech Republic's second largest city, and by the end of 1998, they covered the entire country. They had outlined plans to enter some of the larger Slovak cities by spring 2001, and were considering strategies for entering Poland. Their bias was towards expanding into countries that had similar cultures and lacked established competitors.

The relative geographic centrality and market size of Prague led to a hub-and-spoke distribution system (described below). While they felt like they had only recently moved into their 3,300m^2 customized facility in Dolni Chabry, their rapid growth and the lack of adjacent warehouse space meant that another move was a necessity. They had contracted with a developer who was willing to build out a 7,800m^2 facility with options for another 13,000m^2 – more than enough room to support an operation eight times the company's 2000 size. While intuitively this felt like ample space, they were anxious to plan far enough ahead to accommodate at least three years' growth.

III. Papirius' Strategy

Papirius sold office products directly to business customers. Papirius was a pure distributor, in that it did not manufacture any of its products. All products were purchased from domestic wholesalers or a few international suppliers. The product line included assorted office products (paper, pens, pencils, toner cartridges, etc.), food and beverage products for at-work consumption, and a small number of specialty items stocked specifically for key customers. This was similar to the model followed in the U.S. by companies like Corporate Express and B.T. Office Products.

The Papirius Approach: Customer Service

The typical Papirius customer was a small firm of approximately 50 employees. Larger firms often bought directly from some of the same wholesalers who supplied Papirius. The orderer and recipient of the Papirius delivery were usually the same person, typically filling the role of an office manager or a similar position. The customer would place her order before 5:00 P.M. and expect delivery before noon the next day. Her interface with Papirius would typically be a detailed glossy catalog that was available upon request and automatically sent annually to existing customers. About 65% of the customers placed their orders by filling in the requisite information on the order request form and faxing it via an 0800 toll-free fax number to Papirius' Distribution Center. Papirius launched a web site in the late 1990s, quickly capturing 5% of the sales. The remainder used the phone to order. Petr estimated that internet access among their fax ordering accounts was as high as 95% and believed that it would rapidly replace the fax orders as customers became more comfortable with the web. However, he felt that the fraction of phone orders, originating from old-fashion buyers and those without internet access, would likely remain stable. The next interaction a customer would have with Papirius would usually be with the driver/delivery person the next morning when products were delivered.

The Papirius strategy was to offer its customers excellent service and value as defined by on-time free delivery (for orders larger than $40 US), competitive pricing, ease of ordering, and a large, complete selection of goods. The history of price consciousness among Czech consumers stemming from 50 years of economic hardship continued to exert a subtle, but important impact on Papirius' business. Even when purchasing for a relatively large business, Papirius' typical customer was extremely price conscious, and as a result, Papirius was hesitant to exert too much upward pricing pressure on its customers. For their small business customers, Papirius had to keep prices of many items below those found in small stationary shops. Given that the Papirius did not have to maintain expensive store-front real estate and quickly had larger volumes than small stores, they could easily compete with the stationary stores – even burdened with the cost of free delivery. Competing on price with the wholesalers for high-volume customers (like larger businesses) and products (like copy paper) was more difficult. Here Papirius emphasized the value of their wide range of products and fast service. Much of their advertising was used to educate customers about the value proposition that Papirius provided by saving their customers' employees' time. In tandem, however, they were pursuing a customer acquisition and retention campaign centered around a "Price Jackhammer" mini-catalog. Papirius viewed customer confidence in their delivered value to be of paramount importance.

Overnight Delivery Model

Papirius used an overnight delivery model to fulfill customer orders. The quick response and large SKU selection were the primary reasons large customers would choose Papirius over existing wholesalers. The order-processing department received customer orders throughout the day, and then the warehouse filled the orders in the evening. Each order was picked and then placed on a "spur" according to its final destination. Orders bound for Prague were queued according to their delivery route around the city. In addition to the Dolni Chabry distribution center, Papirius had 11 regional depots situated around the Czech Republic. Orders bound for different regions were queued up for the "line-haul" trucks that carry orders to depots around the Czech Republic. At these depots, orders were then reloaded into delivery vans according to their specific regional delivery route.[6] The regional depots were simply transfer stations and did not hold significant inventory.

Headquarters **Regional Depot**

Figure 2: Facility locations.

By the early morning hours, order picking was complete and delivery drivers loaded their trucks. Orders for regional customer would first be trucked to transfer terminals close to the customer and then transferred to delivery trucks by mid-morning. The order cycle was complete when drivers finished their delivery routes by around 2:00 P.M. The breakdown of a typical day at Papirius is shown in the Figure 3.

	Customer orders	Deliveries	Order processing	Inbound processing	Inventory mgt.
6:00 AM		Drivers load trucks			Cycle count
7:00 AM					
8:00 AM	Orders taken over	Vans leave Depots		Receipt and putaway	
9:00 AM	phone, fax, internet	and Prague;			
10:00 AM		Deliveries to			
11:00 AM		customers from			
12:00 PM		8 until 2			
1:00 PM			First pick at 1:30;		
2:00 PM			picking throughout		
3:00 PM			day		
4:00 PM					
5:00 PM					
6:00 PM	Order cutoff @ 6:30				
7:00 PM					
8:00 PM					
9:00 PM		Line haul trucks leave			
10:00 PM		Prague; travel			
11:00 PM		to transfer stations			
12:00 AM					
1:00 AM					
12:00 AM					
1:00 AM					
2:00 AM					
3:00 AM			3-5 a.m.: Final pack		
4:00 AM					Cycle count
5:00 AM					

Figure 3: Operations Schedule.

[6] Map of Czech Republic from Maps.com

In 2000, Papirius used a conventional set of information systems to manage its processes. There were four important components in their suite of systems[7]:

Web Applications	**Order Management System**	**Warehouse Management System**	**Accounting System**
• Web front end for order management • Online catalog • Online brochure	• Order processing • Purchasing • Inventory management • Customer invoicing	• Manages order fulfillment • Pick/pack/ship • Slotting • Receipt & put away • Queues orders but outbound spur • Manages material handling equipment in warehouse	• General ledger • Accounts payable • Accounts Receivable • Supplier invoicing

Figure 4: Key Systems.

[7] Source: Interview with Papirius' senior management.

Papirius' Organization

Papirius' business processes were straightforward. There were eight groups within the company[8]:

Order processing	Order entry and customer service
Marketing	Prepare and distribute catalogs; choose products for inclusion in catalog; promotion; Sales
Product group	Purchase products from suppliers; establish service levels for various products; establish and maintain vendor relationships
Warehousing	Receive inbound purchase orders from vendors; Pick/pack/ship customer orders
Distribution	Deliver products to end customers; manage delivery fleet
Information technology	Systems development and maintenance
Accounting	Accounts payable, accounts receivable, management reporting
Personnel	Human resource management

Figure 5: Business Processes.

All of these functions were housed at corporate headquarters in the central Dolni Chabry distribution facility. Petr and Jan split responsibilities, each taking four groups, and managed the business on a day-to-day basis[9]:

[8] Ibid.
[9] Source: Internal Papirus documents.

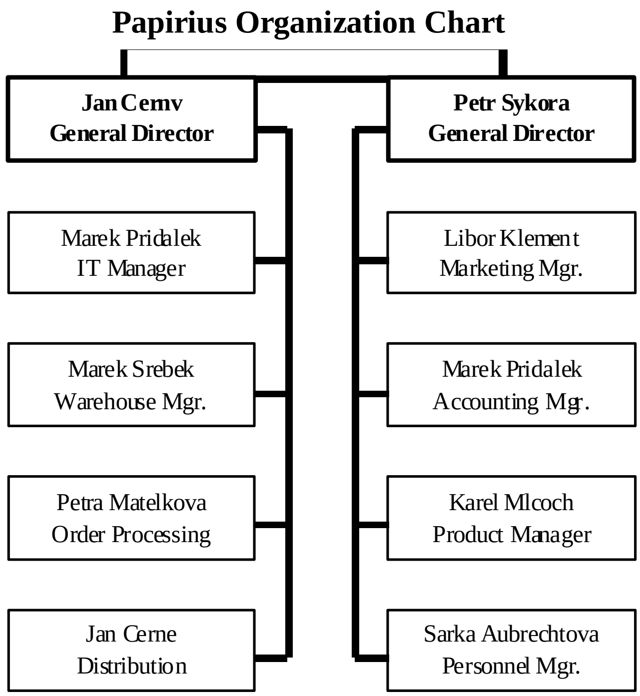

Figure 6: Organizational Structure.

Capabilities

Papirius served a base of over 16,000 customers, delivering approximately 1000 orders daily. While an average day generated about 3M Kc ($82,500), swings of 30% were common with Monday, and Fridays typically slower than midweek. The sample monthly operations report, shown below, provided a set of sales and fulfillment statistics[10]:

[10] Source: Internal Papirius reports, interviews with Papirius management

Date: 27/04/00	
Turnover	
Today's gross revenues	2,578,024
Month-to-date revenues	77,340,720
Lines per day	
Items ordered	5,367
Items fulfilled	5,351
Items unfulfilled	16
Percentage	99.70%
Invoices per day	
Total invoices	743
Invoices completely filled	728
Invoices not completely filled	15
Percentage	97.98%

Figure 7: Sample monthly operations report.

Exhibit A2 contains other statistics about the Papirius operation. Papirius strove to provide very high levels of order fulfillment with fill rates of greater than 99.5% for each item they stocked. To showcase its high service, Papirius offered customers the guarantee, "Tomorrow or It's Free." Items that were not in stock would be delivered later at no charge. Of course there were some limits on the types of products covered under the guarantee and customers could not order multiple units of an out-of-stock item and receive them all free. Petr estimated that the promotion cost less than $200/day and thought the publicity was well worth it. In fact, he felt that it was good that some customers received free merchandise – he argued that it was a positive thing to give something to the customer from time to time to reinforce the value of their service and ability to meet promises. Providing high levels of customer service did cost Papirius precious capital. With tight payment terms from many of their suppliers, inventory investment was a key consideration in growth – particularly as Papirius added more items to its offerings. Papirius worked hard to keep inventories low – holding about one month of demand in inventory, which is less than half of Office Depot. The company did this by carefully monitoring its customers' interests and the sales data to determine which items to add and maintain in the catalog and which items to prune.

IV. Superstores Expand Globally

Over the past decade, U.S. and European superstores, like Wal-Mart, Carrefour, Toys 'R' Us and Office Depot, have taken their concepts abroad, attempting to gain market share and economies of scale on a global basis. Wal-Mart, for example, opened its first international supercenter in Mexico in 1991.[11] By 2000, Wal-Mart's international division operated in nine countries, with a European presence in Germany and the U.K.[12] Underscoring the increasing importance of international expansion, Wal-Mart expected 30% of its profit growth to come from abroad by 2005.[13] So-called "Category Killer" retailers had headed abroad as well. Toys R Us International opened its first stores in 1984, in Singapore and Canada. By 2000, Toys R Us maintained over 450 international stores in 27 countries, including franchise operations.

International Struggles

While international expansion had provided these retailers with a good avenue for growth, many superstores and category killers encountered difficulties abroad. Long known for its flawless execution stateside, even Wal-Mart stumbled numerous times in entering overseas markets. Through a joint venture with C.P. Pokphand Co., Wal-Mart opened three Value Club discount stores in Hong Kong in late 1994. Joe Hatfield, who headed Wal-Mart's China unit, acknowledged that those stores stocked some merchandise that was more appropriate for

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[11] Source: Company information posted at http://www.walmartstores.com/corporate/coinfo_international.html
[12] Source: Company information posted at http://www.walmartstores.com/corporate/coinfo_international.html
[13] "Wal-Mart Goes Shopping In Europe," Jeremy Kahn, *Fortune*, 6/7/1999.

Westerners than Hong Kongers. One of the outlets prominently displayed a basketball hoop -- an unlikely adornment for Hong Kong's high-rise apartments.[14]

Likewise, in Japan, retailers met with mixed success. The office superstores were among a big crowd of American retailers that had run into trouble there. During Japan's recession of the 1990s, U.S. companies stormed in, aiming to make a killing by revolutionizing a tradition-bound retail industry. They sparked profound changes with their new products, offering better value and wider selections. But only a few, including Toys R Us Inc. and Gap Inc., truly succeeded. Many others were scrambling to revise their strategies, and some were even giving up.[15]

Though it was still early in Wal-Mart's Brazilian foray, the Bentonville, Arkansas retailer had been posting wider-than-expected losses, resulting from a ruthless price war with well-established local competitors.[16]

Other retailers felt the pain along with Wal-Mart as they adapted to new markets. Some retailers failed to merchandise properly for the new markets they entered. Other firms were unable to circumvent local middlemen in purchasing. All firms had to deal with hostile responses from home-market competitors. These expansion difficulties all came at a time when growth in the home markets was drying up, making growth abroad even more imperative.

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[14] "Wal-Mart Expands Cautiously in Asia," *Wall Street Journal*, Bob Hagerty and Peter Wonacott, 8/12/1996.
[15] "U.S. Superstores Find Japanese Are A Hard Sell," *Wall Street Journal*, Yumiko Ono, 2/15/2000.
[16] "Wal-Mart Won't Discount Its Prospects in Brazil, Though Its Losses Pile Up," *Wall Street Journal*, Matt Moffett and Jonathan Friedland, 6/4/1996.

Office Depot Follows Suit

Wrangling with all of these competitive pressures, Office Depot had also chosen to go abroad for growth. Office Depot claimed to be among the world's largest office products retailer, operating a total of 989 stores operating in 10 countries worldwide by mid 2000[17] Having begun operations in Delray, Florida, Office Depot ran operations in Canada, France, Japan, Mexico, Israel, Poland, Hungary, Columbia and Thailand.[18] These international expansion plans were in part enabled by the acquisition of Viking Office Products. Viking, an office products cataloger, had already developed a strong international presence in both catalog and web sales. Office Depot had made it clear that expansion in Europe was coming and that it planned to rely on Viking's knowledge of the marketplace to succeed.[19]

Viking had an established record in cracking new European markets. It reportedly broke even in the U.K. during its first year; when it launched in Germany a few years later, it reportedly showed a profit after 18 months. As in the U.S., Viking was not the cheapest option: customers just thought it was. After years of lackluster service, U.K. customers appreciated the high levels of service offered and the convenience of buying from a catalog.[20] Office Depot was using this platform to enter new markets via the web. Country-specific web sites had been launched in three countries, with at least three more to come.[21]

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[17] Source: Company information posted at www.officedepot.com
[18] Source: Company information posted at www.officedepot.com
[19] "Viking Purchase Readies Chain for Overseas Expansion," Discount Store News, 10/26/1998, Anonymous.
[20] "Business-to-business Overseas Success Stories," Catalog Age, 3/1/1999, Mike McKenna.
[21] "Office Depot: Gravitating Towards Its Strengths," JP Morgan Equity Research, 4/12/2000, Danielle Turnof.

As Office Depot continued to integrate Viking into their operations, they increasingly endeavored to gain scale globally in their operations. Office Depot was just beginning to realize benefits from global purchasing. It had deals with well over 65 major manufacturers on a global basis and they planned to go through each category of products to identify cost savings and/or private label opportunities. Company executives and analysts both agreed that the biggest opportunities for the future growth were the internet and overseas sales channels. The company's international division, which included operations in 17 countries, continued to report the biggest increases in existing-store sales of any area outside the internet.[22]

Office Depot in Japan: Not-So-Smooth Sailing

Just as with other superstores and category killers, Office Depot had encountered bumpy roads abroad, including Japan. Like many foreign merchants, Office Depot had linked up with local partners that knew the lay of the land, a strategy that permitted quick expansion but limited operational control. After a promising start, “the Americans soon hit a wall.” Japanese office products were very different from those in the U.S. For example, loose-leaf binders had two rings instead of three, requiring Office Depot to buy most products from traditional local suppliers.

In the U.S., Office Depot was able to operate each store profitably by selling a portion of the products from each store via retail and then delivering the rest directly to consumers. They presumed that this model would also work in Japan. Instead, the Japanese stores had been plagued with problems where the challenge was delivery and acceptance. In Japan, Office Depot

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[22] "Office Depot Clicking Online, But Not In Stores," Portland Oregonian, 5/14/2000, Elaine Walker.

struggled to shrink the store footprint to make the economics work. These profitability problems were compounded by the actions of local competitor Plus Corporation, the number two competitor in Japan. Struggling to lift its sagging sales, Plus created a small division in 1993 called Askul to sell discounted stationery by catalog. Askul targeted exactly the same customers as its U.S. rivals: small business owners that were not getting the discounts that big companies buying in bulk received. In the face of operational difficulties and competitive pressures, Office Depot was forced to make drastic changes, closing its large store in Hiroshima and focusing on Tokyo.

V. A Lurking Threat

By 1998, Office Depot had established a sizeable presence in Poland and Hungary through a series of retail super centers and a growing business-to-business direct delivery business. The Viking acquisition gave Office Depot a large presence in Europe and a platform from which they would be able to accelerate expansion across Central and Eastern Europe. Papirius viewed Office Depot’s strategy as a serious threat to their business and believed they would enter Prague before the end of 2001. Jan and Petr estimated Office Depot's current Polish turnover (including their supercenter sales) to be around $100 million, or about five times Papirius' current level. But Office Depot was not the only threat. European office supply companies, such as French Lyreco, had already entered Poland and were eyeing other countries in Eastern Europe.

As they began formulating their potential responses to an Office Depot entrance into the Czech market, Jan and Petr thought of several different responses. After seven years of aggressively growing their business under adverse conditions, they were very focused on not squandering their incumbent position. Among the alternatives they discussed were:

- Developing a competing chain of superstores.
- Aggressively growing their current delivery business by adding SKUs to lock-in the best customers.
- Expanding into the home delivery market.
- Opening their distribution network to other retailers.
- Partnering with a retail operation that could benefit from Papirius' distribution network.
- Acquiring domestic competitors to gain market share.
- Competing creatively, not just on price.

Many of the proposed strategies would involve a movement away from the "organic" internally funded growth that had characterized their business to date, and could quite possibly require dilution of Jan and Petr's economic interests and operating control of the business.

They believed that the Czech business environment, despite the country's accession into the E.U. in 2004, was a hostile environment for any new business. They knew that their strong presence in the Czech market could serve as a deterrent to new entrants, and that a new entrant would have to endure a lot of costs as they learned the local landscape.

Plotting Their Future

Although Petr and Jan had traditionally made it their first priority to focus on growth within the Czech market, two things were becoming clear to them. First, Poland offered a market potentially four times larger than the Czech market with similar cultural and operating conditions, and Slovakia, the Czech Republic's former sister state, stood barren with no major competitors. Second, they wondered about their decision to provide coverage to the entire Czech Republic. From a marketing perspective, it was a huge advantage summed up by the tag line "Anywhere within the Republic within 24 hours." Operationally and financially, however, they knew it was a different story.

Petr and Jan were also trying to realistically assess the threat posed by a potential entry by Office Depot into the Czech marketplace. Clearly, Office Depot had deep pockets, and viewed their entry as a long-term investment. Additionally, Office Depot would have the ability to source their product internationally and undercut Papirius on many commodity-type products. Office Depot would also have a broader strategy, opening retail super centers alongside their business-to-business delivery services.

On the other hand, however, they would be entering the country with relatively little experience in the Eastern European market, and far less knowledge of the Czech customers. Petr and Jan were determined to make Office Depot's entry into the Czech market as unattractive and unprofitable as possible, but without resorting to a price war.

VI. Update and Learnings

Papirius continued its rapid growth, doubling 1999 sales by 2002 (Figure 8) while moderately increasing the SKU offerings (from 3000 to 4500). Petr and Jan extended their distribution network into neighboring Slovakia in 2001 and then into Hungary in 2002. Given the formidable competition in Poland, they postponed entering that market. Rather, in 2005, they entered Lithuania through the acquisition of Mabivil – a local office supply firm.

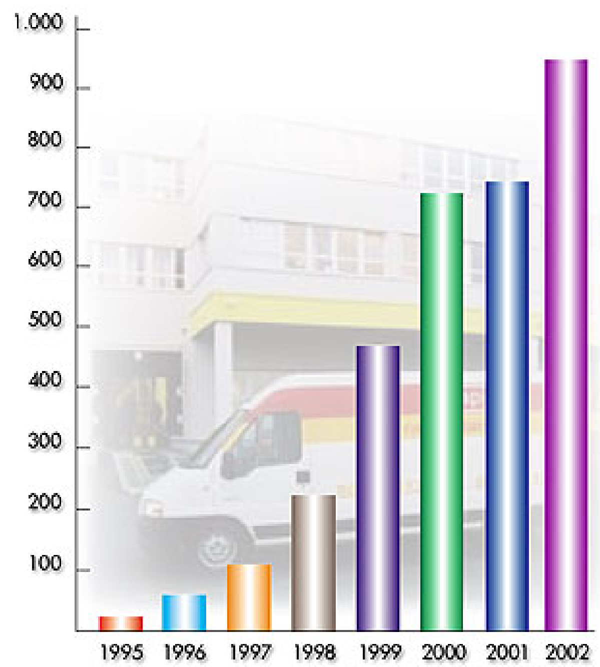

Figure 8: Sales in M Kc.

Fortunately, Petr and Jan's fear of foreign competition was not immediately realized. All three major US office supply firms were busy with their own domestic problems, giving Papirius four more years to expand and solidify their base market. However, with the introduction of both Czech Republic and Hungary into the EU in 2004, these markets became even more attractive to foreign competition. U.S.-based Staples made the first move in the Czech Republic acquiring Austria-based Pressel Versand International and the office products division of Denmark-based

Malling Beck A/S. These acquisitions extended Staples' European catalog operations into both Hungary and the Czech Republic among several other European markets. Also in 2004, Office Depot bought Elso Iroda Superstore Kft in Hungary that operated four Office Depot stores under a license agreement and announced plans to open 17 additional locations by the end of 2006. The arrangement marked the first time Office Depot directly owned international retail stores operating under its name.

Papirius' success in organically developing a distribution business in Eastern Europe illuminates several important lessons:

1. As emerging markets mature, customers' expectations for service increases. Distribution firms can use service to quickly capture these more demanding customers. Focusing on a service based strategy, Papirius was able to leapfrog the competition.
2. Distribution in emerging markets requires more infrastructure development and closer attention to execution. Papirius had to develop and extend is distribution capabilities, without the help of many other outsourced partners. By starting in a major city and building out from an area of strength, Papirius could extend its reach while maintaining high levels of service and efficiency.
3. Organic growth in an emerging market requires careful inventory management to conserve capital. Increasing the product offerings in any distribution business makes it harder to achieve perfect orders without increasing inventory[23]. Papirius carefully managed the SKU

[23] "Improving Supply Chain Performance Using Order Fulfillment Metrics," *National Productivity Review*, Johnson, M. Eric and Tom Davis, Summer, 3-16, 1998.

growth to maintain high service (high order fill rates) while avoiding rapid increases in working capital.

4. Defending local markets from multinational competition requires a competitive supply chain that is tailored to local tastes. By focusing on the needs of it core customers, Papirius was able to quickly grow and solidify its based while driving efficiencies to make it competitive with world-class firms.
5. Some of the best opportunities to develop a western style distribution business occur before an emerging market ascends onto the world economic stage. Building their business during the decade before the Czech Republic and Hungary entered the E.U. in 2004 gave Papirius the opportunity to solidify their business without multinational competition. Clearly, the competition will now become more intense.

For firms in an emerging market where the competition is not mature, there are always opportunities to exploit some dimensions of service that have not yet been satisfied. One way to gain entry in such markets is to look for such gaps and build a solution to fulfill it. This is what Papirius did. They identified the lack of rich variety and long response time as the gaps of the current market, and created a solution to address them. However, to be successful in the long run such firms must find true competive advantage to maintain a defense against larger foreign competitors. This requires being efficient and effective so that the solution is sustainable and profitable. For Papirius, growth in their markets while replicating large scale distribution practices enabled them to be efficient enough to withstand global competition. However, a key part of their success was building an understanding and relationship with their customers that could not easily be replicated.

Exhibit A1: Selected Financial Data[24]

Income Statement (in 000s)

	1997	1998	1999
Net Revenues	108,530	221,514	465,739
COGS	79,285	165,490	325,039
Material/Energy Cons.	4,384	7,015	13,968
Services (leases, rent, etc.)	10,614	22,293	61,896
Wages, Social Security	8,969	21,244	52,893
Fines and Penalties	9	43	93
Depreciation	1,045	2,935	4,528
Taxes	-	-	-
Other Expenses	2,935	1,971	4,902
Net Income	1,289	523	2,420

	1997	1998	1999
Net Revenues	100.00%	100.00%	100.00%
COGS	73.05%	74.71%	69.79%
Material/Energy Cons.	4.04%	3.17%	3.00%
Services (leases, rent, etc.)	9.78%	10.06%	13.29%
Wages, Social Security	8.26%	9.59%	11.36%
Fines and Penalties	0.01%	0.02%	0.02%
Depreciation	0.96%	1.32%	0.97%
Taxes	0.00%	0.00%	0.00%
Other Expenses	2.70%	0.89%	1.05%
Net Income	1.19%	0.24%	0.52%

Balance Sheet (in 000s)

			1997	1998	1999
Assets					
	Fixed Assets		1,263	6,125	11,644
	Current Assets				
		Cash	2,582	5,531	5,615
		Inventory	5,926	15,811	25,834
		A/R	7,719	14,954	36,993
		Accruals	961	3,185	2,409
			18,451	45,606	82,495
Liabilities					
	Line of Credit			6,000	13,000
	Required Reserve		1,148	570	952
	A/P		12,655	31,577	54,153
	Other Payables		3,244	4,766	8,377
			17,047	42,913	76,482
Equity					
	Paid-in Capital		100	100	1,000
	Retained Earnings		1,304	2,593	5,013
			1,404	2,693	6,013

[24] 1USD = 36.34 Kc (7/2000). The Czech Republic in now part of the EU.

Exhibit A2: Selected Operations Data

Papirius Operations Information			
Delivery Vans		85	
Line Haul Trucks		5	
Total Number of Drivers		90	
Cost/driver/day (wages + benefits)		800	
Cost/truck/day (daily lease expense)		450	
Daily turnover		3,000,000.00	Kc
SKU base (2000)		3500	
SKU base (1999)		3000	
SKU base (1998)		1500	
Time between deliveries (Prague)		10	min.
Time between deliveries (Regional Depots)		20	min.
Time required to complete a delivery		5	min.
Orders processed/regional depot/day		25	
Total number of regional depots		11	
Average order size		3000	Kc
Number of suppliers		80	
Customer credit terms			
	10 days	70%	
	<45 days	20%	
	Cash on Delivery	10%	
Source: Papirius internal reports, interviews with management			