

Developing Housing Abroad: A Case Study of  
K.Hovnanian's Project in Poland  
by

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B.A., Art History, 1991  
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Submitted to the Department of Urban Studies and Planning  
in Partial Fulfillment of the Requirements for the Degree of  
Master of Science in Real Estate Development

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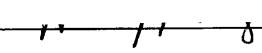
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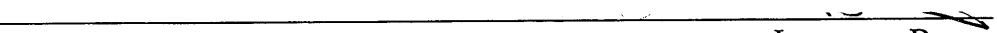
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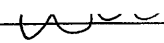
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**ABSTRACT**

Many home building companies in the United States are investigating the possibilities of expanding internationally for growth, diversification, and higher returns. As a few of the larger companies have learned, international home building presents challenges that are not encountered in the United States. These challenges can be categorized into the following divisions: differences in legal systems and amount of government involvement, differences in financial concerns, differences in the operational methods of a project, and differences in culture.

K.Hovnanian Companies, the nation's 12<sup>th</sup> largest home builder, is developing a townhome project in Gdynia, Poland. This company seeks to grow geographically as well as financially, and sees Poland as an opportunity to do both. In the project, however, there are many challenges which the company must overcome that would not be a consideration for a project in the U.S. One such challenge is understanding the housing preferences of Polish home-buyers. This is partly due to the fact that there is no large scale speculative development in the region to look to as an example. Another consideration is working within a different planning, permitting, and approval system. Hiring appropriate professionals to facilitate the process of acquiring permits and approvals also proved to be a challenge. In the U.S. the company is familiar with the process and has some of its own professionals on staff to oversee the process.

Another challenge has to do with structuring contracts. In the U.S., the company has standard home-buyer contracts which describe a home-buyer's rights pertaining to when the balance of payment on a house is due. Hiring the appropriate local lawyer to convey the same information in a Polish contract is a challenge. Another consideration pertaining to contracts is providing inflationary clauses. These clauses are necessary in all contracts governing materials, subcontractors, and home-buyers due to the high inflationary environment in Poland.

Differences in the taxation system of Poland compared to the U.S. poses another challenge. For K.Hovnanian, this challenge most affects the compensation of employees. Having to deal with a fluctuating exchange rate makes reporting to shareholders difficult. Other challenges include finding a favorable land purchase deal, hiring local employees,

and maintaining both financial and operational control over a subsidiary so far away. Planning for delays in construction is also a huge challenge that would not be present to such an extent in the U.S. By examining K.Hovnanian's project, possible methods for meeting these risks and challenges are uncovered.

K.Hovnanian has learned from its experience in Poland. If the company were to undertake another project there, it would make several changes. These changes include; negotiating a more favorable land purchase deal, building a smaller project with only half the units, investigating more carefully its choices of professionals, and allowing for a more lengthy construction time in the initial budget. Some of the knowledge acquired by K.Hovnanian in this venture is more general and can be applied to any international project developed by any home-building company. Such issues include investigating the capability of home-buyer's to acquire mortgages, making sure the person in charge of the division speaks the local language, and using local building styles and materials to construct homes. Such insight will be useful to any developer wishing to pursue operations abroad.

Thesis supervisor: Lawrence Bacow  
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## ACKNOWLEDGEMENTS

I wish to thank the following people without whose help this thesis and hence my degree from MIT would not have been possible:

My parents for their generosity in allowing me to pursue this degree.

My husband for his incredible support and understanding throughout this stressful year.

Professor Bacow for his incredible patience in advising my thesis.

George Di Martino, and other members of the Maly Kack team, for putting up with all my questions.

Jenny Gorman for her editing suggestions.

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## INTRODUCTION

Many major United States home-builders have at one time or another contemplated building abroad. Overseas investment is potentially attractive because the U.S. domestic home-building market is intensely competitive. Competition comes not only from other major home-builders, but also from the great many small companies in existence. Many small companies exist because there are few barriers to entry in the U.S. home-building business. Because of their narrow focus, smaller companies tend to be more familiar with their local markets than do their national competitors. In a low interest rate environment, such as the U.S. is in now, competition increases because of the relative ease of securing financing. The ensuing intense competition results in thinner profit margins. By contrast, foreign markets are not nearly as well developed or mature and hence may have opportunities for higher returns. Some major U.S. firms are seeking to gain from the opportunities abroad. These firms believe (rightly or wrongly) that they enjoy better technology, skills, and access to capital than do foreign firms operating in their home markets. These qualities, the U.S. firms hope, will give them a competitive advantage.

Foreign markets also have the potential for far greater growth than the U.S. Household formation in the U.S. peaked in 1980 and is expected to decline for the foreseeable future.<sup>1</sup> By contrast, many foreign housing markets are starting to grow rapidly. Poland's housing market, for example, is not expected to peak until the year

2007<sup>2</sup> (See Exhibit One). Another reason that developers think they will attain higher returns abroad is that many foreign markets have a legitimate shortage of housing. Poland has a current shortage of 1.5 to 2 million homes.<sup>3</sup> In Mexico City alone there is an estimated shortage of 800,000 homes.<sup>4</sup> Besides the possibility of higher returns, another benefit of going international is the diversification of market risk. Not all economies move in lockstep with the U.S. Moreover, the U.S. real estate market is notorious for its cyclicity. Having an international presence may lessen the impact of a downturn in the U.S. economy. This benefit, as well as the others described above, demonstrate why American home builders are considering expanding abroad. The potential for growth is substantial. However, such growth will not occur unless U.S. firms first understand and devise strategies to address the unique challenges of working abroad.

Building homes in a foreign country adds certain risks to a project that would not be present domestically. The added considerations include managing exposure to currency swings, understanding foreign cultures and legal systems, repatriation risk, the risk of material shortages, and many others. Once the above issues are handled, questions arise about the actual organization of the foreign entity. How will the entity be structured with respect to the parent company? How will the project be staffed? Do local craftsmen exist with the required skills? If not, can they be imported or trained? Are materials available locally? Is there enough information to properly evaluate the market? Will homes be “American style” or the style to which the country is accustomed? Finally, there are many cultural differences that must be taken into consideration. Will the buying



public buy wood framed housing? Is the population mobile and thus inclined to move? Will local consumers accept American products? Many of these questions can be answered by analyzing the experience of developers who have already expanded abroad.

This thesis analyzes these risks and organizational problems through a case study. K.Hovnanian is an American home-building corporation that is in the process of completing its first successful international project. The project is in Poland, a developing country which has a shortage of housing and the potential for rapid growth and development. These factors, the developer hopes, will produce higher returns than are possible in the U.S. The company also considers the project a means for growth and diversification. The company does not have much competition from local developers in Poland, primarily due to the lack of Polish capital. K.Hovnanian plans to compete on the basis of better access to capital, better skills and technology, and a well-developed method for addressing cultural differences.

The beginning of this thesis will identify the challenges faced by firms pursuing international expansion. Examples will be cited from other American developers who have attempted projects abroad. The next section of the thesis will provide an in-depth look at one company, namely K.Hovnanian, and its project in Poland. This chapter will describe the company, its general corporate strategy, how the company decided to develop in Poland, and why Poland was a good choice for the company. The next chapter will address the risks and challenges presented in earlier sections as they apply to the

Poland project and describe K.Hovnanian's methods for dealing with these challenges. Finally, the last section will summarize the lessons learned from K.Hovnanian's experience. This is meant to provide future international developers a path to follow as well as a path to avoid.

**CHAPTER ONE:**  
**CONSIDERATIONS NECESSARY FOR DEVELOPING HOUSING ABROAD**

Understanding the history and recent trends in the home building industry will make clear why the larger U.S. home building companies are looking to invest abroad. Prior to 1980, housing finance was largely controlled by the federal government. Federal legislation limited the interest that banks and thrifts, the major sources of mortgage money at the time, could pay on deposits. When the economy expanded and interest rose, capital would flee the regulated housing sector in search of higher returns. Because of disintermediation, housing construction would grind to a halt. As a result, market cycles were national, not regional. In the early eighties, thrifts were deregulated. Secondary mortgage markets emerged, and mortgage money became available even in high interest rate environments. Jim Brown of the Joint Center for Housing Studies at Harvard noted that this change allowed “markets with strong economies and vigorous demand to produce even when national interest rates were rising”.<sup>5</sup> This switch meant that there were advantages in diversifying geographically that did not exist before. When a market was performing well, the profits earned in that market could be used to buy land at a discount in a market that was doing poorly. The larger the builder, the more he could take advantage of this diversification. Thus, a furious desire by home-builders to grow was inevitable. Industry consolidation is one method of fulfilling this desire.

Industry consolidation is already taking place as the largest home builders are buying out small and medium builders in their home markets. Toll Brothers, whose

primary market was suburban Philadelphia, now builds in 13 states. D.R. Horton of Dallas-Fort Worth now builds in 22 markets. Kaufman and Broad, which used to focus only on California, now builds in Las Vegas, Phoenix, Denver, Salt Lake City, and San Antonio thanks to its acquisition of Rayco. As these companies get bigger and expand geographically, they move into and challenge each other's markets. The logical step, then, is for these "mega-builders" to expand internationally in order to find and develop untapped markets.

Competition is not the only reason these U.S. "mega-builders" are seeking international expansion. When the U.S. housing market hit rock bottom in 1990, traditional lending institutions stopped issuing construction loans. Therefore, many large companies went public as a means of gaining access to capital. Now, in order to keep Wall Street happy, these companies must continuously grow. Wall Street's expectations are high, looking for 20% growth a year.<sup>6</sup> Expansion into new markets helps these large companies maintain growth levels and hence remain attractive to Wall Street.

Differences in building processes make developing homes abroad more risky than building in the U.S. for American developers. These differences can be grouped into several categories. Differences in the legal system of a foreign country are the first challenges a developer must understand. Government involvement in housing development may also be more or less prevalent than it is in the States. Once a developer has learned to work within these confines, he or she must consider financial challenges

that inevitably arise with international investments. If all these challenges can be met in a concrete way, the operational aspects of the project can be planned.

The company must also take care not to underestimate any cultural differences that may affect either the construction or design of the homes or its marketing. Challenges that relate to the development of housing that is built to sell will be described in the following paragraphs.

#### LEGAL SYSTEMS/GOVERNMENT INVOLVEMENT

Differences in the legal system and differences in government involvement in development are two categories that overlap. For example, many countries have legal restrictions on foreign ownership of domestic real estate. These restrictions may allow no foreign ownership or partial ownership if one partner is local, a limited monetary investment in a domestic entity, limited repatriation of profits, and/or foreign leasehold interests only. These restrictions may also include requirements for local ownership of a majority of foreign-based companies operating in the country. In other cases, the government may own all the land and only lease it, not sell it. Depending upon a developer's goals, these issues may not be equally relevant. For example, if a company wants to build apartments for rental purposes, it may be able to operate in a leasehold economy where a builder of homes for sale may only seek freehold estate economies. If a developer wishes to build only one small project and is not overly concerned about growth opportunities in a country, then limits on the amount of monetary investment

placed on a U.S. developer by the foreign country may be of little concern. However, this approach is contrary to the actions of successful U.S. home-building corporations which have operations abroad. K.Hovnanian, Pulte, Kaufman and Broad, and Ryland are among the largest builders of homes for sale in the U.S., and each of these companies is building abroad. These companies seek to avoid countries that limit the amount of monetary investment in a domestic entity. They do this because these companies believe in investing money into countries with the intention of leaving it there and growing it. They feel that making a quick profit and exiting a country is not worth the time and effort it takes to learn how to operate in the particular foreign market. These big builders actions suggest that any limits on future growth, such as restrictions on monetary investment or repatriation of profits will discourage home-builders looking to invest abroad.<sup>7</sup>

*You have to be committed to it. It takes an enormous amount of energy and time and a degree of capital. You have to study it well, know what your company is capable of, what materials you want to use and where you want to work.*<sup>8</sup> Joseph Barker, former vice-president of Ryland Homes International Division

Some countries, such as Russia, require joint ventures between local and foreign entities. Relationship problems frequently arise from these situations. For example, joint ventures may pose a problem if the American developer wishes to establish its name brand in the foreign country. First, the brand reputation could be at stake if the partner acts inappropriately. Second, if there are no trademark or copyright laws in the country, a local partner may be able to learn from the American company and then copy the product

using the same name. People may think they are buying an American product when they are not. One of the reasons Pulte chose Mexico as a site for international expansion was that U.S. trademark and copyright laws are recognized there. Since the company established itself as one of the biggest home-builders in the U.S., brand recognition is very important for the company.<sup>9</sup>

Another legal difference may be the lack of anti-bribery policies. K.Hovnanian, in investigating Moscow for possible international expansion in 1990, found that bribery was an established part of doing business. This was one of the reasons it chose not to develop there.<sup>10</sup> All of these issues must be investigated by a company before targeting a country for investment.

International tax is a highly technical topic and must be well understood before a company invests abroad. From an investor's point of view, a developer must understand how profits and interest are taxed when they leave the country. Will profits be taxed twice? Are there taxes on land development? A developer must also understand how his customers are taxed. If there is a tax on moving, for example, people may never buy new homes unless it is absolutely necessary. Are property taxes extraordinary? Is there a value-added tax? (This is a tax similar to the sales tax of the U.S.) How are wages taxed of U.S. workers working abroad? Many of these questions became important to K.Hovnanian in its Poland project and will be discussed in the third chapter.

Land use controls can also differ substantially from what home-builders are used to in the U.S. Does the country regulate land use comparably to our zoning systems? Is land regulation controlled at the local, regional, or federal level? Is the process predictable? Are like cases treated alike? Do rights to develop vest at a certain time or do they expire? Does a developer risk reversal of fortune through the capricious acts of local approval authorities? Finally, does the country have a title system or a registry of deeds?

Poland provides a good example of how title system differences can complicate and slow development. While the country has a registry system, it has no title insurance. Lack of insurance makes buying property very risky since many enforceable liens do not need to be recorded. Also, the order of precedence of liens complicates matters. Unpaid taxes take precedence on debt as in the U.S.. However, unsecured debt to Polish institutions takes precedence over secured debt from foreign institutions. Employees and anyone else to whom a previous owner owes money can put a lien on a property. Unlike the U.S., these people are not limited to those involved in the development of the property. Rather, a lien can be placed on a property by a friend to whom money is owed, a store which has not received payment of a bill, or other such entities.<sup>11</sup> Thus research into these matters can continue without resolution.

U.S. firms often underestimate the complexities of foreign planning, permitting, and approval processes. In its first project in Mexico, Kaufman and Broad employed



Americans to oversee the approval process. The differences were so vast that the Americans were struggling to understand the system. This lack of understanding caused delays that the company sought to avoid in future endeavors. In subsequent projects, the company insisted on hiring only local Mexican professionals to handle this process.<sup>12</sup>

Even when laws exist on paper, there is no guarantee that they will be enforced as written. Similarly, in some countries, laws are subject to change without notice. K.Hovnanian had a problem with just this issue in both Moscow and Armenia between 1988 and 1990. The laws changed so much that they were posted daily in the newspapers. Even local lawyers could not keep up with the changes. One day the company's operations were completely legal. The next day, the process for registering a company would change rendering the company's operations illegal.

Similarly, the Russian civil justice system cannot be relied upon to enforce contracts and agreements. In fact, criminal elements are sometimes used by unscrupulous parties to enforce "their version" of a contract. U.S. firms often take for granted their ability to resolve commercial disputes. Is the country a litigious society or is it rare to hire a lawyer and fight in court? While our country may seem litigious, at least a process exists for parties to resolve their differences peacefully. In doing business abroad, enforceability of commercial agreements must be a primary concern.

## FINANCIAL ASPECTS

Since most companies are primarily concerned about profitability, they should be particularly sensitive to a number of financial issues. These include investigating sources of capital, dealing with exchange rate risk and inflation, and establishing land values and home prices. Another question that falls into this category is whether or not there is sufficient information to properly analyze and understand the market.

Finding sources of capital may be more of a problem in foreign countries than it is in the United States. These countries may not have an organized system set up for construction loans. Sources for loans may be different than the developer is accustomed to in the U.S. In the U.S., to raise capital a developer can sell securities. The company can try and sell securities in the country in which it plans to develop only if a market for such securities exists. Other potential sources of capital are selling securities in the Eurocurrency market or finding a commercial bank willing to invest. Kaufman and Broad found that while some construction loans were available in Mexico, the qualifying requirements were much too strict.<sup>13</sup> Therefore, Kaufman and Broad structured the project in Mexico as a wholly owned subsidiary funded entirely by the parent company in the U.S. Of course, if development capital is scarce domestically, a U.S. firm may have a competitive advantage if it can access capital from sources outside the country.

A developer must also consider the borrowing capacities of its customers. Are there thrifts or banks that make mortgages available to home buyers? Is mortgage money regularly available, as in the U.S. due to an active secondary mortgage market? Is there

mortgage insurance? Are interest rates affordable? In Mexico, for example, mortgages for home-buyers essentially do not exist. Interest rates are very high. They are also variable, not fixed, which makes them less attractive to home-buyers. In addition, the qualifying requirements are very hard to meet. According to Jeff Chamberlain of Pulte Latin America, there is no secondary mortgage market to facilitate the lending process. As a result, interest rates are exorbitant.

Pulte Homes had two interesting projects in Mexico which dealt creatively with the problem of financing. In both projects, Pulte established a joint venture with Grupo Condak, a prominent Mexican developer. In the first project, the team entered into an agreement with General Motors Corporation's Delphi division in Mexico. GM signed an agreement with Infonavit, Mexico's government housing program, to help provide financing for its employees working throughout Mexico. In the agreement, Infonavit provided the mortgage, and GM provided the down payment. The homes, numbering roughly 6000, were then built by Condak-Pulte.<sup>14</sup> In another project in Mexico, the team joined with Sony's Sony Magneticos de Mexico division in a similar agreement to provide roughly 500 homes for its employees. Sony provided supplementary financing to complement Infonavit's primary mortgage offerings. However, the involvement of the government slowed down the process according to Jeff Chamberlain of Pulte Latin America. Employer financed housing is rare in the U.S., but may be necessary abroad in order to develop in certain markets. Pulte is currently trying to structure a similar employer financed deal for a copper mine in Chile.

Exchange rate risk and inflation risk are two very real problems for the international developer. Some countries have exorbitant inflation rates. Inflation can affect a project in many different ways including the salaries of workers, the cost of materials, and the profits gained. Debt markets also do not function well in high inflation environments. Lenders may be reluctant to lend for fear of being repaid in an inflated, cheaper currency. While it is possible to index debt for inflation, borrowers may be reluctant to borrow if they do not know what they will be required to pay back. Exchange rates change daily, making it impossible to know exactly what profits will be. This fluctuation is especially challenging for public companies doing business abroad who may see their balance sheets and income statements fluctuate along with foreign currency moves. The case study in chapter three will describe how exchange rate risk and inflation risk can affect a project.

Establishing a land value and determining reasonable prices for the product can be challenging due to lack of information. For example, American home building firms are accustomed to buying large parcels of land. Land value can be estimated by looking at recent similar purchases. In foreign countries, information on comparable sales often does not exist either because developers don't develop parcels of comparable size or because sales records are not kept. This is especially true in former communist countries which tend to have little activity in the real estate market. Another issue is the vulnerability of property values. Property values tend to fluctuate due to inflation,

currency shifts, the availability of financing, and the supply and demand for the property.<sup>15</sup> Appraisers often are not used in some foreign countries, and when they are, their qualifications often do not meet U.S. standards.

Similarly, home prices in the U.S. can be determined by looking at the selling prices of comparable homes in the area. In the U.S., this data is routinely collected and publicly available. Moreover, the U.S. housing market is sufficiently liquid that enough transactions exist to permit a timely assessment of market conditions. Depending on the product being built overseas, there may be no comparable product sold recently or there may be no records kept. The country may not even have an active real estate market. These imperfections in the real estate market create both risks and the potential for reward. While the unsophisticated investor may overpay for land, the lack of market data may also create opportunities to acquire properties at bargain prices.

Market studies in the U.S. are not without challenge, but at least the data exists to create them. There is always some degree of information at the state or local level which can help a company understand who lives where and why. Information is also available on vacancy rates, new housing starts, household formation, job growth, and income growth. This information may not be available in foreign countries. Information may also not be available on current income, types of preferred housing, sizes of typical families, etc. In some countries, it may be common for extended families to live together in a single household making such information confusing. In some restrictive states, laws

may still limit where certain people can live, as opposed to free mobility as in the U.S. Targeting a specific market, then, may become virtually impossible.

Economic growth trends can indicate a market's suitability for investment by a U.S. firm. A rising GDP and rising personal and business incomes can be a good indication of a market ripe for investment if this information is available. It is important to know if private enterprise is encouraged or if privatization of state owned businesses and industries has begun. Declining personal and corporate tax rates are also a sign of a healthy economy, which makes investment attractive. Other indicators are growth in financial markets, encouragement of foreign investments, a well-educated workforce, and development of high tech industries.<sup>16</sup>

## OPERATIONAL ISSUES

Operational issues may not be as important in deciding to expand internationally as some of the other topics listed above. However, without proper investigation into some of these issues, the international entity may not be as successful as it could be. Some of these issues will help a company decide which country to operate in.

How to actually structure the ownership of the foreign entity is a big concern. The country itself may put limits on this decision however, as discussed in the section on legal systems. The structure of the entity may affect profits, taxes, financing, and

permitted control by the parent company. Kenichi Ohmae, in his article “The Global Logic of Strategic Alliance,”<sup>17</sup> recommends using a joint venture for first timers as a method of minimizing risk. Both Pulte and Ryland have done this in almost all of their projects abroad. Pulte said that executing a joint venture with a prominent developer in Mexico allowed them to be “somebodies” according to planning and other government officials, thereby facilitating the building process.<sup>18</sup> Pulte had only one joint venture fail because of operating style differences but said that in the future they will still seek a joint venture partner, believing that the benefits more than offset the costs.<sup>19</sup>

If a company is intent on undertaking a project entirely on its own, it may seek to avoid countries where there are limits on foreign ownership. Utilizing a wholly owned subsidiary may help ease the financing of a construction project by allowing the subsidiary to directly access U.S. sources of capital. A wholly owned subsidiary also allows for more control by the parent company. Control may be less important for companies willing to give up some command in order to minimize risk. For example, a joint venture with a local partner, as mentioned above, will minimize cultural risks while also reducing the amount of control exercised by the parent company. Both K.Hovnanian and Kaufman and Broad chose to structure their foreign entities as wholly owned subsidiaries. Both were reluctant to cede any significant power to local partners. In Mexico, Kaufman and Broad hired local professionals as top managers to counteract the cultural risks involved in proceeding without a local partner.

Local conditions may also influence construction costs and schedules. In K.Hovnanian's Armenia project, for example, frequent power outages made keeping a schedule virtually impossible. Workers also needed to be trained in constructing wooden houses. The wise firm will consider the level of sophistication of the workers before settling on a particular design or construction technology. In Ryland's projects in St. Petersburg and Moscow, a few Ryland representatives trained and supervised Russian workers in areas where they had no expertise. Different building technologies became an issue. Russians are accustomed to very thick walls. Ryland was trying to introduce wood paneled construction. This method of construction requires the use of two by fours or two by sixes and two by eights for the foundations. Russians were accustomed to building twenty-four inch thick concrete walls. Convincing them to build anything thinner was a challenge.<sup>20</sup>

Another factor which may limit construction is the availability of materials. Even if sufficient materials are available, do the prices make sense? Kaufman and Broad, in Mexico, chose to build using local materials and building styles, namely concrete and brick, in order to keep down expenses. Building in wood required more expensive laborers and more expensive materials. In some countries it may be feasible to import materials, but not in others. In some countries, insufficient infrastructure exists to get the materials to the site. This proved to be an issue for K.Hovnanian in Armenia because the country was at war with neighboring Azerbaijan. Surrounding countries took sides and



blockaded many of the roads leading into Armenia. This made importing necessary materials impossible until the blockade was lifted.

How important is it that everyone on the staff speak the language? All of the developers spoken to agree that knowledge of the language is critical for the person in charge of the project. Both Pulte and K.Hovnanian said that this person needs to be able to speak to contractors in their native language. However, both firms learned this lesson the hard way by having U.S. employees without foreign language skills manage their first projects abroad. Both companies said that they will be more sensitive to the importance of language in the future. Translators rarely possess the skill necessary to allow the kind of close communication needed between developer and contractor in order for a project to move smoothly. Jeff Chamberlain of Pulte says, “We needed to do a better job of developing people and teaching them ‘the Pulte Way,’ but we weren’t bilingual”.<sup>21</sup> Pulte did say, however, that having a local partner alleviated this language problem somewhat.

There are still more operational questions that will come up in international development. Where are the best and most cost effective places to advertise? Do brokers necessarily have to be used? If so, how do they make their commission? Some operational questions may be addressed by the employment of a consulting company or a lawyer. But, the question remains as to whether the company should hire these services in the foreign country or hire an international firm from the U.S. that is familiar with the country in question.

## CULTURAL ISSUES

The last category of considerations necessary in international housing development that will be discussed in this thesis is cultural differences. Understanding these differences is more important to a housing developer than an office developer, for example, since a housing developer is trying to cater to people's personal lifestyles. It is impossible to list all of the questions a developer should ask in order to uncover these differences and how they might affect the project. A few basic ones will be listed and a few examples will be given to demonstrate the enormity of this category.

Do people generally move? In many countries it is customary to live with parents until marriage or after, and then move only once to start a family. This leads to questions regarding the size of the typical family, what the customary level of finish is required to sell a house, and whether the developer is in charge of providing appliances. In Senegal, Ryland marketed homes with full amenities and appliances.<sup>22</sup> However, people were not accustomed to this level of finish. Pulte, in a speculative housing project in Mexico, built and sold homes with only water, sewer, electricity, and a concrete shell. These moved quicker than their other two Mexico projects which were fully finished. In Mexico, this is the usual way of building. It is called "progressive housing," in which people add to the house on their own as they can.

Do people prefer a certain type of housing? In many countries, stick built housing is not acceptable. For example, in Russia, wood housing is considered “peasant” housing. In Puerto Rico, people associate wood housing with ghettos, and a central courtyard with the wealthy. Also in question is whether or not people would even buy a foreign housing product. Some countries are very wary of American products or foreign products in general. The country itself may try to emulate international cultural patterns or repress them, such as in the Middle East. K.Hovnanian, Pulte, and Kaufman and Broad stressed the importance of mimicking local ways, at least at first. They did not advise the forcible impression of American ideas and technology. Ryland, in contrast, was anxious to show countries the “American style of doing things”.

Further cultural questions include: How much time do families spend in their house? Are work schedules similar? Are Western work hours the norm or are siestas a tradition? Are winters or summers too brutal for outdoor work? Does it get dark too early or too late? Again, this is just a small representation of the many cultural issues that may arise.

Is trust a big issue? In Mexico, Kaufman and Broad found that trust was very important. Home buyers do not trust local developers because they have been known to run away with deposits and never build the houses.<sup>23</sup> Because Kaufman and Broad is a large American company, Mexican home-buyers trust the company and the product more

than they would a local developer's company and product. This creates a competitive advantage for Kaufman and Broad.

In K.Hovnanian's project in Armenia two cultural oversights caused the homes to sell more slowly than anticipated. The first was the fact that the houses were built without basements. The company later found out that a basement is an important part of the Armenian household. People use it for storage of their root vegetables, such as potatoes, which are scarce in the winter months. Another oversight was the lack of fireplaces in the homes. Again the developer underestimated their importance to the Armenian people. As it turned out, the electricity, and therefore the heat, was turned off during most of the day due to the waging war and the people depended on their fireplaces for warmth.<sup>24</sup>

In Ryland's projects in Russia, their typical house plan had to be altered to appeal to the local market. They had to add an entry vestibule to keep out the cold. They also had to change aesthetic details. They accentuated the windows more from the outside and coated the exterior in sand colored stucco. They made the roofs out of metal.<sup>25</sup>

While not every developer will face each of these challenges in every country, a majority of these topics will become issues in any international venture. Being aware of them will hasten the progress of an initial project. Learning what major U.S. home-building corporations do in similar circumstances will give some direction to the novice.

It is important to note however, that even large U.S. firms, with their understanding of challenges and risks associated with international home-building, make mistakes. Ryland homes provided visitors of their model in St. Petersburg with an expensive, detailed, color brochure in hopes of marketing today what customers may buy in two or three years when the economy improved. The economy in St. Petersburg has yet to improve. The expense of such marketing then, presumably has yet to pay off. Ryland eventually gave up on at least one project in Russia according to George DiMartino, President of K.Hovnanian's international division. K.Hovnanian was in Moscow at the same time trying to initiate a project. Ryland approached K.Hovnanian in order to sell its division; K.Hovnanian did not buy, but Ryland left the market nevertheless.<sup>26</sup>

**CHAPTER TWO:**  
**INTRODUCTION TO K.HOVNANIAN COMPANIES**

K.Hovnanian Companies was founded by Kevork Hovnanian in 1969. Mr. Hovnanian, who is of Armenian descent, immigrated to the US from Iraq in 1959. At that time he had had no formal schooling beyond the 8<sup>th</sup> grade. Instead, he had worked with his father building roads in order to send his five brothers and sisters to school in America. Upon arriving in America himself, he started a home building business with his three brothers. In 1969 they split, allowing Mr. Hovnanian to form his own company. By introducing prefabricated methods in house construction, Mr. Hovnanian was able to supply better products, in less time, with reduced costs. With time, the company discontinued the prefabrication element of the business yet, still remained extremely competitive. The company went public in 1983 and is listed on the American Stock Exchange as the symbol HOVN. His son Ara Hovnanian joined the company in 1983 after completing his MBA at Wharton. In 1988, Ara became president of the company. Currently, Mr. Hovnanian, at age 75, is Chief Executive Officer and Chairman of the Board of the company.

## THE BUSINESS

As of 1996, the company is the 12<sup>th</sup> biggest home builder in the country with revenues of \$807,464,000. K.Hovnanian primarily designs, constructs, and markets multifamily attached condominium apartments and townhouses and single family detached homes in planned developments. Its market is currently based in the U.S.; in

the Northeast region (New Jersey and eastern Pennsylvania), southeastern Florida, North Carolina, Washington, northern Virginia and southwestern California. Previous markets also included Georgia and Texas. K.Hovnanian markets its homes to first time buyers and to first and second time move-up buyers, and concentrates on the moderately-priced segment of the housing market. The company also builds many communities aimed at empty nesters. The company has diversified its business, on a limited scale, through mortgage banking, title insurance activities, and the development and ownership of commercial properties, primarily in New Jersey, and to lesser extent, in Florida. As of October 31, 1996, K.Hovnanian employed approximately 1,100 full-time associates.<sup>27</sup>

The company's residential development activities include evaluating and purchasing properties, master planning, obtaining governmental approvals and constructing, marketing and selling homes. A residential development generally includes a number of residential buildings containing from two to 24 individual homes per building and/or single family detached homes, together with amenities such as recreational buildings, swimming pools, tennis courts and open areas. By using standardized designs and materials and by rigorous control of subcontracting costs, the company keeps its selling prices moderate.

K.Hovnanian's home building process, and to some extent, strategy, follow these principles:

a) *Acquisition* The company acquires land for future development principally through the use of land options which do not need to be exercised before the completion of the regulatory approval process.

b) *Pre-sales* Generally, construction on a residential multifamily building begins only after entering into contracts for the sale of at least 75% of the homes in that building. Single family detached homes are generally started after a contract is signed and mortgage approvals obtained.

c) *Geographic distribution* Through its presence in multiple geographic markets, the Company's goal is to reduce the effects that housing industry cycles, seasonality and local conditions in any one area may have on its business.

At the company's communities, on site personnel facilitate sales by offering to arrange financing for prospective customers through K.Hovnanian Mortgage, Inc.. Management believes that the ability to offer financing to customers on competitive terms as a part of the sales process is an important factor of completing sales.<sup>28</sup>

## INTERNATIONAL EXPANSION

The company's initial international project was somewhat of an accident. After a major earthquake in Armenia in 1988, Kevork Hovnanian was asked by Armenian government officials and clergy if the company could donate its resources to oversee rebuilding homes in several towns that had suffered great damage. Mr. Hovnanian and the company complied with the request. They sent over personnel to help build new,



American style townhouses. These homes were built using technology that would counter the effects of another earthquake, should one occur. The company also trained local workers in American home building technology.

Once the project was completed, the company decided it should not waste its newly acquired knowledge in international building. It had already flown many employees there and had them take Russian language classes. For this reason, the company began to investigate the possibility of building in Moscow for profit. After two years of research, the company felt that, although it was already familiar with the region, the former Soviet Union was not an appropriate location for future expansion. The economy was not stabilizing, and the laws were changing on a daily basis. Therefore, the risks were too great.

The company was not willing to give up on the idea of international expansion, however. Markets in the U.S. were becoming saturated in the low interest rate environment. Small companies were forming everywhere. Therefore, competition in the U.S. was getting fierce. International expansion would provide the company with a vehicle for growth that the small developers could not acquire because of capital constraints. International expansion requires large amounts of capital to which small developers typically do not have access. Growth was important to K.Hovnanian because it believed that when the housing market in the U.S. entered a downturn, only the large companies would survive. Hence, company growth would be a hedge against the

possibility of going out of business during a U.S. housing market downturn. International expansion would also provide the company with diversification, a hedge against housing cycles of the U.S., and the possibility of higher returns that were not currently available in the U.S. due to the amount of competition. K.Hovnanian may have an additional advantage in going international. This advantage is the CEO's nonchalant attitude towards conquering new markets. This attitude may be attributable to the fact that, having immigrated into the U.S., he had, in essence, overcome international challenges once already.

*There is a trend for globalization in business. There is no difference between the U.S. and abroad. California is 3,000 miles away and Poland 6,000 miles. I know that to start business in another country you need to learn the local culture; that takes time, but it is like planting a seed. Standards of living are rapidly increasing abroad and this will also increase demand for housing. I want K.Hovnanian to be there when this happens.<sup>29</sup>*

*Kevork S. Hovnanian*

K.Hovnanian's decision to choose Poland was again a bit of an accident. When the company realized that Moscow was not feasible, it began searching for another country. During this time, an individual made an appointment to see the CEO about a parcel of land he was trying to sell in the tri-city region of Gdynia, Gdansk, and Sopot in Poland. The company investigated the parcel. It found that although the parcel was not satisfactory, the region was. It began collecting data about the market.

Activity in the housing market in Poland slowed in the mid 80's to reach an all time low of only 65,000 units built in 1995.<sup>30</sup> Because of this extended period of low housing development, a shortage has arisen. This is exacerbated by the fact that the

economy is growing rapidly since the fall of Communism. There is currently an estimated shortage of 1.5 to 2 million homes.<sup>31</sup> The market is not expected to take off, however, until 1998 when, hopefully, the idea of mortgages will have taken hold and means for acquiring them will be relatively easy as new sources are created. By the year 2007, residential single family construction is expected to have climbed to a stable level of 150,000 to 160,000 units per year, thanks to Poland's prospective membership in the EU.<sup>32</sup> European Construction Research senior analyst Michael Loua thinks that the period up until the year 2000 will be dominated by private, single and two family construction. After that point, multi story developments, some of which will be publicly supported, will share the stage.<sup>33</sup>

In 1995 and 1996, economic growth reached 6% of the GDP.<sup>34</sup> Inflation is currently down to around 14%, down from 22.4% in 1995 and 18.5% in 1996.<sup>35</sup> The government's goal for the year 2000 is to have inflation drop below 10%.<sup>36</sup> From 1989 to 1996, the Polish people bought ever increasing amounts of high priced luxuries such as televisions, automobiles, and similar expensive items. It is expected that the next big focus for several years will be on homes, specifically smaller homes.<sup>37</sup>

Because of these conditions, Poland seemed like an ideal place for expansion. K.Hovnanian's entry into the market is timed perfectly, according to the results of studies mentioned above. Two similar housing companies, one from Israel and the other from

Germany, are initiating projects in Poland as well. Currently there are no U.S. home-builders in the country.

**CHAPTER THREE:**  
**'MALY KACK', POLAND. THE CASE**

Economic growth can be an indicator of suitability of a country for investment. The economy in Poland is growing and the currency is stabilizing. 1995 experienced a 7% rise in GDP and, also during that year, the currency, "zloty," was replaced by a hard currency of the same name.<sup>38</sup> If the European Economic and Monetary Union is ever established, Poland is among the second tier of countries being considered for membership.<sup>39</sup> The workforce is well educated, and labor is inexpensive. There is growth in private enterprise, denationalization of state owned businesses and properties, and encouragement of foreign investment. In 1989, 47% of the population was recorded as working in the private sector. That figure grew to 63% in 1995. Since 1989, 40% of state sector enterprises disappeared. They either collapsed under the weight of their own debts, were taken over by private investors or were bought out by management and employees. At the same time, the number of private companies has grown six fold.<sup>40</sup> Poland's appeal to foreigners has also increased. 82.2 million foreigners visited Poland in 1995 compared with 8.2 million in 1989. Along with information about housing studies mentioned in the last chapter, these topics are all indications of a growing economy and hence a country ripe for investment. It is clear then why a company such as K.Hovnanian would consider developing in Poland.

Once K.Hovnanian established that the economy was growing and stabilizing, it needed to identify a specific region in the economy for investment. Information about the

housing market in general was given in the previous chapter. This information came from two reports used by the company to determine suitability of the country for investment. These reports are entitled "*Housing and Financing of Residential Construction in Poland*" by Marek Dabrowski, the President of the Polish Real Estate Fund and "*Housing 1997-2007*" by Michael Loua, a senior analyst for European Construction Research. Aside from studies such as these, the company gathered information on the market through the use of focus groups, Polish consulting groups, and networking. The Polish American Builders Association had already done a study of the region. This association conducted market studies in a typical American fashion. Because this study had been done for the Gdynia region, K.Hovnanian felt more confident in building its first project in Poland in the north part of the country.

K.Hovnanian's project in Poland, "Maly Kack," is located in the northern Polish city of Gdynia.(See Exhibit Two) Sales offices are located in both Gdynia, a modern seaport, and Sopot, a resort town. These two towns, together with Gdansk, constitute the tri-city region and are located on the Gulf of Danzig. The region serves as the most important shipping area of the country. It handles the bulk of import trade and a considerable amount of export trade as well. It is also an important manufacturing center. The region is rich in history. It was declared the free city of Danzig by the League of Nations after World War I, and was later incorporated into the Third Reich by the German government during World War II. At the Potsdam Conference in 1945, the region was awarded to Poland. More recently, Gdansk was the scene of wide labor unrest

in 1970, the early 80s and 1988. The Polish labor federation, Solidarity, was organized in Gdansk in 1980. In 1989, the Solidarity party replaced the Communist government. In 1990, the first free presidential elections since World War II were held. The country is still in the process of transformation from communism to democracy and a market economy.<sup>41 42</sup>

As stated above, K.Hovnanian used focus groups to help the company understand the market in the region of Poland and to help determine an appropriate product to market. Focus groups, made up of local people, established that Polish home-buyers were very sophisticated. Since many of them had been planning to build their own homes for years, they had read large amounts of information regarding housing technology and materials. They had also attended many trade shows. The focus groups also knew a lot about prices from land costs to lumber. Thus, these groups helped inform the company on the price they should pay for the land, the material the homes should be made of, the prices the homes would sell for, and to a greater extent, the home designs.(See Exhibits Five and Six)

The project was originally planned as a 117 unit townhouse development on 9.1 acres. The plan has now been downsized to 107 units.(See Exhibits Three and Four) This change was implemented to accommodate buyers' interest in larger units. (Focus groups are not perfect.) The original plan had more smaller units nestled between two large end units. Now, there are more clusters of two large units with nothing in between.

The homes range in size from 1200 to 1400 square feet including a one car garage.(See Exhibit Seven) This size allows for three bedrooms. The homes are built of concrete, as is typical in Poland. The interiors are left unfinished. Buildings on the site consist of anywhere from two to seven units. Development is proceeding in two phases. The first phase consists of 39 units. The second phase consists of 68 units. As of July 6, 1997, 20 units have been completed and closed. 39 have been started. 39 are under contract. 14 units are under deposit (2% down with 45 day limit on purchase decision). Home prices range from \$62,500 to \$72,500.

The home prices above are neither expensive nor inexpensive for the region. While the declared average income is only four hundred dollars a month, it is common knowledge that there is a sizable “gray economy” which may equal 25-30% of the GDP. The recent surge in cash purchases of big ticket items supports the idea that people have large undeclared cash savings. Some buyers do take out loans. The buyers of K.Hovnanian homes who wish to take out a mortgage must qualify by showing that the total family income for 20 months equals the value of the loan. Buyers generally come from the emerging middle class, and are typically entrepreneurs, business people and seamen.

K.Hovnanian’s total investment in the project in Poland amounts to roughly \$3 million to date. Aside from an initial cash outlay of \$100,000, the rest of the project has been financed as loans from the parent company which the Polish subsidiary pays back



with interest. The company's January 1997 budget projections estimate that the net loss of this project through April 1998 will be roughly \$280,000.<sup>43</sup> Considering all the challenges the company faced on this international endeavor the dollar amount of the loss is insignificant. The negligible amount is due to optimistic revenue projections for 1997, which have been accurate so far, and for the first four months of 1998. According to company executives interviewed, the company does not perceive this amount a loss but rather a research and development expense. Comparing this number to total K.Hovnanian Companies 1996 revenues puts the project in some perspective. \$280,000 equals only .03% of 1996 revenues. Net income for the same year was \$17,287,000. \$280,000 is 1.6% of 1996 income.

#### LEGAL SYSTEMS AND GOVERNMENT INVOLVEMENT

Poland is free of some of the problems of international development due to the fact that the government wants to encourage foreign investment. For example, the country does not restrict the amount of foreign investment or the company structure. The only limitation is that money intended for a project in Poland may not be kept in the U.S. In other words, K.Hovnanian could not pay the bills for the project in Poland out of a U.S. account. It had to send the money to a bank in Poland and then draw on that account. Foreign firms are not required to have local partners. The project, therefore, is a wholly owned subsidiary of K.Hovnanian Companies.

At the onset of the project, K.Hovnanian did not want to form a joint venture. Instead, it wanted to establish its brand identity by operating under its own name as it does in the United States. The CEO felt that forming a joint venture could compromise these objectives. He also felt that a joint venture could jeopardize the company name if a local partner turned out not to have the same standards as K.Hovnanian. Since identity is so important to the company, K.Hovnanian applied for trademark protection at the onset of the project. Follow up has been lax for the moment since the company does not expect trademark protection to be an issue until the company's presence has grown considerably in Poland. Similarly, bribery laws have not been investigated since they have not played a role in the Polish venture thus far. The American Polish Builders Association as well as Polish attorneys, architects, engineers, and contractors assured the company from the beginning that bribery was not an issue. The legal system is stable, not in a constant state of flux, as in Moscow. "You can see what is taking place. Things don't just drop out of the sky," said George DiMartino, president of K.Hovnanian's Poland division and former president of the Russia division.

Land in Poland is not owned by the government; it is private, and can therefore be purchased outright. When the Communist regime ended, land was given back to those who could prove they owned it before Communism had taken over. There are still complicated property rights issues, but they can be avoided by refusing to buy a parcel under negotiation of ownership rights. There is a title and registry system in place. Lawyers are hired to search the "Eternal Book" before a sale takes place, where all sales

are recorded. There is no title insurance as yet. If a problem arises, it is settled in court. However, this is not common. In comparison with the U.S., Poland is a non-litigious society.

The planning, permitting, and approval process in Poland is controlled by the municipality. It is a different process than in the U.S. One of the two main differences is that the requirements for compliance are much looser. The city or town has a master plan that describes the desired type of building ( for example office, residential, etc.). It also has some idea of floor area ratios and height, as well as setbacks and rights of way. The rest is open for negotiation. Lawyers are not involved in this process, which brings up the next major difference. Architects and engineers handle the negotiations and the approvals. After several interviews, K.Hovnanian hired an architect based not only on his design capabilities, but also on his relationship with local officials. This decision turned out to be a problem. The architect kept trying to convince the company that a certain home design would work. K.Hovnanian finally let him apply for the permits for this design. The town accepted the design readily, even though it was not a customary design for the region. The architect, in this design, experimented with locating the kitchen in the center of the house, and tried to convince K.Hovnanian that this was the norm. K.Hovnanian got weary at the last minute and hired a consulting company to conduct a series of focus groups on the design. The result was that the design was totally unacceptable. The kitchens were too dark. There was no window in the front. The total width needed to be two feet wider. Plans had to be redrawn and permits had to be sought

again. This setback not only slowed down the building process, it also caused a loss of several units due to the new design. The project lost 10 to 15% of its density compared to what was originally planned. It also lost four months of time that could have been used for construction.

Another interesting anecdote that has to do with approvals concerns infrastructure. Since the project was running behind already, the company decided to go ahead with the construction of the homes before it got approvals on the infrastructure. The company was waiting on detailed survey work documents. Proceeding without approvals turned out to be a faulty idea for two reasons. First, the company could not convince the utility companies to hook up meters to individual units. Doing so was contrary to the customary way of doing business in Poland. Typically, utility companies wait until a home is purchased and then put the meter under the owner's name. In the States, the meters are all put in place using the builder's name until the homes are sold. Because homes are usually built in Poland one at a time and for a specific owner, the utility companies are not familiar with the practice of putting in meters under one owner's name only to change the name soon after. The utility companies finally put the meters in but, not without more severe delays. Second, the Polish government usually reimburses a developer for the infrastructure based on acreage used and the cost of pipes and other materials. The government had not agreed on the amount of infrastructure for these homes before they were built, and so would not readily reimburse all of the expenses associated with it. K.Hovnanian and the local government are still in negotiation over this matter. However,

one part of the company's planning and approval process worked out well. The company convinced the town to get paperwork for the project through the approvals process a little more quickly than normal, which is reportedly even slower than in the U.S. It did so by constantly paying the town for permitting fees early or on time, and in cash. The town was not used to this type of efficiency from a developer. Now, when something goes through the office with the K.Hovnanian name on it, the town rushes it through, knowing cash will follow shortly.

Enforcing contracts became a bit of an issue for K.Hovnanian but, not due to any fault of the legal system. Instead, K.Hovnanian blames local attorneys who created the contracts. The home-buyers' contracts have proved the most problematic. The wording in the contracts about the home-buyers' rights in the event that the unit was not delivered on time was too loose. It gave the home-buyers grounds for backing out of the deal and withholding payment for the balance due. While K.Hovnanian could have taken these issues to court, it chose not to because it was trying to establish company image and the idea of customer satisfaction. It did not want to be perceived as a heavy-handed corporation anxious to sue. Yet, K.Hovnanian had a problem if buyers did not pay on schedule. They needed payments to fund operations. A delay on one unit inevitably meant a delay in starting the next one; any delay would result in less profit in the long run. The company hired a different lawyer to draw up new contracts and hence rectified this problem.

## FINANCIAL ISSUES

The system of taxation in Poland is not very different than in the U.S. Most of the taxes are on income. Income tax amounts to about 44% and is paid by the employer to the government. In return, there are many benefits similar to our social security and other programs. In Poland, people generally prefer to be independent contractors because the income tax rate is lower. Property taxes are very low. There is, however, a value-added tax, which is similar to U.S. sales tax. This tax is charged on practically everything and ranges from 7 to 22%. The buyer of a K.Hovnanian home is typically paying an extra 7% due to this tax.

Taxation on repatriation of profits has not been an issue for K.Hovnanian. Aside from an initial cash outlay of roughly \$100,000, the rest of the project has been financed through loans from the parent company. Hence the entity is paying back a loan with interest, not repatriating profits. K.Hovnanian estimated the cost of capital of the project to be 12%. This figure is the same that it uses for all projects in the U.S. Therefore, this amount is the interest that is paid on the loan by the Polish subsidiary. There is currently legal debate as to the right to charge compound interest based on the Polish tax code. Changing the agreement or increasing the interest rate may be required in the future. Another way the company avoids paying double taxes is as follows: the government allows the company to charge a franchise fee, which can be repatriated without

repatriation taxes. So, the Poland subsidiary must pay the parent company 5% of every house sold as a franchise fee.

As of yet, there are no profits to speak of. Everything that is being sent back to the parent company is just returning what was sent over. The company has approached the project as a research and development expense and therefore is not looking for any specific IRR as they would in the U.S. In fact, the company is prepared to take a loss. It is not measuring success of the project based on profits.

Compensation of American employees became an issue due to taxes. This issue mainly applies to George DiMartino, the President of the Polish subsidiary. While he could have been considered a U.S. employee for some time, he has been working out of the country too long to be considered a U.S. employee the entire time. He must receive some of his income in Poland which means having Polish taxes taken out of his salary and put towards benefits he will never use. What the company does to minimize the effect of this problem is to have him earn some salary in the U.S. as an employee of an international company and earn the rest in Poland as an independent foreign consultant hired by the foreign entity. By being labeled a consultant, his tax rate is lower.

Exchange rate problems and the inflationary environment are a bigger problem than taxes. Although the Polish currency is relatively stable, it is not functioning as a hard currency should. It is still being devalued on a month by month basis by the

government. It is also affected by the dollar, the deutchmark, and the pound. Because of this, it is difficult to calculate financial progress accurately. The company uses a monthly average as an exchange rate to estimate progress of the foreign entity. Current inflation rates are around 14 or 15% but are coming down roughly 1% a year.<sup>44</sup> This rate is better than most of the Eastern Block countries. The company believes that futures purchasing of currency is not an effective hedge right now. It believes that it would need someone full-time in order to handle that sort of financial planning. Investing in Polish treasury issues can be somewhat effective but, not as secure as in the U.S. Since the company has only invested, at most, \$3 million in the project, it has chosen to simply absorb the risks associated with exchange rates and inflation rather than hire a full time financial expert to follow the market.

Because of the inflationary environment, it is very difficult to price anything more than six months in advance. The company deals with this challenge differently according to the type of contract involved. All contracts have inflationary clauses built into them. They tie the contracts to hard currency, namely the U.S. dollar. In the case of home-buyer contracts, the contracts are shorter and there is a clause that allows K.Hovnanian to raise the price by 1 or 2%. However, this amount has not proven to be enough. In the case of the contracts with the subcontractors, the company tries to make the contracts longer to take advantage of the inflationary environment. Where it really gets hurt, however, is in the price of materials. Although materials are plentiful, they are sold by small wholesalers, not manufactures. These wholesalers must cover their transportation



costs along with any border tariffs and product certification by Polish testing laboratories. Labor is still relatively cheap in comparison to the U.S. Mr. DiMartino describes the labor to material cost of a typical U.S. project to be 60:40 or 50:50. In Poland it is currently 20:80 or 30:70. Although this is beginning to change, the current problem for K.Hovnanian is still the price of materials and how it is affected by inflation.

The company assembled the project site from three different owners. While it usually options land in the U.S, it bought these sites outright just to get the process underway. The purchase price was \$785,000. The company was so anxious to get the project underway that it actually started building on the land before it had taken full ownership. Fortunately, this move caused no problems. One of the previous owners of the land even bought a townhouse in the project. When the company expands within Poland, it will look for a more favorable land purchase deal. It estimated the land price was fair by much the same methods it would in the U.S. The company hired an appraiser not only for business' sake but also because the government required the company to do so. Hiring an appraiser is part of the application process to the Ministry of the Interior as a foreign owned company requesting permission to purchase land. The company hired consultants to estimate typical hard costs and soft costs associated with building the units. As it would do in the U.S., it then backed into the appropriate land value to double check. Home prices were established by examining prices of comparables. In Poland, prices are compared on a square meter basis. Since the comparables were limited, the home prices

were an educated guess. In the next project, the company will have their own information to look at and judge in estimating prices.

Construction loans are still difficult to secure in Poland. There is a lack of capital markets to provide debt and equity. Local developers typically in Poland do not build such large projects. What they do build, they build in stages as they acquire the funds to do so. They are, therefore, not overly concerned with the lack of financing and hence do not, as a group, put pressure on the government to create a method for acquiring such loans. Capital is not an issue for K.Hovnanian, however, because the project is funded wholly by the parent company in the U.S.

The Polish people are not as accustomed to taking out a mortgage as are home-buyers in the U.S. Rather, they are accustomed to saving for years and paying all cash for home purchases. This is partly due to the fact that mortgages are expensive in Poland, thanks to high interest and inflation rates, and are thus unattractive to home-buyers. The fact that there is no secondary mortgage market yet, is partly to blame for this situation. However, the government is currently trying to establish such a market. The result of this effort is that the Polish people are beginning to use mortgages more frequently. A much larger percentage than anticipated of K.Hovnanian's home-buyers are doing so. This presents a problem for the company because, unlike the U.S., money for the home is not brought to the closing. Rather, a home must be closed on first and then money is sought from the mortgage provider by the developer. This process typically takes three to four

weeks which causes delays for the company. Any delay in acquiring funds results in a delay of the construction process.

K.Hovnanian has been successful in marketing a different kind of financial deal to its home-buyers than that to which they are accustomed. The typical fashion of purchasing a home in Poland involves making a definite decision as to whether or not to buy the home from the beginning and then paying in cash, in stages, as construction is completed. K.Hovnanian has introduced the idea of allowing buyers to pay an initial 2% deposit for which they can be reimbursed should they change their mind within 45 days about purchasing the home. Another 23% of the home price is required at the time a contract is signed. The remaining 75% is due upon completion. The company believes this strategy will encourage more deposits and therefore result in a greater number of contracts than if the buyers had been locked into purchasing from the beginning. Judging from the number of units either sold or under contract, this approach seems to be working.

## OPERATIONAL AND CULTURAL ISSUES

Staffing for this process presented numerous challenges. Aside from George DiMartino, the president of the division, most of the staff is Polish. The company was fortunate in hiring a construction manager; it found someone educated in the States with experience in development who was Polish. It also found both a consulting company and

legal counsel who are American-based but have offices in Poland. Both of these groups, as well as some networking, were critical in hiring many of the remaining staff, as Polish employment agencies are relatively new and as yet ineffective. Other key staff members include a construction supervisor, an infrastructure and site development consultant, a sales and marketing specialist, and a client services manager. All sales agents are employed by K.Hovnanian. So far they have avoided the use of outside brokers, because of the custom of taking fees from both sides which creates a conflict of interest.

A typical project in the U.S. would have its own financial planner. This person would use a job cost estimator on the company's mainframe computer. It is not possible to make this connection from Poland, so the company set up a PC with similar software in Poland. In Poland, however, the person who handles this job does not have the staff or authority that he would have if he was operating in the States; he is simply more of a bookkeeper. This person is also not an employee of the company but rather an independent consultant.

The company structured the financial department of the foreign subsidiary in this way for two reasons. The first is that it is not cost effective to have the same financial set up as a project in the U.S. due to the comparatively small size of the project in Poland. The second reason is a control issue. Since the entire project is run primarily by the president of the Polish subsidiary, the company felt an extra system of checks and balances was in order. A further method of control is the fact that any more complicated

financial matters are handled through the corporate office by a senior accountant in charge of special projects. She receives weekly financial progress reports via e-mail. The foreign entity also has very strict guidelines in its check signing process: less than a certain amount can be signed by the president, the next level has to be signed by both the president and the construction manger, and anything above that level has to be signed and approved by corporate headquarters.

One control that the company does not have on this project that it would usually have on others is the timing of money dispersion. In most projects, owed money is not paid until it has already been spent. In the case of Poland, corporate headquarters acts more as a lending institution. The Polish subsidiary notifies the company in advance as to the amount of money it will require and the company sends it in advance. The reasons for this are mainly tax issues as already discussed.

There were many unforeseen factors at the early stages of the project that limited construction. The first problem encountered was the lack of subcontractors. Typically in Poland, a general contractor is hired who has these workers on his payroll. K.Hovnanian successfully managed to pry subcontractors away from their general contractors and teach them about entrepreneurship. (It should be noted here that these workers are neither bonded nor insured. If anything goes wrong, civil code regulates the legal remedy.) The subcontractors readily responded to the idea, especially since they were getting paid on time and in cash. While they were used to receiving cash, having no faith in checks, they

were not used to being paid on time. Another problem was the building material. Homes were built out of concrete since that was the norm. K.Hovnanian chose not to add to the risk of the project by trying to introduce American wood housing. Concrete, by nature, is a much slower process.

Another time constraint in the construction process was fierce winters in which laborers worked very short hours, if at all. Infrastructure cannot be built during bad weather. Holidays are plentiful. Workers were used to building without a rush because the building of one's home would usually take years as described above. Developers also built gradually as funds became available. The notion of building a complete house within a short time frame was virtually unheard of. These slower habits were, and continue to be, difficult to break. Some of the people involved in the project, including Mr. DiMartino, feel that if he could speak Polish, he may be able to spark them to move more quickly by conveying a sense of urgency. Since they cannot understand his style and pace, they are left with only instructions.

Another construction difference, but one that causes no major problems, is the level of finish at which homes are sold. This issue is also a cultural difference. Polish people typically favor purchasing a shell rather than a unit complete with appliances and kitchen cabinets. They typically have large pieces of furniture that they use for cabinets. They buy their own appliances as they deem necessary. The shell construction is also preferred because families use the rooms for different uses. Some, with extended family

living with them, may choose to use most of the space as bedrooms while others may prefer typical uses that we are accustomed to in the States. K.Hovnanian, in recognizing this difference, also included an extra 200 to 400 square feet of attic space on each unit. This space can be finished as an extra bedroom or extra living space. The typical middle to upper income buying families have so far been comprised of four people; K.Hovnanian was told to expect five or six as the norm.

It is important to note that the typical Polish family spends a lot more time at home, together, than an American family. Work hours are shorter. Frequent holidays are all family days, where people stay home and relax, together. Families rarely dine out. As American fast food chains are making their entry into the business day, home delivery is accommodating family dinner time. Satellite TV is increasing television watching time, another at home activity. Home design must take into account this difference.

A final interesting cultural anecdote has to do with superstitions. The Polish have a device shaped like an arrow head with a pendulum in the middle. They take this device to a piece of land they are considering to buy. Depending on the results of the pendulum swing, they will decide whether or not the lot is acceptable. One buyer of a K.Hovnanian townhouse in Poland used such a device to choose his parcel. Later, the company wanted to alter the site plan somewhat. This alteration meant that the man would not have his home built on the chosen lot but, rather have it built at a different, but better location. The man refused to accept a different lot and threatened to sue if the townhouse was not

built on his original selection. The company kept his lot the way it was and found a different area to alter.

## COMPETITIVE ADVANTAGE

K.Hovnanian is not without competition in Poland. It feels it has an advantage over local developers primarily due to the availability of financing. Local developers simply cannot build large projects due to lack of funds. It feels it has an advantage due to its technological capabilities, knowledge, and experience. While some of this knowledge, such as the use of job estimating software, is being used today, other knowledge, such as building with different materials, is being reserved for a time when the company believes it has gained the trust of the people and has established its name brand as reputable. K.Hovnanian plans to build this reputation through methods such as paying workers and planning officials on time as well as allowing the customers not to pay 75% of their home purchase price until they move in. It also hopes to educate the people on using mortgages and provide these services as it does in the States. K.Hovnanian does have competition from other international firms, although no American firms have joined the market. It is aware of an Israeli developer and a German developer doing similar projects. The company believes its advantage here is in the design. K.Hovnanian is using a modern update of a traditional Polish design. The competition is building very modern housing that K.Hovnanian feels is not as warm or aesthetically pleasing.



International housing development cannot be generalized. Yet, examining a case study, such as K.Hovnanian's project in Poland, can lead to a basic understanding of the concept of building abroad. Each project in each country will have its own intricacies. Being familiar with this study will help a developer be aware of the amount and the type of such intricacies that developing abroad entails.

**CHAPTER FOUR:**  
**CONCLUSIONS AND RECOMMENDATIONS**

*Something the company knew but confirmed is that whenever you go into a new market area be prepared because the issues and problems you expect to have will double or triple or quadruple. Things come up that you couldn't imagine. You have to be prepared to spend money the first time through to solve them and again to understand them. People enter markets, even in this country thinking 'oh, this is a piece of cake'. They just can't imagine some of the local differences.*

Paul Buchanan, Senior vice-president and  
Corporate Controller, K.Hovnanian Companies

While there are many lessons to be learned from any company's international experience, mistakes cannot be avoided. There are some general themes about problems that arise in developing homes internationally. These topics came up in at least some or all the international projects built by Pulte, K.Hovnanian, Ryland, and Kaufman and Broad.

The first and perhaps most important issue is to allow for timing problems. All the companies mentioned above had some unforeseen problem in this area. The problems arose either from slowness of the workers, complications in legal matters, weather conditions, holidays, or just the general working environment. It is safe to say, then, that any developer scheduling an international project should allow great amounts more time than would be normal in the States.

Another problem is language. The companies mentioned felt that mere proficiency by the director of the project in the local language was not enough. These companies recommended two solutions to this problem. One is that the director be practically fluent in the local language. The other is to hire, or join with, someone local who can communicate with the laborers. The person in charge should know the language well. Construction is a very local business. Subcontractors cannot be expected to understand English. Not being able to talk to them directly loses the spirit of the project, the company, and the president of the division. Pulte put it best in saying that the subcontractors could not comprehend the “Pulte way.”

Another common problem in international housing development is the availability of mortgages to the home-buyers. If there are no mortgages available and the people do not have cash, no one will buy the homes. Solutions to this problem include providing financing to the buyers, forming an agreement with a company that will provide mortgages, or finding a government agency that will assist in providing mortgages.

Three out of four of the major U.S. developers with international experience recommended building in the foreign market using the materials and designs already in favor in the region. Introducing American style designs and materials not only creates problems of acceptability by the home-buyers, but also creates additional expenses. These expenses arise from the necessity to train laborers in working with different

materials and designs. Different materials from the norm may also be more expensive to purchase or import.

American home-builders with projects abroad advise that the initial international endeavor should be small. If the project cannot be small, then at least it should require a small initial investment. This will minimize some risk. Initial endeavors should not be approached as a maximum return project but rather as an investment in research and development expenditure. Since developing in a new country is bound to turn up unforeseen expenses, the research and development approach will minimize disappointment.

Examining the many issues that one company would change in the following international endeavors demonstrates the vastness and the complexity of unforeseen challenges that arise in international development even for the experienced builder.

K.Hovnanian's first lesson has to do with the size of the project. It was very difficult to market such a big development. People simply are not used to the idea. The market was not big enough to absorb lots of similar units. While this project, to K.Hovnanian, was smaller than a typical project in the U.S., it was still too big to use as a test. Many in the company use the phrase "getting our feet wet." The company, because of the size of the project, got wet beyond its ankles. The next site it is looking at will accommodate roughly 50 homes.

Another issue that K.Hovnanian may have planned for differently was its distance from the capitol. It was pleased with the region it chose and made the decision based on market research. The problem, however, was that the president of the Polish division felt out of touch with the rest of the country. Many things were developing in the housing market, such as new foreign competition. He would receive the information late because of his distance from Warsaw. It may have been a good idea to establish better contacts in Warsaw before venturing off so far north to start the project. Janet Hoynowski of Prime Property Inc., a residential brokerage firm, agrees. She spoke of a break-off between Warsaw and the rest of Poland and described it as extreme. She was also concerned that the market layers are much thinner. She also mentioned a huge difference in income between the people of Warsaw and the people in the North.<sup>45</sup>

K.Hovnanian's next problem was the land purchase deal. Having to buy all the land outright at the beginning of the project was a huge initial drain that could not be modified. Had it optioned the three parcels first, as it would have done in the States, perhaps the company would not have built the entire project. It realized, half way through, that the project was too big. Yet, the company suspected from the beginning that the land purchase deal was not a favorable one for its operations. It was willing to make this mistake on the trial run just to get things moving.

K.Hovnanian had a problem marketing many of the smaller townhomes. A last minute change allowed for larger units, but fewer of them. In its next project, rather than make smaller townhouses for smaller families or families with lower incomes, the company will build low-rise apartment type units. It seems that the smaller families and lower income families prefer this style. The larger townhouse design for the higher income families will stay the same.

Some of the company's choices in employees and independent contractors were not the best. This situation could easily happen in the U.S. as well. However, the company could have exercised more control over these people. An example is the architect who produced a faulty design. The company trusted his knowledge of the market since he was an insider, something it would not have done in the States. The next time the company will try to conduct preliminary investigations to determine what is acceptable, and then proceed to tell the architect exactly what to design. A similar problem arose with the lawyer who drew up the home-buyers contracts. He was not familiar with K.Hovnanian's deposit and balance system, and did not understand the time pressure. Money had to come in at exactly a certain time to proceed; the contracts he drew up were too loose. Again the company trusted him because it assumed he would know better than itself what the contract needed to look like. After all, he was local and the company was foreign. Next time the company will trust its own judgment better, double check work, and of course hire a different lawyer.

Timing is the biggest issue. It came up over and over again in Poland. While the company expected some delays, it could not possibly have foreseen the extent. Few countries work at the pace as the U.S. Being a company from the New York, New Jersey area only exaggerates the speed at which things are expected to be accomplished. Working within a foreign country, especially one that has been communist for some time, requires a level of patience not known to many northeastern Americans. The Polish people's difference in attitude toward time was evident from the town officials and utility companies to the subcontractors and office workers. To further exacerbate the timing issue, there is a national holiday every other week. People are accustomed to having very short work days in the winter and moderate work days the rest of the year. This problem of timing was discussed by other U.S. developers in other countries as well. Its importance can therefore not be overemphasized. International developers must plan ahead for this problem and must be realistic about the extent to which it will affect the bottom line of the project.

Some of these issues are general enough to be applied to any project. While success is not always measured in dollars, being aware of these problems may save a few dollars. K.Hovnanian feels that although the project may not break even, it was successful. The company wanted to investigate the feasibility of building in Poland. It knew this investigation would cost money, and the company is satisfied with its results. It found that developing in Poland is something that can be mastered. Should it continue

to build abroad, it will definitely build in Poland. K.Hovnanian believes that having completed the first experience, it will be able to make a profit on the next project.

K.Hovnanian's approach toward measuring success is not unlike those of the other American firms with projects abroad. All of these companies offer words of wisdom on the topic of international housing development. A U.S. home-building company wishing to pursue investment abroad would be wise to adhere to these 'mega-builders' advice and learn from their experiences and mistakes, many of which are presented in this thesis.

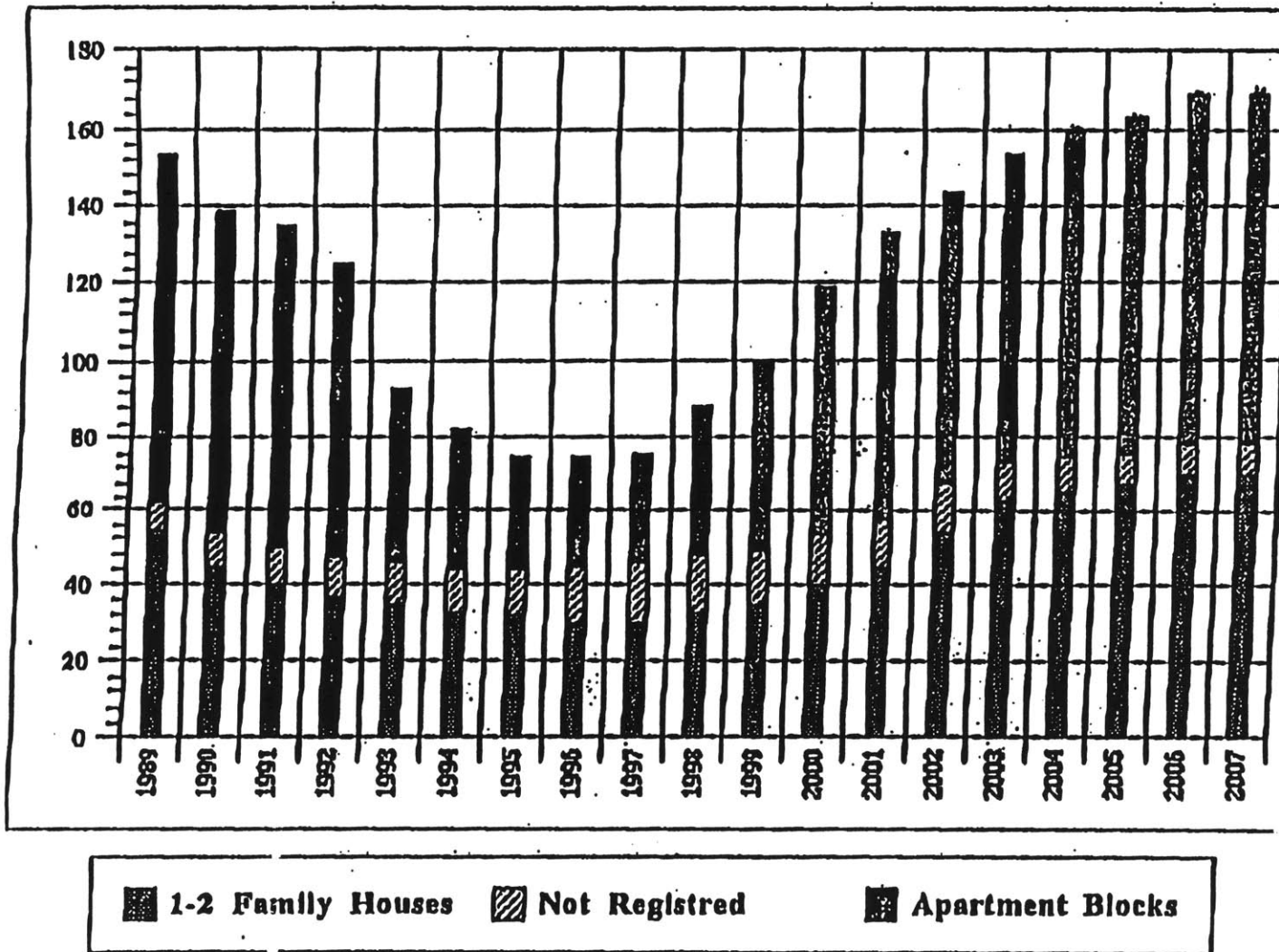


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**Housing**  
(1989-2007, completed units)



67

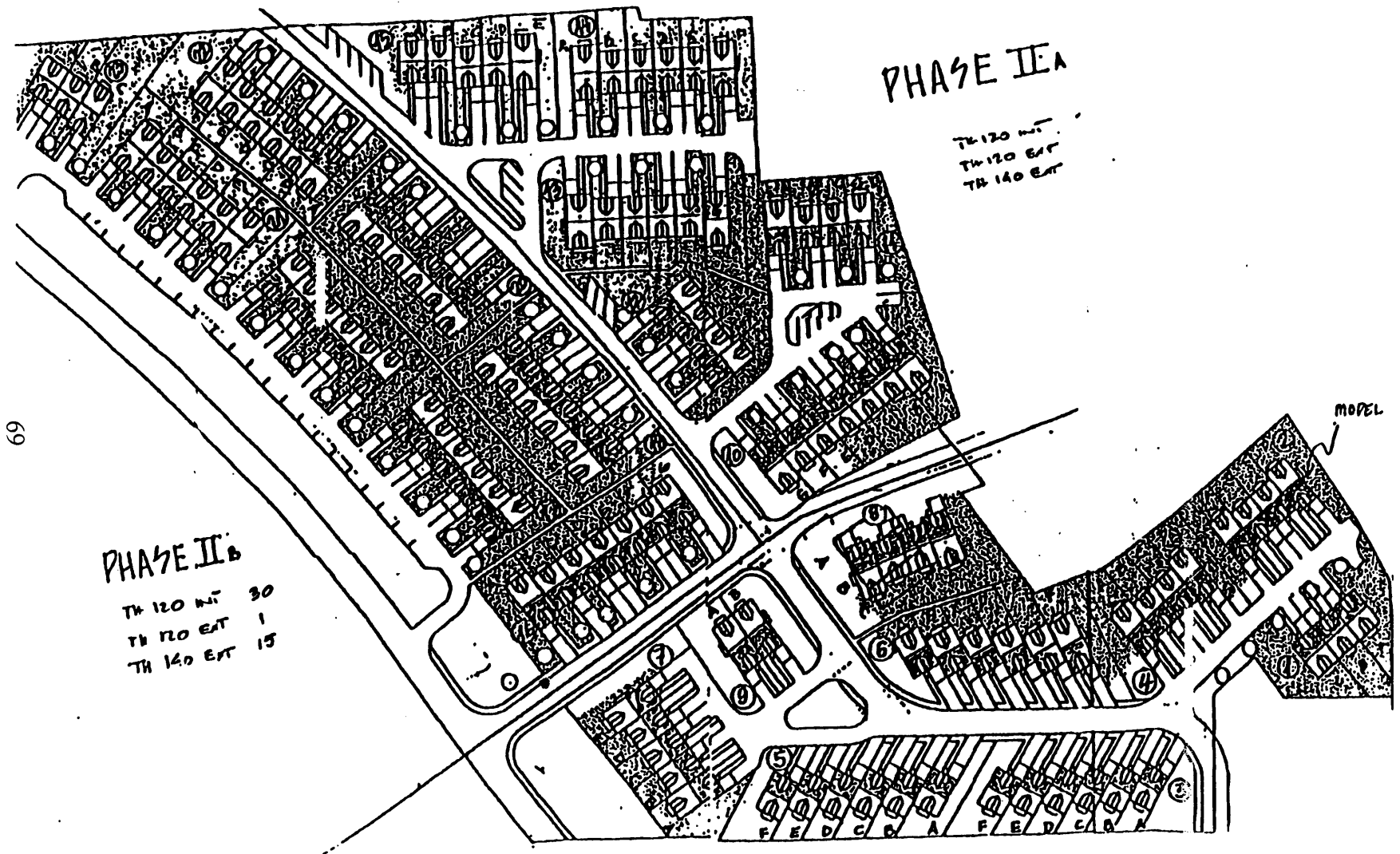
SOURCE: "Housing 1997-2007" by Michael Loua a senior analyst for European construction research.

EXHIBIT TWO MAP OF POLAND



EXHIBIT THREE

ORIGINAL SITE PLAN OF 'MALY KACK'



69

EXHIBIT FOUR MOST RECENT SITE PLAN OF 'MALY KACK'

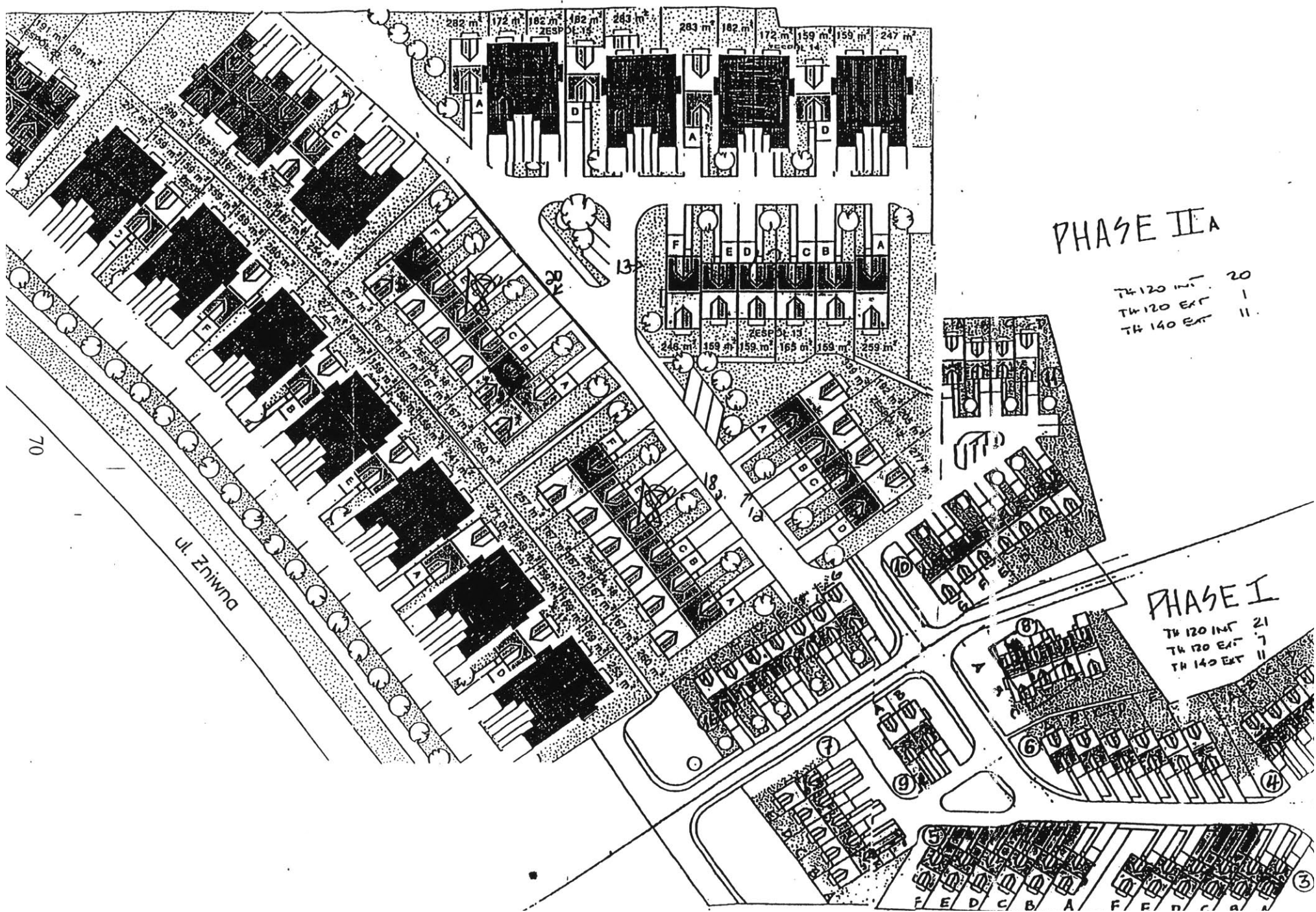


EXHIBIT FIVE RENDERING OF BUILDING IN 'MALY KACK'

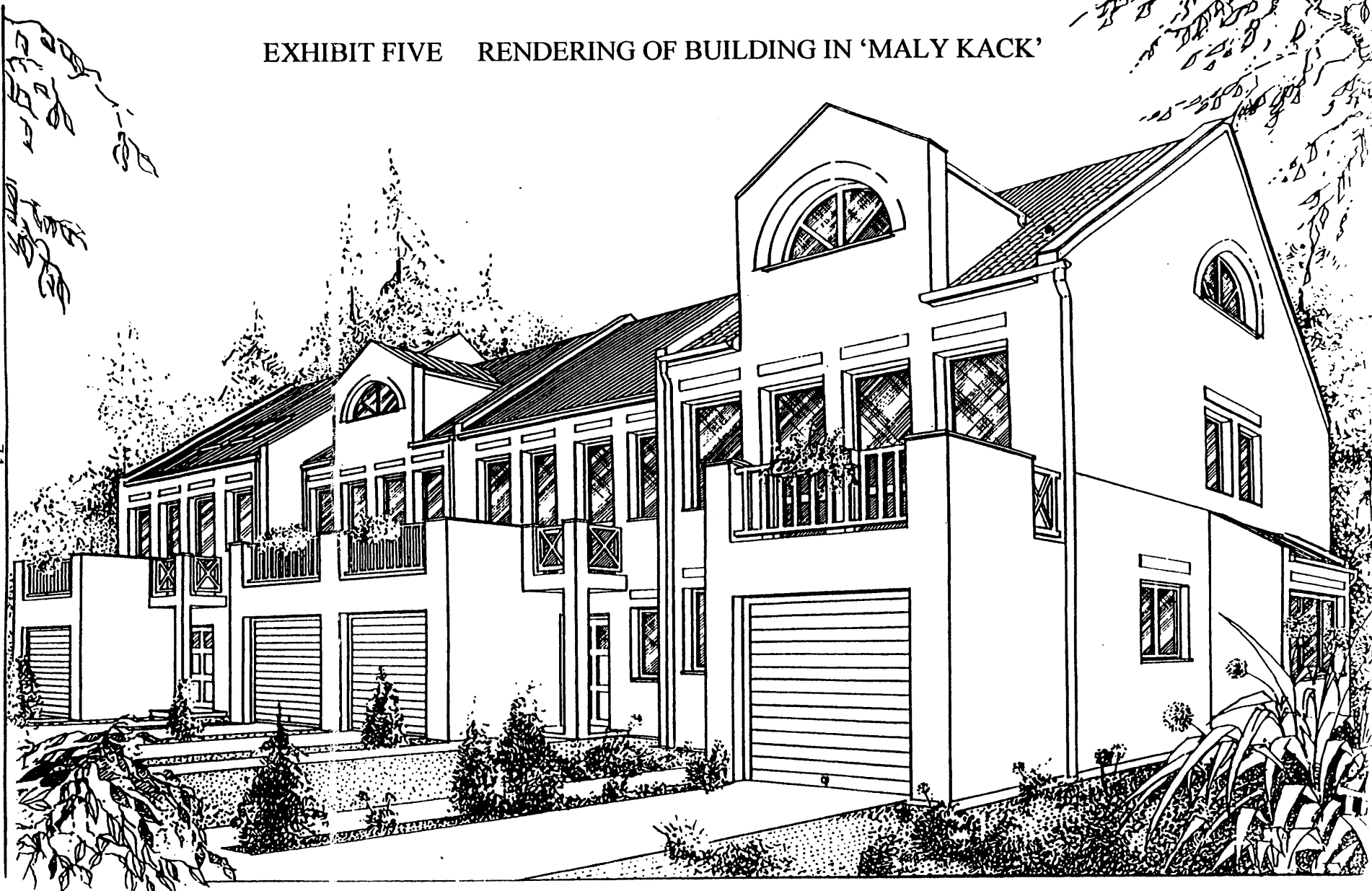


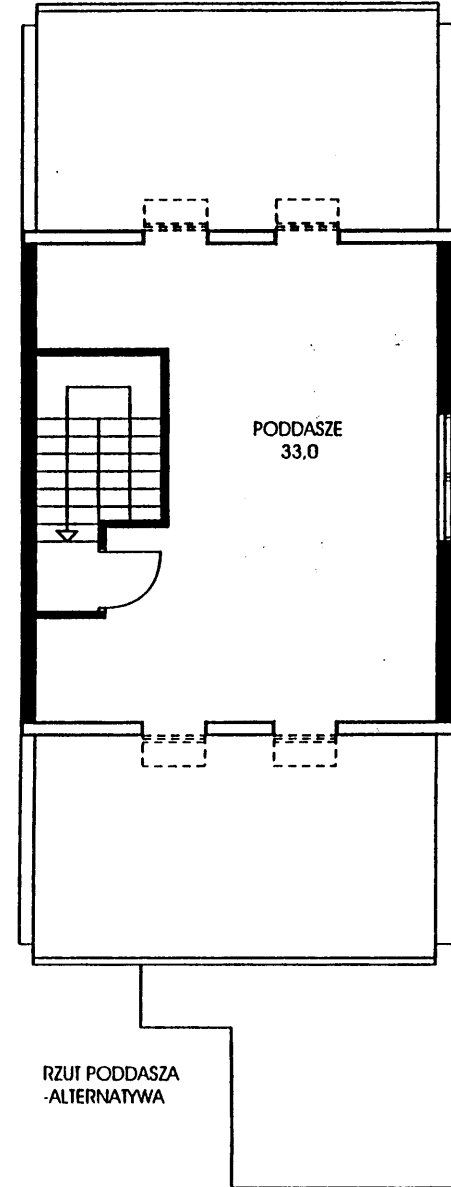
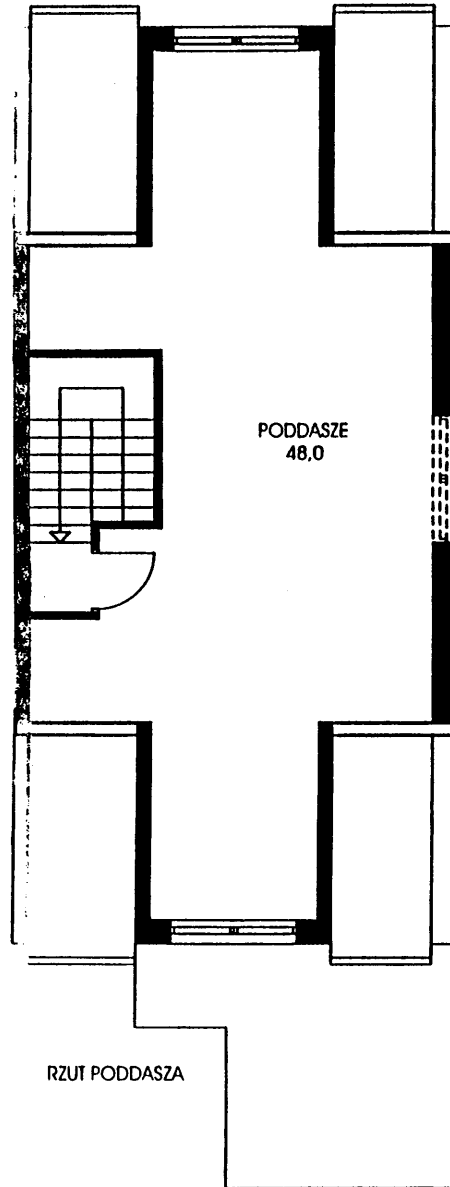
EXHIBIT SIX PHOTO OF TOWNHOUSE IN "MALY KACK"





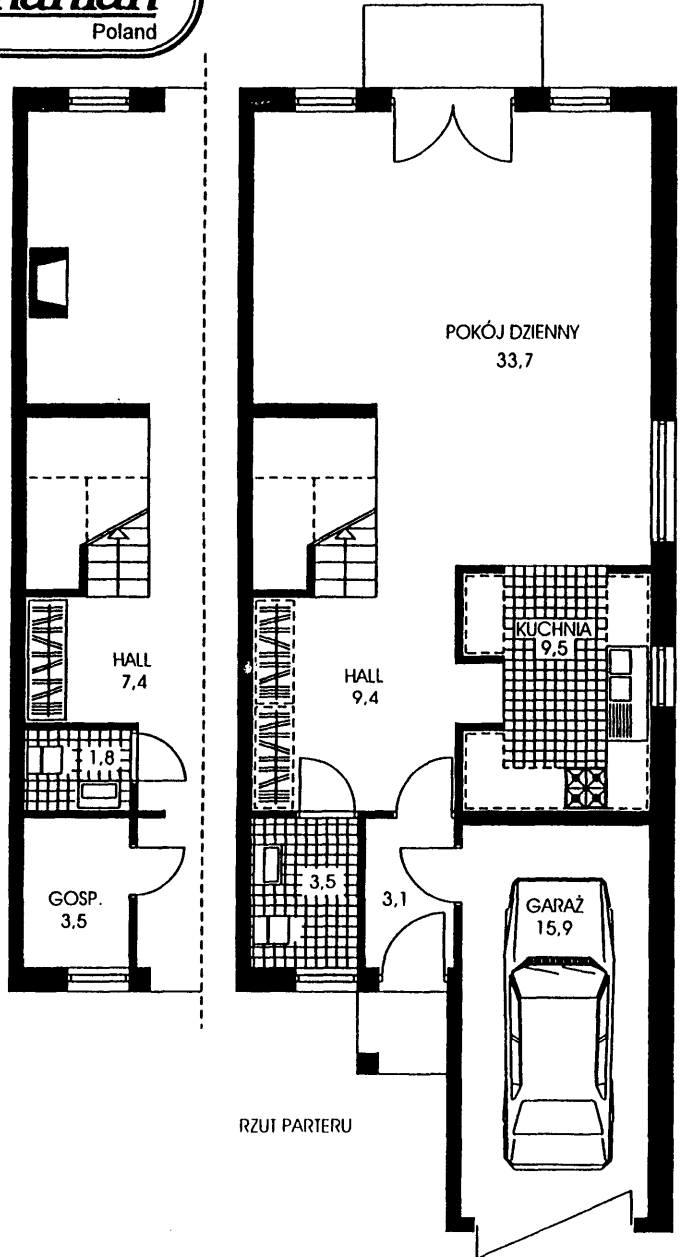
EXHIBIT SEVEN

FLOOR PLANS OF 'MALY KACK'

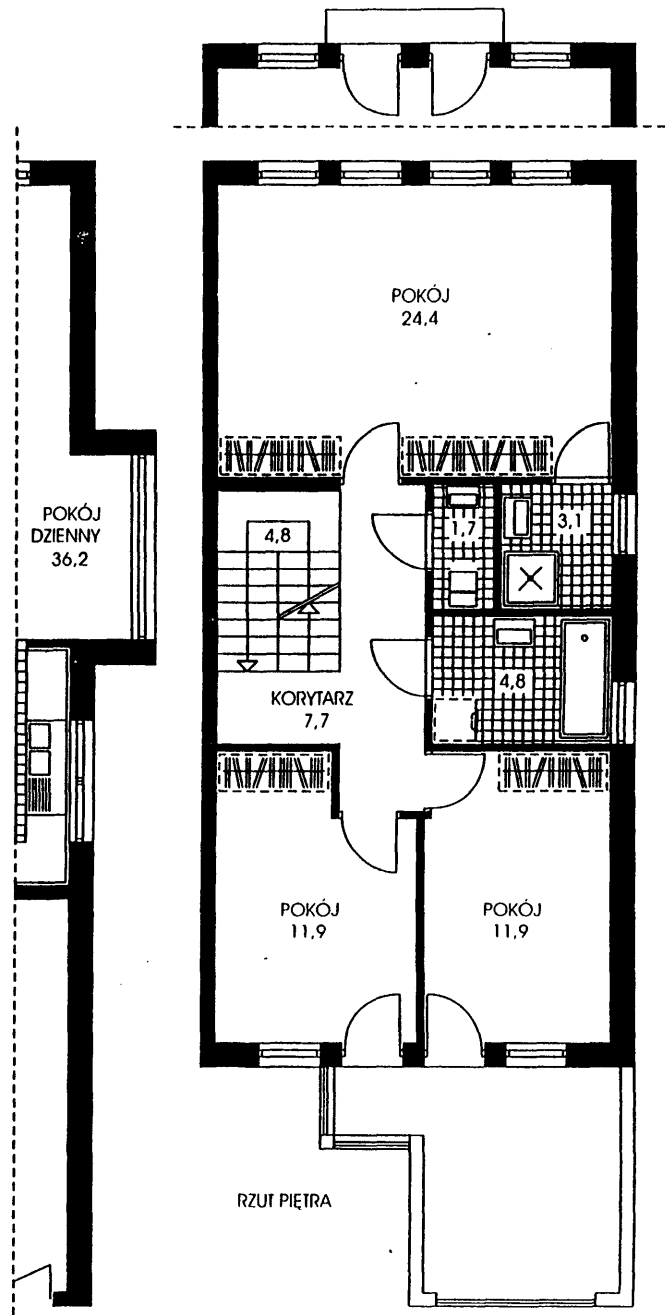


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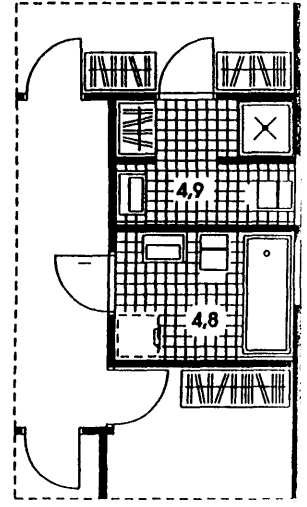
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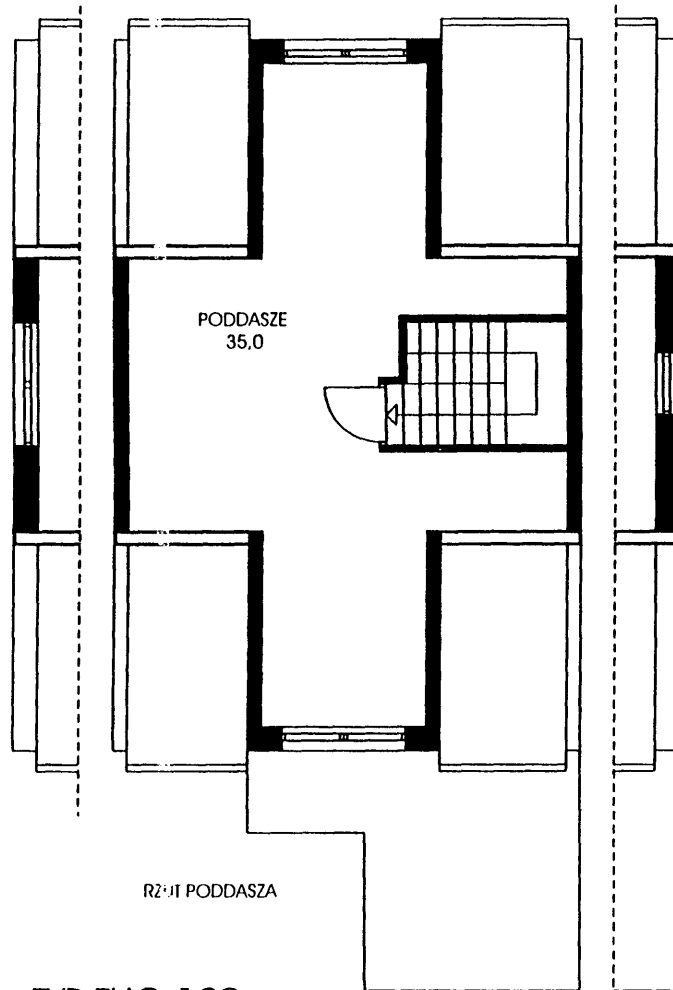


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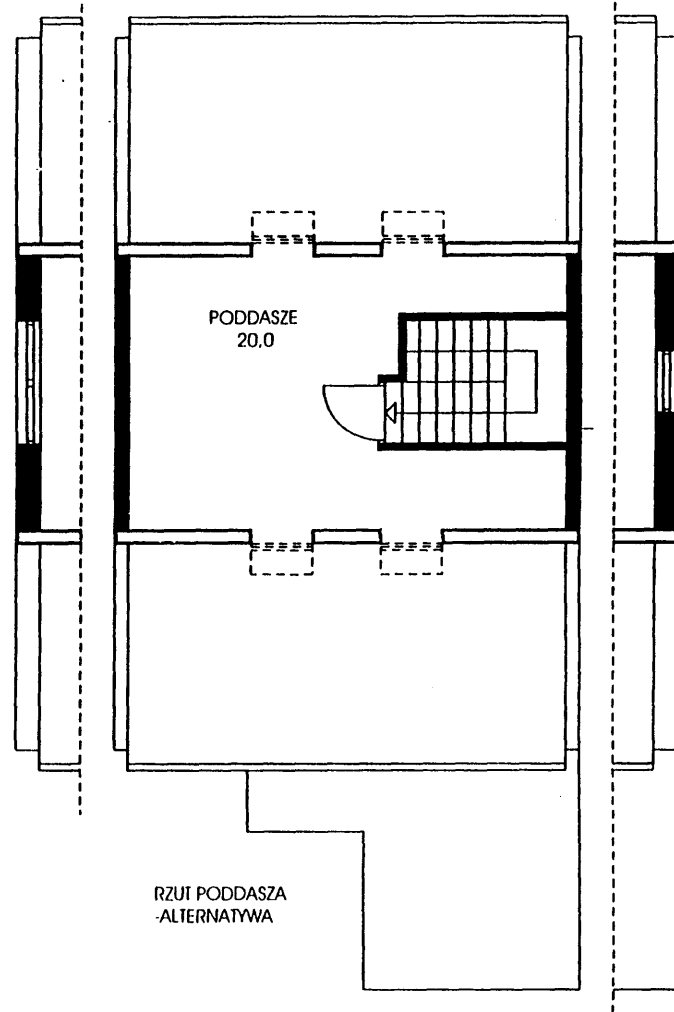


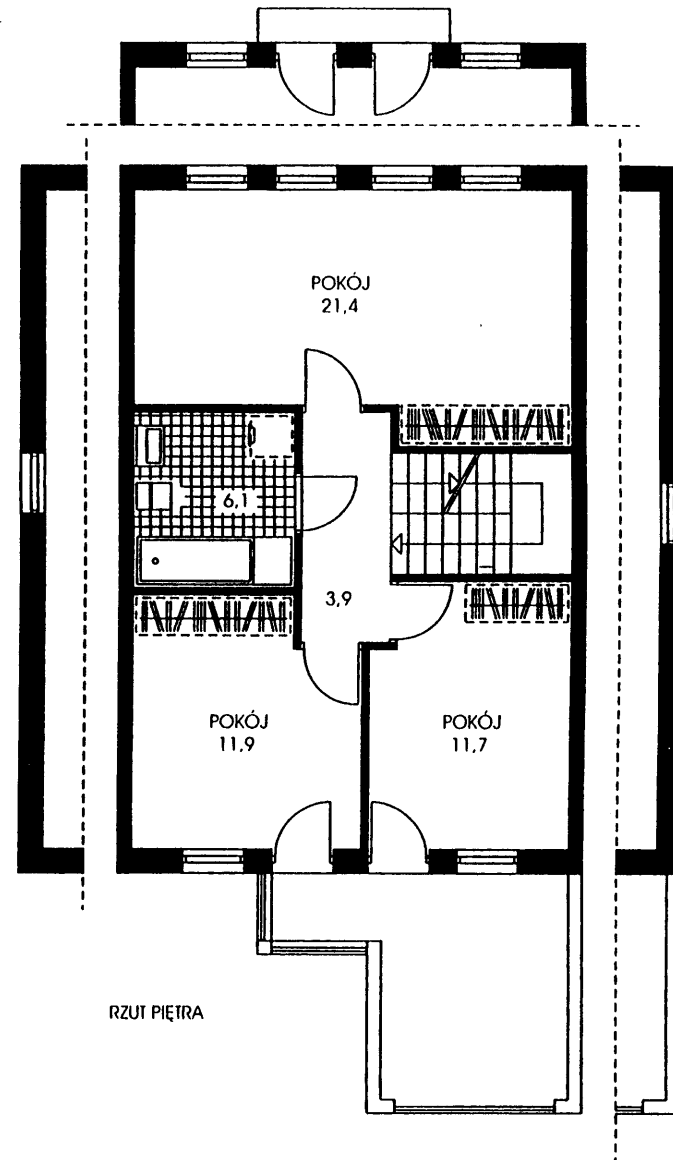
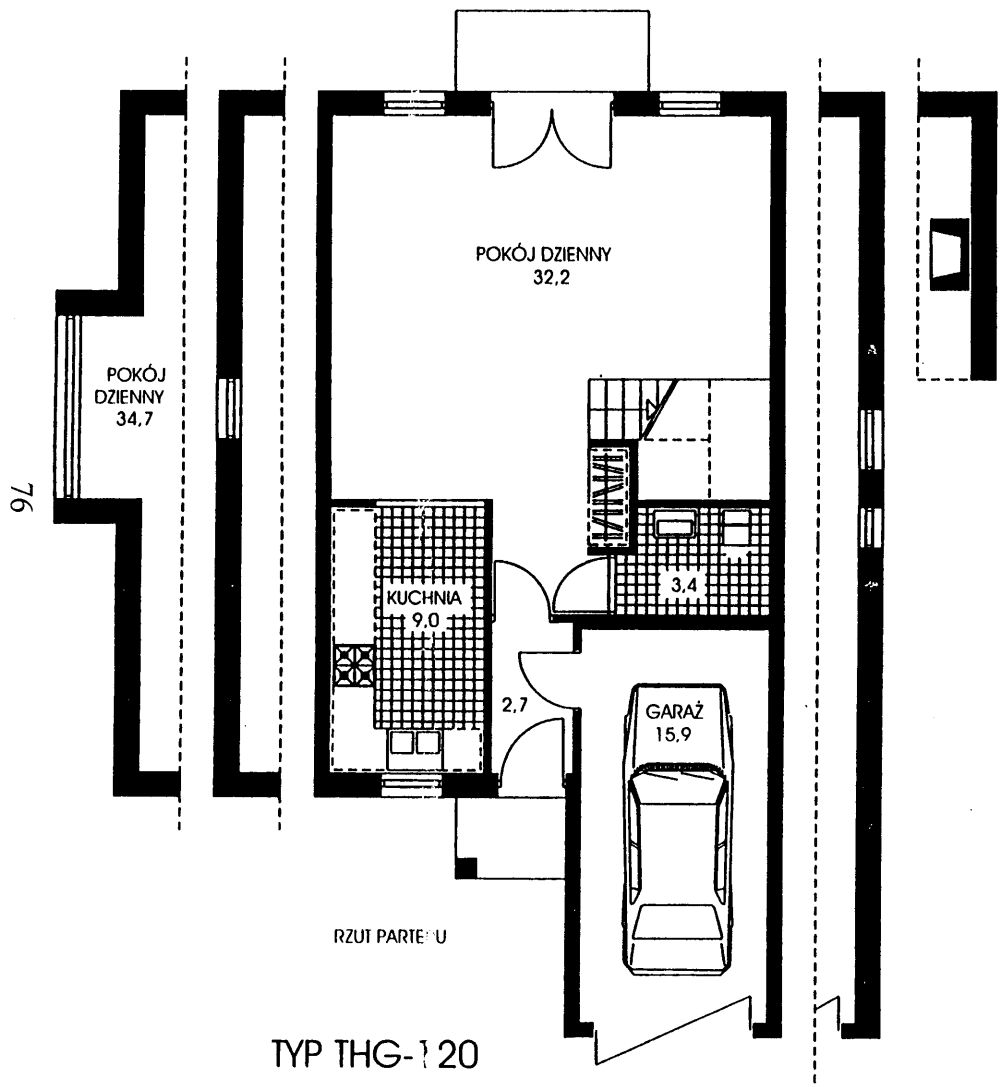
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