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*Institutional Upheaval
and Company Transformation
in Emerging Market Economies*

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**INSTITUTIONAL UPHEAVAL
AND COMPANY TRANSFORMATION IN EMERGING MARKET ECONOMIES**

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ABSTRACT

Company transformation in central Europe is qualitatively different from that observed in the West because of upheaval in the institutional environment. Case data from firms in the Czech Republic suggest that institutional upheaval slows the pace and progress of company transformation because it exacerbates structural inertia effects; eliminates templates for organizing; and promotes strategic confusion. At the same time, inter-organizational and interpersonal relationships facilitate company transformation during institutional upheaval.

Key Words: Organizational transformation, institutional theory, emerging market economies

INSTITUTIONAL UPHEAVAL AND COMPANY TRANSFORMATION IN EMERGING MARKET ECONOMIES

Firms in central Europe faced an unprecedented change in business conditions with the fall of Soviet-dominated communist governments. State-owned enterprises that had been embedded thoroughly in the social, political, and economic institutions of central planning were thrust suddenly into market-based competition. Most firms were ill-prepared to compete because their structures, systems, and capabilities were adapted to central planning, not markets.

Company transformation also was likely to be affected by the unprecedented institutional upheaval that accompanied the change in governments. In a matter of two or three years, the apparatus of central planning was disassembled. Prices were freed. Borders were opened, currencies were revalued, and quotas and plans were set aside. Privatization of state-owned enterprises began. New constitutions, laws, regulations, and reporting practices were implemented though slowly and imperfectly [Peng & Heath 1996]. These were extraordinarily difficult circumstances for companies. How they transformed themselves is the subject of this research.

CONCEPTUAL DOMAIN

Two conceptual domains inform this research, theories of radical organizational change [Tushman & Romanelli 1985; Gersick 1991; Meyer, Goes & Brooks 1993] and institutional theory [Meyer & Rowan 1977; DiMaggio & Powell 1983; Zucker 1987a; Greenwood & Hinings 1996]. Radical organizational change theorists argue that most change is incremental, intended to improve the fit between the company and its environment. Incremental change is punctuated occasionally by radical, pervasive, and rapid change in strategies, structures, and systems that fundamentally transform the firm. Radical change represents a change in organizing templates or archetypes [Greenwood & Hinings 1996]. The more adapted firms are to their environment, the more difficult it will be for them to achieve radical change [Radice, 1981; Granovetter, 1985; Hannan & Freeman, 1984; Greenwood & Hinings, 1996].

Radical change is triggered by a change in the competitive environment, a change in leadership, or

a decline in organizational performance [Romanelli & Tushman 1994; Tushman & Anderson 1986; Virany, Tushman & Romanelli 1992]. The change in the competitive environment in central and eastern Europe was the sort of environmental jolt that was capable of triggering radical change. Industries were deregulated and opened to competition. Market forces replaced planning. New technologies became available, all in a very short period of time.

New leadership also was a near-universal phenomenon in the region. Most managing directors left after 1989, if for no other reason than for firms to rid themselves of their communist leaders. In addition, younger people less socialized by central planning were promoted to take firms forward into competitive markets. Many of these new managers spoke English, German, or both; many had some western education.

Finally, poor financial performance was endemic within three or four years after economic liberalization. Many firms lost their markets to the east. Investment capital was not available and trade credit was scarce. Theories of radical change clearly predict that radical organizational transformations are likely under these circumstances.

Institutional theorists argue that populations of organizations become more similar over time because of a normative process that rewards similarity. Change is a relatively continuous, incremental process in which the drivers of change are strong norms about what constitutes appropriate organizational forms. These norms reside outside the organization and include governmental institutions, laws, and regulations. Firms that are more isomorphic with their institutional environment are more likely than other firms to obtain scarce resources [D'Aunno, Sutton, & Price 1991; Singh, Tucker, & House, 1986]. Firms that adopt institutionally accepted innovations perform better than those that do not and firms that adopt innovations that are not institutionally accepted perform worse than others [Zucker 1987b]. Tightly aligned firms are advantaged, which produces pressure on other firms to align. Institutional pressures mitigate against radical change [Buchko 1994].

Institutional theory also helps explain the emergence of inter-organizational personal networks in

planned economies [Carroll, Goodstein, & Gyenes 1988; 1990; Xin & Pearce 1996]. These networks helped firms compensate for poor connections to powerful institutions (e.g. private business people in China) or inadequacies and inefficiencies in the institutional context (e.g. scarcity or Party politics).

Institutional theory explains the similarity of enterprises under central planning. It explains incremental organizational change in relatively static institutional contexts. It is an explanation of organizational similarity and inertia. But what happens when the institutional context itself changes rapidly, radically, and pervasively? The fact that institutions were simultaneously in such a state of flux might suggest that organizational transformations would proceed rapidly because the major source of inertia was gone. Or, it could suggest just the opposite -- that firms would be slow to change fundamentally because the institutional context did not provide new organizing templates and new models for action [Greenwood & Hinings 1993]. To understand which occurred and why, we need to examine the experiences of companies in the region.

THE RESEARCH

This analysis draws on case data from an investigation of organizational transformation in the emerging market economies of central and eastern Europe [Newman & Nollen forthcoming]. We used case research methodology because we were asking exploratory questions concerning the process of transformation under conditions of extraordinary and unprecedented institutional change. Case research captures the richness of unfolding, uncontrollable events and is an appropriate methodology for theory-building [Yin 1989; Eisenhardt, 1989].

The data are from six Czech company cases developed between 1991 and 1997. The Czech Republic is a good setting for this research because the pre-1989 institutional context was among the most pervasive and consistent of all communist regimes. About 97 percent of the economy was state-owned and the economy was biased by the Soviet Union's cold war defense needs. Formal property privatization after 1989 was done with the greatest dispatch of all former Soviet bloc countries. The bulk of the economy was

nominally privatized within four years after the change in government. Along with a new government and new ownership of firms, the Czech Republic “divorced” its partner of seventy years, Slovakia in 1993. Institutions were in disarray in the early 1990s.

Data sources included face-to-face interviews with top company officials, work observation, archival data retrieval, press reports, and interviews with investment analysts, bankers, partner company officials, and government officials. All firms in the study are manufacturing firms, all were state-owned before 1989, and all were formally privatized between 1992 and 1993. Data collection began in Zetor, the pilot firm, in 1991. The other firms were added between 1993 and 1995 to test emerging conclusions from Zetor, to incorporate different industries and privatization patterns, and to explore different types of transformation. Characteristics of the companies and the data sources from each are shown in Figures 1 and 2. The stories of change are rich and varied. They are summarized in the next section.

Figures 1 & 2 about here

THE COMPANIES

Aero Vodochody

Aero Vodochody (Ā-rō Vō-dō-hō-dē) was the monopoly manufacturer of military jet trainers and light attack aircraft for the Soviet Union and its allies. The company was founded in 1919 as an airplane and automobile maker, but its modern era dated from its post World War II build-up by the communist government. Aero Vodochody had revenue of CZK 1,750 million (about USD 50 million at the early 1998 exchange rate) and employed 3,600 people in 1990. It was the largest manufacturer of jet trainers in the world.

The company had two similar products, the simpler and cheaper L-39 airplane that dated from 1971, and the newer, higher-performance L-59. Either airplane could be outfitted with armaments and

converted from a jet trainer to an air-to-ground light attack airplane. The airplanes were designed and assembled at Aero's plant north of Prague. Over 90 percent of Aero Vodochody's revenue was obtained from its exports of these airplanes to the Soviet bloc before 1990.

Aero Vodochody needed new products and new customers. The main new product was the L-159 trainer, derived from the existing L-59 but with a U.S.-built engine and avionics integration from Rockwell. The NATO-compatible L-159 was to be Aero's main product for the next 20 years. Its claimed advantage in the market would be equal performance at lower life cycle cost. To survive, Aero had to sell this plane first to the Czech government and then to other countries in the region and in the developing world.

Aero Vodochody's financial health began to deteriorate in the mid-1990s. All of Aero's Soviet business was lost after 1990. New orders were scarce. Profits turned to large losses, up to CZK 2,700 million in 1996, twice Aero's revenue that year. Bank debt exceeded CZK 5,000 million in 1996. By mid-1996, Aero Vodochody was technically bankrupt. The first post-Revolution managing director had resigned under fire and been replaced by Adam Straňák, a 40-year old life-long Aero Vodochody employee whose background was design engineering. He had some American business education in 1993, had traveled to the U.S. to visit Rockwell several times after the Revolution, and spoke English fluently. He was a pragmatic problem-solver with good relationships with key government officials.

Straňák and the Czech government put a final privatization plan into operation in 1996. The government restructured the company financially, writing off some of its debt owed to commercial banks, (which were still government-owned) and swapping the rest of it for more equity held by one of the banks. The value of this bailout was CZK 3,000 million. In May 1997 a Boeing-ČSA¹ joint venture agreed, in principle, to buy 34-40 percent of Aero and to invest nearly CZK 1,000 million in the firm. A contract

¹ ČSA is the Czech national airline. Boeing had purchased Rockwell's avionics business earlier - - the company that integrated avionics for Aero's L-159. Boeing also purchased McDonnell Douglas which made jet fighters that were competing for new business in the region among new NATO members. Aero reported to McDonnell Douglas in St. Louis on a day-to-day basis after the strategic alliance was negotiated.

with the Czech government for 72 airplanes, first suggested in 1995, was signed shortly thereafter. Even so, the government order represented less than half the volume needed for break-even on the L-159. After almost a year of tough negotiations, Boeing made its investment and assumed management control of Aero Vodochody. The firm was ready to begin transformation.

Královopolská

Královopolská (Krah'-lō-vō-pōl-skah') was a 100-year old manufacturer of industrial equipment located in Brno, the second largest city in the Czech Republic [Newman & Nollen 1996]. It made tanks and pipes and other metal parts for chemical plants, water treatment plants, and nuclear power plants, and it made cranes, bridges, and other steel structures. It also had a small turnkey water treatment plant business. The company had revenue of CZK 1,745 million in 1990 (about USD 50 million at the early 1998 exchange rate) and employed 5,500 people. Three-quarters of the company's revenue came from exports before 1990, mostly to the Soviet Union and COMECON countries, where there were few if any competitors. In the domestic market, Královopolská was a monopoly supplier.

Královopolská lost most of its export business after 1989. Domestic sales to the chemical and nuclear power industries also fell as those industries weakened, but Královopolská's water treatment plant equipment sales and turnkey business grew rapidly because of the new government's support for environmental clean-up.

Královopolská's management reorganized the company from a functional structure to product divisions in 1992. Several subsequent reorganizations resulted in consolidated divisions and separation of the production function from the product divisions. New top managers were appointed in 1992. The general director was Zdeněk Pánek, who was 37 years old, educated in economics, and who came out of the turnkey business where he had been a field representative. He undertook a competitiveness analysis of Královopolská's in 1993; created subsidiaries to conduct trade with Russia and other eastern European countries; created a strategy department; achieved ISO 9000 certification in 1994; and initiated forays into

new, unrelated businesses. Pánek encouraged his employees to learn English though he was not an English-speaker himself. He had little experience with the West and little trust of consultants.

Královopolská was privatized in May 1992. In March 1995 a partnership among seven company managers called KENAP agreed to buy a 51 percent stake in Královopolská from the National Property Fund (the government entity created to hold unsold shares in companies, pending final privatization). KENAP, led by Pánek, was granted management control of the company immediately.

During the transition years, Královopolská posted better financial results than many other Czech companies. Although revenue decreased in 1990 and 1991, it increased after that. Pánek wanted to make Královopolská into a full-service engineering company for chemical as well as water treatment plants, not just a tanks and pipes supplier. He wanted turnkey business to account for 70 percent of revenue by 1997, and by 1995 it had already passed 50 percent of revenue and accounted for all of Královopolská's profit. Yet the future of the company was not secure. The big water treatment plant business that benefitted Královopolská declined after 1996. New turnkey chemical plant business was being developed in the Middle East and Kazakstan, but these were unstable regions and new businesses for Královopolská. No turnkey chemical plant orders had been received through 1997. KENAP's debt burden placed a premium on cash flow. There was no cash available for new investment in new technologies, plant and equipment, or information systems.

In the fall of 1997 Pánek was briefly jailed while under investigation for "tunneling," a practice whereby assets from one firm (Královopolská) were moved to other firms (allegedly other KENAP-controlled entities or firms controlled by Pánek's family or friends) to the detriment of other shareholders of Královopolská. Tunneling was endemic in the Czech Republic in 1996 and 1997, yet despite numerous high-profile arrests, no one had been convicted of any tunneling crimes and the practice continued. KENAP missed a payment to the National Property Fund for Královopolská shares in late 1997 and the Fund repossessed Královopolská. By 1998 Pánek was no longer managing the company.

PBS

První Brněnská Strojirna (Prv'-nee Br-nyěn'-ska Stroy-ír'-na), or PBS, was a Brno-based manufacturer of boilers and turbines for power plants [Nollen, Newman & Abbey 1998]. The company also built complete power and heating plants on a turnkey basis, serviced old plants, and made a variety of other small industrial components. PBS employed more than 9,600 people and had revenue of CZK 2,050 million in 1990 (about USD 59 million at the early 1998 exchange rate).

Boilers and turbines made by PBS were well-engineered and long-lasting. With 140 years of history, PBS was regarded as a "family silver" company in the Czech Republic. Its turnkey power plant business was a significant part of the company. Exports accounted for a quarter of PBS sales as of 1990, and 80 percent of all exports were made to the Soviet Union and COMECON countries.

PBS was privatized in 1992. Individuals and investment funds bought 36 percent of the shares and the National Property Fund held the remaining shares. The general manager, Richard Kuba, believed that the company's final privatization would require a relationship with a foreign company. He thought it would take PBS too long to catch up technologically, and that new investment was needed from the West because capital was not available in the Czech Republic. In an over-capacity industry dominated by four or five giant producers, PBS had unsatisfactory prospects without a strategic partner.

In 1992, the International Finance Corporation (IFC), acting as consultants to PBS, helped secure proposals from foreign companies that were interested in PBS. The leading bidder was ABB, the Swiss-Swedish engineering and industrial giant. A joint venture called ABB PBS began business in April 1993 with a 67 percent stake held by ABB. About 80 percent of PBS's revenue and just over half its employees went into the joint venture. Kuba was the managing director of the joint venture.

Business was good for the joint venture in its first two years. Orders and revenues increased and the company was profitable in 1994 and 1995. ABB PBS completed the bulk of its physical capital restructuring in 1995, including factory renovation, improvements in engineering facilities, and award of

ISO 9000 certificates. Labor productivity increased markedly.

However, a variety of problems became evident in 1996. The domestic service business, which had been created as a separate profit center, was disappointing as new small competitors entered the market. The coal-fired steam boiler business in which ABB PBS had technological capabilities was becoming strictly a rehabilitation business; there were no new orders.

Relationships with ABB sister companies also were difficult. One project in Germany went badly for PBS and a new management information system took a year longer than planned to come on line. PBS managers admitted that they “lost control of the company” for almost a year while the new information system was installed. Human capital restructuring was difficult as well. To get employees to take responsibility, show initiative, and confront adversity were all challenges. ABB tried to help, but believed that local Czech managers and not expatriates would have to bring about the mentality changes. One critical problem was referred to as “good news management” by ABB personnel and “telling a good story” by Czechs. Czech managers were accustomed to telling the boss what they thought the boss wanted to hear. A holdover from central planning, good news management was a survival skill then, but dysfunctional in the ABB partnership. The extent of problems with the German boiler project and the new information system were not communicated to ABB until considerable damage had been done because of good news management. As a consequence, the joint venture lost money in 1996 and again in 1997. Though ABB bought-out the joint venture in early 1997, Kuba was no longer involved in day-to-day operations. The new subsidiary of ABB, now called ENS (Energetické Systémy) no longer did business in western Europe. Instead, its geographic domain was its traditional one - - central and eastern Europe.

Poldi Steel

Poldi Steel Works at Kladno, just west of Prague, celebrated its centennial in 1989, the same year as the Velvet Revolution. Poldi produced CZK 3,000 million worth of steel that year and employed 20,000 people. Poldi produced carbon and alloy structural steel and stainless steel bars of varying sizes for use in

a wide range of industries. Poldi had been a leader in steel-making technology in the 1920s and 1930s. There were three other large steel producers in the Czech Republic, all located in the Ostrava region hundreds of kilometers distant from Kladno. The industry was over-capacity in western Europe as well as the Czech Republic.

About half of Poldi's output depended directly on Soviet needs, either for export to Russia or for military hardware produced domestically. Exports to western Europe were small (about 15 percent of tonnage) and subsidized. By the end of 1991, Poldi's business had fallen to half its pre-1989 levels. Soviet exports disappeared completely, and losses and debt mounted.

Poldi's urgent need in 1993 was to sell steel. Prospects in the domestic market depended on the economic health of big customers such as Zetor, PBS, and Aero Vodochody, which was not good. Expanding sales to western European customers was hampered by the market downturn in the European Union and by trade restrictions. By the end of 1993, the plant was operating at a third of capacity. Poldi could not afford to pay its electricity bill nor its scrap iron supplier and consequently endured power cuts and raw material shortages. At one point Poldi cannibalized its old, unused physical plant for scrap iron to make steel. Younger managers voiced discontent with the company's lack of strategic thinking. No money was available for new information systems or new technology.

The Czech government sold a majority interest in Poldi in a bidding contest in 1993. Among three bids, one at CZK 1,750 million was more than twice as high as the next closer bid, and it was accepted. (A report that the buyer learned of the competing bid and pencilled in a '1' before his original '750' at the last minute was not denied.) The new owner was Bohemia Art, a small company (800 employees and CZK 500 million in revenue in 1992) that was in the art and architectural restoration business. Bohemia Art was owned by Vladimír Stehlik, a 50 year old Czech. Neither Stehlik nor his company had any experience in the steel business.

Stehlik raised the price of Poldi steel to German customers and lost those customers. He tried to

cut out distributors and sell direct to customers. Output continued to drop but employment stayed the same. Losses worsened. Bank debt grew. In November 1996, Vladimír Stehlik and his son, Marko, were jailed on charges of “illegal property transactions and misuse of information in commercial transactions,” or tunneling. Poldi shut down shortly thereafter.

Several former Poldi managers said that Poldi’s demise had been allowed purposefully by government officials. The Czech Republic’s high steel capacity and low labor costs were worrisome to the EU. Some of the Czech capacity would have to go. According to one senior Poldi official, the government allowed a bad privatization so that Poldi would fail and the reduction in capacity would be accomplished without government officials having to shut down or consolidate companies. Whether through bad luck or clever scheming, steel-making capacity in the Czech Republic was reduced. After a century of history in Kladno, Poldi Steel was only a barren landscape of rusting machinery and empty halls.

Veba

Veba (Vě'-bah) was a century-old maker of cotton textiles located in the small town of Broumov in northeastern Bohemia. With Poland on three sides and a mountain range on the fourth, Broumov was isolated from the rest of the Czech Republic. Veba’s two main product lines were damask yard goods and terry products, principally towels and robes. The company’s revenue in 1990 was CZK 650 million (about USD 19 million at the early 1998 exchange rate), and it employed 3,200 people.

Veba did the spinning, weaving, finishing, and some sewing of its products. Purchase of raw cotton and product sales were handled by Centrotex, the foreign trading company for the textile industry. Nearly half of Veba’s products were exported, mostly high quality damask products to western Europe (much of which was re-exported to Africa). Less than 10 percent of Veba’s revenue depended on the Soviet Union or COMECON countries. Most of the terry products were sold domestically.

Veba was privatized in 1992 via voucher privatization. In 1996, Centrotex bought two-thirds of Veba’s shares from investment funds to gain control. Veba managers welcomed the Centrotex purchase

because they were uneasy about being owned by investment funds that did not have expertise in the textile business or by a new majority owner that might shut down the mills to eliminate competition. Centrotex had helped Veba avoid one such hostile takeover in 1995.

A new general director, Josef Novák, was appointed in 1993. He was age 38, had an economics master's degree, was head of the sales function at the time of the Velvet Revolution. He had traveled extensively during the communist era to the West and was a fluent English speaker. Veba had a tradition of strong management and little government ministry interference, partly because the textile industry was not considered to be important strategically during the central planning era. In addition, Veba's geographic isolation contributed to a sense of resilience and independence.

After privatization, Veba's managers developed new marketing and product strategies after conducting a strengths-weaknesses-opportunities-threats analysis. Novák concluded that Veba's competitive advantage was product quality and that its main threat was low-cost, middle-quality Asian producers. Veba accordingly sought to increase its business in the rich markets of western Europe and North America and to produce more high quality, high margin finished products. Initially, Veba extended its damask product line by adding king size bedding, finished tablecloths, and jacquard shirting, borrowing from Czech and German banks in 1993 to do so. Veba also entered a new market by selling complete sets of bedding, towels, and robes to luxury hotels in Europe.

Business results for Veba were reasonably good throughout the transition. The company was profitable in every year except 1993. Receivables that threatened to become a problem during the liquidity crisis in these years were managed vigorously and were kept small relative to revenue. With the help of a Dutch husband and wife consulting team, Veba implemented an activity-based cost system as well as an inventory management system and a new accounting system (though it took two years to get them working to Veba's satisfaction). Plant rationalization began in 1994. Novák pursued new markets, obtaining his first North American contracts in 1997. Veba was competing in one of the largest, most demanding

markets in the world - - "our emerging market," in Novák's words.

Zetor

Zetor (Zě'-tōr) was a monopoly manufacturer of medium-sized farm tractors located in Brno [Newman & Nollen 1995]. It was the biggest enterprise in Brno with 10,000 employees, annual output of 27,700 tractors, and revenues of CZK 4,000 million in 1989 (about USD 115 million at the early 1998 exchange rate). Zetor also had two small businesses making spherical roller bearings, and castings and forgings, of which only a few of the latter were used in tractor manufacture.

The Zetor tractor was a low-specification machine that was sturdy, easy to repair, simple, yet technologically up-to-date. It was low in price and represented good value for money. It had a reputation as the best of the communist tractors before 1989. Zetor tractors were assembled at the Brno plant from key parts -- engines, tires, cabs -- purchased from sole suppliers as well as parts made by Zetor.

Over three-quarters of Zetor's output was exported at the time of the Velvet Revolution. Nearly one-third of all its tractors went to the Soviet Union and COMECON markets and another 25 percent was exported to countries in western Europe and North America. Zetor's single largest customer was the government of Iraq which accounted for another quarter of its sales in 1989. Export sales were handled entirely by Motokov, a state export trading company. Domestic sales were handled by Agrozet, another state trading company. Zetor designed and manufactured tractors. It did not sell, service, or finance tractors.

Zetor was privatized in July 1993 through a merger with its engine supplier, Brno Diesel. The bearings business and the non-productive assets were privatized separately. The National Property Fund owned 71 percent of shares. In October 1994, Zetor was recapitalized in a debt-equity swap, and the Konsolidační Banka (a government bank created to facilitate privatization) acquired 79 percent of Zetor's shares. Business conditions facing Zetor in the early years of the transition were poor. Tractor exports to the former Soviet Union and COMECON markets dropped more than half, and exports to Iraq disappeared

completely because of the Gulf War embargo. Zetor lost money every year between 1994 and 1997 and was expected to lose money through 1999.

A new managing director in his 40s, Miroslav Poláček, took over Zetor in July 1993. Poláček had been head of production at Brno Diesel, the engine company. In 1993 Poláček had very little experience in the West and was not an English-speaker. He reorganized the company several times, creating and dissolving “daughter companies” that might be sold, adding business units, and consolidating business units. He made technical improvements and design modifications in Zetor’s tractors. He began installation of a new information system that ran a year or more behind schedule. He undertook some rationalization and modernization of the plant beginning in 1995, financed with new borrowing, but was unable to complete it. Bank loans increased to half of Zetor’s total assets by 1995.

Despite some progress, Zetor’s performance was unsatisfactory. Output only inched up from its 1992 low point, and revenue decreased in real terms. The over-capacity world tractor industry was dominated by four large producers. An attempt to sell Zetor to the U.S. manufacturer, Deere and Company, fell through. More debt was restructured in 1997 as Zetor awaited a strategic investor.

INSTITUTIONAL UPHEAVAL AND COMPANY TRANSFORMATION

Amid the institutional changes associated with the change in government, companies in the Czech Republic were slow to transform, despite the clear need to do so. Radical change in the institutional environment did not free companies for radical, rapid, and pervasive change. Instead, institutional upheaval slowed the pace and progress of company transformation. Among the six firms in this study, only two, Veba and PBS, had undertaken significant transformation by 1998, and even those two were slower to change than theories of organizational transformation would predict. Královopolská undertook many changes but they were short-lived. Three phenomena that might explain slow or no transformation in the face of the apparent need for transformation: organizational inertia, the absence of templates for change, and strategic confusion. These data also suggest a facilitator of change for firms: informal inter-

organizational and personal networks.

Organizational Inertia

These companies surely show evidence of organizational inertia. Most did not change fundamentally through 1997. Without external guides for new strategies, structures, systems, and capabilities, some firms continued to do what they had done before 1990 and others tried to change but reverted to their old, familiar structures and capabilities within a few years. Inertia explains why new information systems were not introduced more rapidly, why performance-based rewards were slow to come to most firms, and why managers continued to manage with their “good news” capability. If anything, institutional upheaval exacerbated the effects of organizational inertia because firms adhered to practices that were known and familiar in the midst of a tumultuous and uncertain institutional environment.

The persistence of “good news management” was a good example of an old capability used under new circumstances. Though a survival skill under communism, good news management did not contribute to organizational transformation after 1989. Good news management was particularly a problem for firms in strategic relationships with western firms. One of the causes of the cooling relationship between Deere and Zetor was Zetor managers’ inability or unwillingness to be forthright about delivery schedules. Zetor managers repeatedly reported more optimistic delivery dates and quality levels to Deere officials than were possible, even in the face of clear evidence to the contrary.

PBS’s difficulty in 1996 also was attributable, in part, to good news management. Both the German boiler contract and the information system installation were severe problems, yet top management in ABB did not know the extent of the problems because they were not told. Good news management contributed to Kuba’s reassignment and to PBS’s poor financial results for two years. In the end, ABB bought out the joint venture and instituted tighter controls.

These data suggest a phenomenon similar to that observed in organizations in crisis. Firms in crisis often show more centralization and less communication [Hermann 1963; Gaertner, Gaertner &

Devine 1983], more self-protective behavior [Hall & Mansfield 1971], and rigid adherence to familiar routines [Staw, Sankelands & Dutton 1981]. These behaviors exacerbate the crisis until firm performance is so severe that the firm either fails or changes radically. The experiences companies in central Europe suggest that institutional upheaval magnifies the tendency to rely on old routines during crisis, thus slowing organizational transformation.

Proposition 1: Institutional upheaval slows organizational transformation because firms adhere to old routines in the face of turmoil and uncertainty.

In at least two cases, Aero and Zetor, managerial inertia was exacerbated by government bailouts that protected the firms from the rigors of market-based competition. While both may have failed with no help from the government, government support in the form of debt restructuring and large guaranteed purchases postponed the day when true transformation would have to begin. According to Straňák at Aero, very little internal restructuring had been accomplished while the firm awaited its new owners. According to both Zetor and Deere officials, Zetor had not solved its quality, service, and timeliness problems through 1997, and expected to lose money for two more years.

Both firms also were affected by the government's interest in keeping Czech assets in Czech hands, which resulted in more government involvement in day-to-day operations than would otherwise have been the case. Early in the privatization process Aero was forced by the government to trade its assets for forgiveness of debts held by other firms in the Czech aircraft industry, not its own debts. Later, government officials seriously considered selling Aero to a Czech company with no ability to make a strategic investment, no management know-how, no up-to-date technology, and rumored ties to the Russian mafia. Its main assets were its Czech ownership and its ownership of Aero's foreign trading partner.

Zetor was still owned by the government (Konsolidační Banka) after privatization. Disagreements between Konsolidační Banka and Deere contributed to Deere's unwillingness to buy Zetor. Konsolidační Banka, as a major shareholder, placed people on Zetor's Board of Directors who gave the firm bad,

sometimes self-serving advice. While Konsolidační Banka bailed-out Zetor twice, saving it from bankruptcy, it also meddled in internal company management unproductively, further delaying Zetor's true transformation.

Proposition 2: Institutional upheaval slows organizational transformation when the institutional context protects firms from the new competitive environment or becomes involved in the organization's day-to-day operations.

No Templates for Organizing

A second effect of institutional upheaval was that the templates for organizing that form the normative foundation for firms within an industry disappeared and new ones were slow to evolve. The prediction from institutional theory that firms mimic each other was observed in these companies, but the mimicry was trial and error adoption of new structures, not adoption of dominant or legitimate structures. New organizational forms, consistent with and appropriate for competition, were neither known nor grounded in managers' experiences. Reading about product organizations or learning about them from consultants was one thing. Truly understanding why one structure might be more suitable than another was quite another.

Most large firms reorganized from a functional structure to an SBU structure to facilitate privatization within three years of the change in government. Most of these reverted, in whole or in part, to a functional structure; in some cases they reverted because the SBU structure was not appropriate and in other cases because the functional form was familiar. Veba's brief experiment with a product-based structure in 1991 and 1992 was scrapped before it was fully implemented because Novák found it inefficient; the same raw materials equipment were used for all Veba's products. For a short time after its merger with Brno Diesel, Zetor was organized in three SBUs: tractors, foundry, and engines. By 1996 Zetor was again organized by function when its Board suggested creating three spin-offs (energy, rail transport, and tool shop) that were organized as SBUs. When no buyers emerged, the SBUs were

dissolved. In 1997 two new SBUs were created, one to handle parts and service world-wide (copying Deere's structure) and the other to handle domestic sales, service, and tractor finance.

Královopolská created five product-based SBUs in 1992, then began a series of consolidations back to the familiar functional form. By 1996 Královopolská had three sales divisions instead of five product divisions, production was once again centralized as a function, and department names had reverted to their pre-1992 form (marketing became "commercial" and finance and accounting became "economy").

Evidence from these companies suggests that the rate of change in organizational structures increased markedly during the early 1990s but that many of the changes were temporary, to facilitate privatization, or ill-informed, the product of bad advice from advisors. Privatization templates for organizing were promulgated by western consulting firms, usually operating without much experience in the region or in centrally planned economies. Absent new, relevant institutionalized templates for organizing, company reorganizations had an almost random quality about them.

Proposition 3: Institutional upheaval will increase the rate of change in organizational structures and systems over that expected during transformational change.

Proposition 4: During institutional upheaval changes in structures and systems will tend to revert to familiar structures and systems more than expected during transformational change.

Companies mimicked each other in other ways. The most obvious was the explosive use of trappings of status. In 1994 company cars began to appear, followed shortly by cell phones, company credit cards, laptop computers, and company guarantees for mortgage loans. Foreign cars in particular became symbols of job status and were awarded to managers almost regardless of individual or company performance. Aero Vodochody was the one exception ("We need to make money before we get cars," said Straňák). One Veba manager candidly admitted that they provided company cars so that their employees would "look good" and "compete" with others of similar status from other companies.

This phenomenon is easily understood as an effect of institutional upheaval. During periods of significant institutional change, many of the mechanisms that facilitate inter-company interaction disappear, leaving heightened uncertainty and ambiguity in the conduct of business. Any symbols that indicate status or success are likely to be used to guide individuals in their inter-company interactions. Cars, cell phones, and company credit cards are among the salient symbols.

Proposition 5: Institutional upheaval eliminates established symbols that guide inter-organizational relations. As a result, new symbols are developed, used, and mimicked.

Strategic Confusion

Some of these firms exhibited what appears to strategic confusion. Královopolská's experience is instructive. The firm tried to enter two new unrelated manufacturing businesses, brake shoes and city buses, to use excess plant capacity and increase cash flow. Neither venture built on the firm's competencies and both failed. Královopolská also sought to become more engineering-focused rather than a manufacturer of others' designs. This did build on its competence in water treatment plants, but Královopolská tried to extend it to chemical processing plants, perhaps one of the most over-built industries in central and eastern Europe. Its attempts to build new business in the Czech Republic did not bear fruit, and new opportunities in Kazakstan were uncertain at best.

Zetor, too, showed strategic confusion as it sought new customers without doing the necessary analysis to determine whether the new business was profitable. Zetor was defrauded in a Libyan deal in 1992, terminated a joint venture with an Italian firm after one year in 1993, and lost money on its Deere business from 1994 to 1997. The design changes made in the tractors were all too often about aesthetics and not about the real quality problems that were at the core of Zetor's difficult relationship with Deere.

While poor strategic decision-making in Královopolská and Zetor was unfortunate, it was probably no worse than would be observed in a firm whose industry or technology had undergone fundamental

change but whose remaining institutional environment was stable [Tushman & Anderson 1986].

Institutional upheaval in the Czech republic did not have any apparent exacerbating effects on the quality of strategic decision making, except for the fact that most managers were inexperienced in strategic decision making. The experiences of Veba, PBS, and perhaps Aero Vodochody suggest that good strategic decisions can and were made by others in similar circumstances.

While Královopolská's and Zetor's difficulties were attributable to managerial inexperience, evidence from these cases also suggests an institutional cause for strategic confusion. Institutional upheaval is a distraction. How can Straňák be expected to develop a coherent corporate strategy when he does not know about the Czech Republic's entry into NATO? Aero invested hundreds of thousands of crowns in a civilian turboprop aircraft (a very crowded industry) and undertook subassembly work for Boeing while its fate was being decided by government officials. Neither of these activities was strategically central to Aero's survival. Did the government's post-1990 emphasis on clean water lull Královopolská into believing it had a secure customer base and that it had engineering capabilities that could be transferred into other industries? Královopolská was overly optimistic about its ability to become a design and engineering company because of the abundance of water treatment plant opportunities between 1992 and 1996 and may have chosen the wrong strategy altogether.

Proposition 6: Institutional upheaval slows organizational transformation because companies try to deduce and influence the form that new institutions will take and over-commit to temporary opportunities created by fluctuations in the institutional environment.

Informal Networks

Informal relationships between firms and between individuals were very important in understanding the course of organizational transformation. Straňák's relationships with Rockwell, Boeing, and government officials; Novák's relationship with Centrotex; Zetor's decades-old contacts at Deere; Poldi's

lack of high-level government support; and the tunneling phenomenon are all examples of the importance of inter-organizational networks and personal contacts during periods of institutional upheaval. When the institution environment was in disarray, firms with contacts with powerful actors were advantaged. Those that had contacts with firms in more stable countries also were advantaged because they could operate according to their partners' norms. PBS was particularly advantaged in this respect in its partnership with ABB. It was able to pursue its strategy in concert with ABB therefore becoming less vulnerable to the disarray in the Czech Republic. Královopolská and Poldi did not have the same advantage. Veba had never stopped selling highest quality damask to German and Austrian importers; it benefitted from those relationships during the 1990s. Aero Vodochody hoped to begin its transformation through a partnership with Boeing.

Proposition 7: During institutional upheaval, firms with connections to stable institutional environments will transform more rapidly than firms without such connections.

Connections to powerful figures in the emerging institutional context also were beneficial. Straňák had close relations with the Ministry of Defense. Poldi did not have strong contacts in the new government, but the three competitors in the Ostrava region did. One key government official with ties to the Ostrava region was quoted as saying, "Poldi should be privatized immediately, if only for one crown." This official's role in Poldi's privatization was pivotal.

Good relationships with others in a firm's task environment were beneficial as well. Novák's good relationships with Centrotex were in sharp contrast to Zetor's poor relations with Motokov, its foreign trading company. Centrotex "saved" Veba from an unfriendly takeover. Zetor had been trying since 1992 to save itself from an unfriendly takeover from Motokov.

Proposition 8: During institutional upheaval, firms with relationships with powerful actors in their task domain (customers and suppliers) and in the emerging institutional domain (lawmakers & regulators) will transform more rapidly than firms

without such contacts.

Finally, the tunneling activity of which Stehlik and Pánek were accused, was made possible by enterprising individuals finding holes in the emerging legal code through which they could enrich themselves and their families without behaving illegally. Not only was tunneling commonplace, but seeking favor through government contacts was a common business practice. Allegations of financial misconduct brought down Vaclav Klaus's government in 1997. The entire legal foundation of business changed and the basis on which business was conducted changed. The Czech republic pursued rapid privatization, a policy that had never been attempted before and certainly had never been tried in the absence of a constitution, legal system, and commercial code. That holes emerged in the legal framework through which some people benefitted themselves is more a disappointment than a surprise but significant organizational transformation was unlikely in the absence of resources.

Proposition 9: Institutional upheaval increases extra-legal activity which decreases the likelihood of organizational transformation.

DISCUSSION AND CONCLUSIONS

These data provide rich insights into the pace and progress of company transformations in the Czech Republic. Theories of radical change did not explain the speed of change, the extent of change, or the companies' prospects for future success under conditions of institutional upheaval. The experiences of these firms suggest that institutional upheaval, overall, slows the pace of company transformation both by exacerbating phenomena that would be expected to slow transformations under any circumstances (structural inertia) and by inhibiting transformation in ways deriving directly from the institutional upheaval itself (no new templates to guide change, government protection from change, strategic confusion due to institutional confusion, and increased extra-legal activity). Formal and informal relationships with foreign firms, customers, suppliers, and government officials facilitated transformation.

Theories of radical organizational change suggest that company transformation occurs quickly, in

many organizational domains simultaneously, and that it is not the sum of incremental changes [Romanelli & Tushman 1994]. The conditions were appropriate for radical transformation in the Czech Republic, yet the observed behavior at the company level was slow change, strategically opaque change, and the privatization of company assets into the hands of some owners. This analysis suggests that characteristics of the institutional environment intervened between the stimuli for company transformation (new competitive conditions, declining performance, and new leadership) and actual transformation. Institutional upheaval produced, by and large, conditions that may have increased the rate of some change but also the randomness of change. These data suggest that institutional upheaval lengthens the period of confusion and uncertainty in transformational change. Institutional upheaval produces a business climate that lacks templates, models, and norms about the appropriate strategies, structures, and systems. Absent these templates, organizational change was often episodic, ineffectual, temporary, or misguided.

Institutional upheaval also changed the legal and moral environment within which business takes place. In the countries of central Europe, profit became good rather than bad, private ownership of property became the goal rather than “theft”, and capitalism and competition became the friend, not the enemy. What was right became wrong and what was wrong became right. It should be no surprise that the behavior observed by some individuals suggests that they may have misplaced their moral compass. That extra-legal behavior occurred was unfortunate and damaging to companies, but not unexpected. That firms invested considerable resources trying to influence the direction of the newly forming political and economic system also is not unusual.

Organizational transformation is far from complete in the Czech Republic. In many companies it has hardly begun. It may take a generation to transform the economy. Whether firms can change so fundamentally remains to be seen. Until the new institutional context begins to take form, transformation efforts will be slow, strategically unfocused, and temporary.

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Figure 1: Longitudinal Cases Developed for this Research

Company	Managing Director in 1996	Products	Data Collection Interviews at the Company	Other Data Sources
Aero Vodochody	Adam Straňák	Jet trainers and light attack jets. L-159 is new product.	5/94, 6/94, 7/95, 7/96, 4/97, 11/97	Company documents, analysts' reports, media reports
Královopolská	Zdeněk Pánek	Tanks and pipes for chemical & water treatment plants, turnkey water treatment plants, and steel structures and cranes	3/93, 12/93, 6/94, 12/94, 7/95, 7/96, 4/97	Company documents, MBA Enterprise Corps report, consultant's report, analyst's report
PBS (Including joint venture partner and owner as of 2/97 ABB)	Richard Kuba	Boilers and turbines for power generating plants. Turnkey power plants.	7/95, 7/96, 4/97, 11/97	Company documents, press releases, ABB personnel
Poldi	Vladimir Stehlik	Rolled construction steel Stainless steel	3/93, 12/93, 6/94, 12/94, 7/95, 7/96, 4/97	Company documents, press reports, Kaiser Engineering report
Veba (including Centrotex, owner as of 4/96)	Josef Novák	Textiles -- damask and terry cloth	7/95, 7/96, 4/97, 11/97	Company documents, Centrotex personnel (trading company and owner as of 7/96) CMC # 93-008 and 94-022 by J. Matesová
Zetor (including John Deere, commercial partner)	Miroslav Poláček	Tractors, bearings until 7/93	5/92, 3/93, 6/93, 12/93, 6/94, 12/94, 7/97, 7/96, 4/97, 11/97	Company documents, media reports, John Deere employees, former employees, banks

Figure 2: Company Characteristics

Company	Revenue 1990/1996 (CZK million)	Profits before Taxes 1990/1996	Employment 1990/1996	Exports (% of revenue) 1989/1995	Dependence on Soviet Bloc ^a (% of 1989 revenue)	Average Receivables 1992-1994 % of revenue/ ratio to payables
Aero Vodochody	1,750 1,340	125 (2,688)	3,600 2,300	95 100	> 90	33 1.1
Králóvopolská	1,745 3,000	120 49	5,500 2,800	75 na	50	31 0.8
PBS	2,050 10,960	224 (820)	9,600 3,200	24 28	20	38 ^c 2.0 ^c
Poldi	3,000 < 100	n.a. >(1,000)	20,000 4,300	32 n.a.	85	67 0.7
Veba	650 1,100	111 9	3,200 1,800	46 71	<10	16 1.4
Zetor	4,000 ^b 4,570	424 (1,600)	10,000 5,500	75 92	50	66 ^c 1.4 ^c

^a COMECON + domestic defense sales + sales to Iraq

^b Author's estimate

^c Excludes 1993