

IN THIS WEEK'S ISSUE...

Tom Phillips, special reports and Europe editor

Country: Austria

After an accounting error by the International Monetary Fund (IMF) that flagged Austria as being in more debt than it actually was, the country's bankers have been trying to restore its reputation.

An apology from the IMF helped, but the fact that economists believed the miscalculation to be true highlighted the country's exposure to debts in Central

and Eastern Europe (CEE). This Austria Special Report looks at arguments for and against Austrian firms spreading themselves across CEE.

Some who stayed within the country's borders to rely on best friend networks insist they are pleased with their conservative approach, while those who expanded into CEE say the headlines that speak of economic doom are greatly exaggerated.

Practice area: ADR & Mediation

The requests for arbitration from commerce have been increasing over the past 20 years, along with the arguments for it to play a larger part in business. However, the regulations need to be tightened for it to achieve the success it promises. This report by Lord Goldsmith QC outlines how new International Bar Association rules could be just the tonic that arbitration needs.

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CEE farers

Austria's law firms have been put through the ringer in CEE, but after having seen off competition from UK and US giants they are feeling a lot more positive about their future prospects in the region. By **James Swift**

In an embarrassing and damaging debacle in April 2009, double-counting errors led the International Monetary Fund (IMF) to exaggerate the external financing needs of some Eastern European countries in its Global Financial Stability Report.

With Austrian banks having lent the equivalent of 71 per cent of the country's GDP, €201bn (£180.5bn), to emerging markets, the fluffed figures led commentators to make dire forecasts about Austria (one even went as far as to say the country was in danger of going bankrupt) and provoked the fury of the country's politicians and bankers as they scrambled to counter the effect this negative publicity would have on the country.

Wrong risk

"In Austria there was a very strong focus on the financial sector in Eastern Europe," says Dorda Brugger Jordis partner Andreas Zahradnik. "If you look at leading banks' lending volume there, they're number one [in the region], and this created some turmoil because the IMF in early 2009 miscalculated the risk Austria posed.

"They later revised this and apologised. However, some concerns remain, because there are not only issues of the local Austrian market. The general discussion is that growth rates will be higher in Central and Eastern Europe [CEE] than in Western Europe, but on the other hand the question remains as to how much risk is still undiscovered?"

So while things were not as bad as

first appeared, for Austria or CEE as a whole, the risks of having invested so much in the region should not be underestimated either.

The banks

Austria's banks learnt pretty quickly that, if they were to grow, then their market had to be the entire CEE region – domestically there was just not enough profit. But this exposure to CEE has meant that since the downturn Austria's banks have needed a lot of restructuring. Two banks, Hypo Group Alpe Adria and Kommunalkredit, had to be nationalised, while Raiffeisen International and its parent company Raiffeisen Zentralbank are, at the time of writing, considering a merger to gain access

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to the capital markets – although there are mixed feelings about what this move says about the bank's health.

"Austria was modestly affected by the crisis, but it has been affected," says Wolf Theiss managing partner Horst Ehardt. "For example, the banks that invested heavily in Central and Eastern Europe – most of them have been forced to get participation capital; we represented around 70 per cent of the banks in the negotiations with the [Austrian] government."

The firms

Like banks, law firms have also long had roots in CEE. Some, such as Binder Grösswang and Dorda, choose to operate in the region through alliances and best friends; others, such as Wolf Theiss and Schoenherr, choose to establish offices in the region. Even in 2009, when US and UK firms were

pulling out of the region, Austrian firms continued to expand into CEE.

"The way we've seen the last year, we've acted anticyclically, taking over Prague and Bratislava offices, which has helped us in having a one-stop shop, from Poland to Ukraine," says Schoenherr partner Christian Herbst.

Wolf Theiss opened an office in Kiev in 2009, taking its total number of offices in the region to 12. In the same year Cerha Hempel Spiegelfeld Hlawati combined with local Hungarian firm Dezso & Partners to launch an office in Budapest to replace the last one, which had defected to a local rival in January 2008.

But questions have begun to arise about whether this approach is sustainable. Of course, the region is always going to be a vital market for law firms, but the downturn has created a rift between those that believe having a network of offices across CEE is no longer necessary to get work but is a heavy burden on a firm's costs and those that stand by the strategy of expansion.

Freshfields Bruckhaus Deringer is one of the few international firms in Austria, or the only one, depending on how you view networks such as Baker & McKenzie's, DLA Piper's and CMS Reich-Rohrwig Hainz's. Freshfields used to have offices in Eastern Europe too; for instance, it opened in Hungary in 1989, but now pitches for mandates in the region out of its Vienna office and its other European bases.

Nous over nearness

According to Freshfields corporate partner Günther Horvath, not having offices in the region has done no harm to the firm's ability to land work. He says clients care much more about whether a firm has undertaken the kind of work before than whether it has an office in the country. He also believes that since the downturn, and perhaps even prior to it, CEE was not providing the returns it used to, and furthermore that firms that had adopted the strategy of opening offices throughout CEE may be beginning to regret it.

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Horvath: knowledge more important than location

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Vienna: Austrian firms' CEE offerings are looking more sound



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"The only office we maintain is in Moscow, which is big jurisdiction," says Horvath. "But I'm pretty sure our competitors will have to revise their respective strategies of having local offices in CEE in order to save costs because an office is a big cost item on your ticket. Taking over offices from firms that were in the area and continuing on that footing, I'm not sure if it pays off in the long run, or even in the medium term."

Growers' pains

He is not alone in his view that the downturn has been particularly rough on those firms that expanded most in CEE.

"I think they certainly had a hard time," says Binder Grösswang partner Raoul Hoffer of those Austrian firms that have spread themselves out across Eastern Europe. "We're happy that we don't have any offices there and that we have a best friends system, where we're good friends with two or three firms in each country in Eastern Europe."

"We considered this issue [whether to open offices in Eastern Europe] in the 1990s and at the time we chose rather to establish a best friends network, which we have in all countries that are relevant for our business," says Zahradnik at Dorda. "There were times during the boom when we were thinking that maybe we should have [expanded into Eastern Europe], but now we're quite glad we didn't."

Local force

It is not just the economy in Eastern Europe and a lessening of those big-ticket deals that had categorised the boom years that has made some partners question the sustainability of multiple offices. Competition from local firms in Eastern Europe has become tougher too, which means that competing with local firms requires greater commitment.

"Another aspect is that the level of sophistication in the Central and Eastern European area is increasing," says Horvath. "It's not a wasteland; there are good indigenous firms there and there's no point having a three-, four- or five-lawyer office in Bucharest doing local work, because clients are starting to ask themselves why, for local work, they shouldn't go to an indigenous firm that provides a reasonable level of work for lower costs."

"It's not only the crisis that makes people pull out of the region," agrees Hoffer. "There's been a change of circumstances too. Ten years ago, when the firms first moved into the markets, those markets were underdeveloped, but now you find nice, up-to-date full-service firms. This is also a factor that made firms pull out and makes life much harder for Austrian firms there."

"And most Austrian firms moved in [to Eastern European countries] with a client, building something in that country. But once that subsidies they have to change to

attracting local work. In the meantime you have local firms that are nicely established and clients are asking why they should pick an Austrian firm with 10 lawyers and not a local firm with 30 lawyers."

Sticking to your guns

The other side of the argument is that, like the IMF's report, the situation in Eastern Europe for Austrian law firms has been exaggerated. For the firms that have offices across the region, retreat is not an option.

"Our strategy hasn't changed at all," insists Ebhardt at Wolf Theiss. His firm entered into one of Eastern Europe's most difficult markets last year, Ukraine; but with the exception of a few layoffs in Bucharest Wolf Theiss has stood firm in the region.

"Even though some countries have had really bad press, it doesn't mean that it's affected our work," insists Ebhardt. "For instance, Hungary had bad press, but our office there is very busy and we've grown there - it's a good example of how the economic headlines don't always reflect the level of legal work."

Leaving by example

Nor is Ebhardt perturbed by the withdrawal of some Anglo-Saxon firms, such as Linklaters, from the region.

"We see it as the logical result of a global firm that has to look at its core markets," explains Ebhardt. "Firms that want to be a strong global practice will look after the US, the Far East and China, and for them Eastern Europe isn't at the forefront of their interests."

Others even believe that international firms' withdrawals have opened up the market and made things easier for the Austrian firms in the region. One partner at a smaller Austrian firm has admitted that, as the international firms' commitment to the region continues to look shaky, "smaller firms like ours may look more closely at these countries".

"There's an advantage now for firms who've remained in the region because other firms are pulling out," agrees Herbst. "We've profited from Linklaters moving out of the market and the uncertainty of US and UK firms, so we could hire talent in this market, particularly in Romania, where we got banking and capital markets experts from global firms. So we saw the crisis as an opportunity as opposed to a big hit."

So it seems that, regardless of the perception that some have about the sustainability of CEE as a hub for international firms, any mass exodus or even streamlining seems unlikely. For Austrian firms, markets such as China and India are too remote (although Turkey, with its historical links to the country and large migrant population in Austria and Germany, looks as if it could well be a lucrative market) and, like for the country's banks, the domestic market is just not big enough.

"Austrian law firms that have established themselves in Central and Eastern Europe have done that for the long term," insists Peter Huber, managing partner of CMS Reich-Rohrwig Hainz, "and, unlike the Anglo-Saxon firms, they will not recede." ■



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