Deloitte Study
Central Eastern Europe as the Focal Point of the Automotive Industry
2016
It is my pleasure to present Deloitte’s new survey of the Central European automotive industry, which presents the opinions of leaders of manufacturing and supply companies in the industry. The aim of the survey conducted in six countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia) is to describe the specific features of the sector in the region, as well as to show how the relevant companies see their positions.

The automotive market is constantly growing in the region and is recognised as a sector of increasing importance, as shown by the rate of investments. The survey clearly shows that despite the numerous external and internal risk factors, companies in Central Europe are positive about the future. In our discussions with leaders of 80 companies in the region we touch upon issues such as location related conditions, the local legal environment, grant opportunities, relationship between suppliers and manufacturers, and future plans of their companies.

Let me thank the representatives of companies involved in the survey for their time and contribution to the success of the survey. I hope that you will find this study an insightful and inspiring read.

Best regards,

Péter Gerendási
Partner, Tax and Legal
I. Background

The importance of automotive factory locations in the European Union (hereinafter: EU) member states of Central Eastern Europe (hereinafter: CEE) has steadily increased in recent years. Automotive facilities in Western Europe have been subject to closure and total employment has been reduced since 2009. However, employment opportunities have been partly re-established in CEE countries, based on the fact that the previously closed factories have been relocated in the recently joined EU member states. As a result of these changes, approximately one in three vehicles are produced within the following EU member states: the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. Based on manufactured vehicles per capita, Slovakia is the leading producer of vehicles with 180 units per thousand inhabitants, according to the industry association European Automobile Manufacturers’ Association (hereinafter: ACEA). The Czech Republic ranks second with 108 vehicles and Germany third with 70 vehicles.

Deloitte conducted a survey, by means of questionnaires provided to executives at 8 automotive manufacturers and 72 supplier companies (hereinafter: Companies) in Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia. Questions were posed about the advantages and disadvantages of each countries’ economic setting within the scope of automotive industry. The aim of the survey was to receive information about the following:

- Which location-related factors led to the CEE automotive industry success story?
- How have the factors changed in recent years?
- What is the future vision of senior management at the manufacturers and suppliers?
- How can these countries become more competitive and attractive within the automotive industry?
The primary focus of the Companies is potential modifications within the scope of infrastructure, the jurisdiction and education systems. In each of the countries surveyed, companies are planning to make additional investments and to increase their workforce. New technology is a key factor in the process, based on the rapidly increasing pace of innovation in CEE. Many of the companies surveyed are convinced that the interconnectedness of traffic, the electrification of the powertrain and autonomous driving as well as Industry 4.0 will have an impact on their business in the near future. The respective Companies are preparing for these trends.

This survey was conducted during Q3 2015 prior to the deceleration of the growth rate in China. A further strengthening of the US-Dollar resulted in manufacturers favouring the export of European car manufacturers and their suppliers. In our opinion, these global developments do not compromise the results of our survey. Rather, it seems likely, that the above mentioned issues will serve to propel current trends at an increased pace.

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### Number of participants in survey per country

<table>
<thead>
<tr>
<th>Country</th>
<th>Supplier</th>
<th>Manufacturer</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>9</td>
<td>2</td>
<td>11</td>
</tr>
<tr>
<td>Poland</td>
<td>16</td>
<td>2</td>
<td>18</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>19</td>
<td>3</td>
<td>22</td>
</tr>
<tr>
<td>Slovakia</td>
<td>7</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Romania</td>
<td>6</td>
<td>1</td>
<td>7</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>15</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>72</strong></td>
<td><strong>8</strong></td>
<td><strong>80</strong></td>
</tr>
</tbody>
</table>
II. Location factors

Question 1: Location: General Conditions at surveyed locations

Which of the following location factors in your host country would you assess as three competitive advantages and which ones as three disadvantages?

<table>
<thead>
<tr>
<th>Factor</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of labour</td>
<td>75%</td>
<td>9%</td>
</tr>
<tr>
<td>Availability of skilled labour</td>
<td>55%</td>
<td>33%</td>
</tr>
<tr>
<td>Tax regime</td>
<td>36%</td>
<td>23%</td>
</tr>
<tr>
<td>Available grants and incentives</td>
<td>34%</td>
<td>19%</td>
</tr>
<tr>
<td>Traffic infrastructure and logistical environment</td>
<td>34%</td>
<td>28%</td>
</tr>
<tr>
<td>Educational system</td>
<td>38%</td>
<td>18%</td>
</tr>
<tr>
<td>Energy prices</td>
<td>26%</td>
<td>13%</td>
</tr>
<tr>
<td>Reliability of legal system</td>
<td>46%</td>
<td>4%</td>
</tr>
</tbody>
</table>

The table above illustrates that there are several viable reasons for companies to invest/operate in the countries surveyed. Please find below a brief list of the highest ranked beneficial factors:

- low labour costs
- availability of skilled labour force
- favourable tax regime

However, there are also some negative aspects which require attention, such as:

- lack of trust in the jurisdictions of these countries
- poor/under developed educational systems
- deficiencies in transport infrastructure
Workforce and education

Three quarters of our respondents consider low labour costs as an advantage of the locations in the CEE region, while more than 50% of those interviewed consider the availability of skilled labour as an added benefit. However, here the perceptions are not consistent: at the same time 33% of the interviewees consider the availability of qualified labour a disadvantage. Based on the information received, it appears that countries with high employment rates such as Slovakia and the Czech Republic are beginning to reflect increasing wages and growing scarcity of skilled labour. Csaba Wolf, business development director at the Deloitte office in Budapest commented: “When manufacturers and suppliers built their plants in CEE it was relatively easy to find a sufficient number of skilled workers. However, this task is increasingly a challenge.” In addition to the above, the companies’ rising quality standards and the progressing technology incorporated in their products and processes further increase the demand for skilled employees.

It is interesting to note that 38% of the respondents consider the educational systems within the surveyed CEE countries to be a locational disadvantage, only 18% consider these systems to be an advantage. Consequently, investors will rightfully be concerned about the extent to which the academic education and vocational training provided in CEE countries will impact the skilled labour force. Hungary, Poland and Slovakia show that they are improving the process of qualification in these areas.
The German-Czech Chamber of Commerce recently conducted a survey on the investment climate in the Czech Republic, what were the major results with regard to professional education in the manufacturing industry?

First of all we have to state that 92% of the participants of our survey would invest in the Czech Republic again. This is a good message. But there is one aspect which threatens the competitiveness of the country. In our survey, the aspects ‘quality of the VET system’ and ‘availability of skilled workers’ were rated very low by the companies. Also, in these areas, the Czech Republic is rated among the worst of all countries in Central and Eastern Europe. This is particularly alarming because the situation will deteriorate in the years to come if the VET system will not be reformed. This is the essential message that we draw from the results of our survey and which unfortunately confirms our concerns and political interventions in the past years.

What do you think is missing in the educational system of the Czech Republic, and in particular professional training?

What is missing in the educational system of the Czech Republic is an institutionalized cooperation between vocational schools and companies. There is a massive lack of practical training in the vocational education institutions, the facilities are outdated and so is the curriculum. Especially in the technical-industrial and partly also in the commercial sector, the vocational training no longer meets the demands of the labour market.

In order to meet the requirements of companies who invested in the manufacturing industry and who plan to stay, what do you recommend?

The companies investing in the Czech Republic have been complaining for many years about the lack of qualified vocational school graduates. In order for the Czech Republic to remain a competitive and attractive business location for investors, we recommend the implementation of a dual education system which combines apprenticeships at companies and vocational education at vocational schools. The public educational system and the companies have to cooperate.

Providing a VET system that prepares the students for the professional practice is a direct investment in the competitiveness of the Czech Republic. We have therefore made this as one of our key topics of the German-Czech Chamber. Our message is clear: it is time to act now.

How does the situation in the Czech Republic compare to other countries in Central Europe?

If we look at other Central European countries such as Poland, Slovakia and Hungary, we see a similar situation to that of the Czech Republic with regard to the educational system. But they have already taken measures to better adapt their VET systems to the demands of the labour market.

Some countries, e.g. the Netherlands or Austria, - those with by far the lowest youth unemployment in Europe - show with their training models how a successful educational system should be: The state holds the educational authority but delegates some of its powers to the formation of companies. This is a model of shared responsibility for the vocational training. Poland and Hungary have already partly adapted this system. We are convinced that this system could work in the Czech Republic as well. The implementation of such a system of shared responsibility could guarantee the competitiveness of the Czech Republic for the future. The process of digitalization of the industry, which will increase with Industry 4.0, will raise new challenges and the demand for qualified employees.
Tax regime, Incentives and legal system

As mentioned earlier an efficient tax regime plays an important role in where manufacturers will choose to locate. Tax rates are generally lower in CEE than in Western Europe, while the transparency of the applicable tax legislation must also be taken into account. This may provide information about why many of the respondents see the tax regimes in CEE as being a disadvantage.

The impact of available grants and incentives in CEE appears to have less of an impact on manufacturers’ decisions. Slightly more than 33% of the respondents consider grants/incentives as a motivating factor. The above may confirm that factors such as the availability of skilled labour and an advantageous tax regime are more important drivers of investment decisions than grants and incentives. However, the role of incentives may still have an impact when they are compared from country to country.

An important result of the survey was that 46% of the respondents commented on the poor reliability of the legal system in many countries as a major disadvantage. This is something we suggest the Governments in CEE look at closely in order to address this concern.

Infrastructure and Energy

Traffic infrastructure and the logistics environment show a diverse result among the countries surveyed. Overall the region is perceived as being weak by 34% of the respondents. The development levels of infrastructure facilities in the CEE countries surveyed were impacted by geographical location, size and economic strength. According to the respondents Hungary and Slovakia yielded more positive results whereas the remaining CEE countries showed a marked disadvantage in these areas. This is certainly a relevant obstacle for the highly connected supply chains involved in the automotive sector where just-in-time delivery and security of supplies are necessary for the maintenance of effective assembly lines.

The responses related to the importance of energy prices do not reflect a clear trend. Respondents in Poland viewed energy prices as a disadvantage, while they see it as an advantage in Bulgaria. The national energy policies in place in the CEE countries surveyed clearly influence the perception of a sector with a relatively high energy consumption rate.
**Question 2: Workforce qualification**

What measures have been taken to support the qualification of your workforce?

<table>
<thead>
<tr>
<th>Measure</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provide internal training</td>
<td>89%</td>
</tr>
<tr>
<td>Cooperate with public schools and professional training institutions</td>
<td>64%</td>
</tr>
<tr>
<td>Set up own academy or training capacity</td>
<td>29%</td>
</tr>
<tr>
<td>Nothing</td>
<td>0%</td>
</tr>
</tbody>
</table>

All of the companies within the CEE countries that were surveyed are aware of the importance of providing education/training required for a skilled labour force. However, the companies surveyed varied in their responses to the measures taken to ensure the support and development of their employees. In Hungary and Slovakia, the focus is on increasing cooperation with public schools, providing internal training and developing company-owned academies are only a second or third priority. Companies in Bulgaria, the Czech Republic, Poland and Romania are relying primarily on internal training and vocational education.

Automotive manufacturers’ expectations regarding vocational training are not being met in the CEE countries surveyed. In addition, as a result of ever increasing expectations in technological progress and increasing global competition, employees also feel the pressure to improve their skills. Employers and employees must rely on their own ideas and initiative to improve the qualification and skills required for future success. Reforms to the public education system have become an urgent matter as they are required to maintain a competitive advantage. Imbalances between multi-national companies and small and mid-size companies may develop: multinationals are able to invest in internal training and academies, while small and mid-sized companies have fewer resources to finance training and consequently must draw from a less educated workforce.
Question 3: Satisfaction with EU incentives

Are you satisfied with EU incentives your company received so far?

Satisfaction with European Union subsidies and grants appears to be varied based on the response of CEE countries surveyed. 40% of the respondents have never received EU subsidies, while 30% are satisfied with what they have received so far. The remaining 30% responded that EU incentives could be improved.

According to Ludek Janacek, tax partner responsible for grants and incentives at Deloitte in Prague, there are only limited subsidies available from EU funds for large investments as they are frequently found in the automotive sector. However, the lack of EU funds for significant investments is often compensated by packages offered by local governments. EU funds are provided primarily for R&D and environmental projects. At a national level cash grants are often capped, as a result, investors prefer tax-related incentives with higher total benefits.
Question 4: Corruption and business

Do you think corruption influences business in your host country?

When conducting the interviews, most of the respondents agreed that corruption is present in their country. However, with regards to the automotive sector they did not feel directly affected or to a lower degree only. From comments, it appears that respondents affiliated with multinational companies tended to rely on the application of anti-corruption policies (“zero tolerance”). However, in many instances especially at local companies there appears to be a greater challenge when dealing with corruption.

Transparency International’s latest survey (2014), which is related to all industries in the CEE countries surveyed, shows Poland as being in 35th place. This puts the country in a comparatively good position. Other countries fared worse in this study: Slovenia (39), Hungary (47), the Czech Republic (53), Slovakia (54), Bulgaria (69) and Romania (69).

Source: https://www.transparency.org/cpi2014/results
Question 5: Relocation of operations

Are you considering the relocation of your production facility in the next 5 years?

The question dealing with the potential relocation of operations received a clear response. Not one single company surveyed in Poland, Slovakia, Romania or Bulgaria is considering the relocation of its production facilities to another country within the next five years. Only a small percentage of companies in Hungary and the Czech Republic are considering relocating to another country in Central Europe. None of the companies surveyed is planning to relocate outside of Central Europe.
Question 6: Preferred locations

If you were to open a new branch of your company in Central Europe, which country would you choose?

When asked about the preferred location for a new plant, a majority of respondents in Hungary, Poland, Romania and Bulgaria indicated their own country. In Poland, 100% of the executives surveyed chose a new facility in their own country. In the Czech Republic and Slovakia, other CE countries were preferred sites for new facilities. In Slovakia, more than 50% of those surveyed preferred Poland as the location for a new facility. In turn, 23% of the respondents in the Czech Republic gave priority to Slovakia and Hungary.

These responses reflect a high degree of preference for current locations. Most of the executives surveyed preferred to remain in their current location. However, overall averages reflected a preference for Poland if new operations are established.
III. Investments and Growth

Question 7: Production capacity

Are you planning to increase your production capacity in the next 5 years?

In response to the question, “Are you planning to expand your production capacity in the next five years?” a majority of the executives in each market participating in the study responded in the affirmative. 74% of the executives surveyed wished to increase their production capacity.

Bulgaria and Poland led the way with over 80% of executives planning to expand production and more than 10% indicated that expansion was a possibility. Hungary scored lowest in terms of expanding production, although 64% of the companies surveyed wished to expand their production capacity. This is clearly a very optimistic message for the CEE region: the automotive sector has not yet reached its limits in terms of growth potential. The advantages offered by being located in CEE will remain available foreseeably, thus allowing for advantageous positioning on the global market.
Over the next five years those surveyed intended to focus on the innovation of new products and educating a skilled labour force. Additionally the development of new technologies and the expansion of product lines into new segments were cited. However, it appears that marketing has a rather limited role in future plans. Investments in services and new markets also remained in the background. Such functions are apparently still reserved for the headquarters of the companies surveyed. “We are seeing the locations outgrowing their role as purely production facilities and they are increasingly taking on tasks in research and development or roles as technical competence centres,” said Christoph Greving, Deloitte partner responsible for German multinational clients in Central Europe based in Prague.

In all of the CEE countries surveyed the areas of focus for new investments are subsidized by tax exemptions. These exemptions are usually granted to companies that commit to new investments of a certain value and/or to the creation of new jobs.

Question 8: Investment plans

When planning a new investment in the next five years, which of the following factors are you planning to focus on/increase (up to three answers)?

- Products: 76%
- Employees: 66%
- Technology: 28%
- Sales in new segments: 24%
- New markets: 14%
- Services: 6%
- Marketing: 1%
- Other: 3%
IV. Supplier-carmaker-network and innovation

Question 9: Supplier networks

Are you planning to increase the number of suppliers in the next 5 years?

Within the CEE countries surveyed no decisive pattern emerged as to whether the automotive companies intend to increase, reduce or maintain the number of suppliers they are currently cooperating with. Technology trends will impact the direction of these companies. If electronic propulsion and/or connectivity become more popular various new suppliers may enter the market. These suppliers will conceivably introduce new electronic components.

Simultaneously, less technologically advanced suppliers may be forced out of the market. (e.g. brake and exhaust systems will be modernized, potentially very complex engines and systems may be sourced from only one supplier). Such changes would reduce further the number of suppliers on the market. Furthermore, more cost efficient suppliers may gain entry into the industry in order to reduce the in house production depth and exploit outsourcing and specialization potentials.
Question 10: Client portfolios of Suppliers

Are you planning to supply to more car manufacturers in the next 5 years? (only for suppliers)

Within the CEE countries surveyed nearly 70% of the automotive suppliers intend to expand their client portfolio (this percentage reaches 100% in Romania and Bulgaria). These percentages reflect that the search for new sales channels and targets continues. Based on this trend it appears that the search for new sales channels continues when suppliers are operating relatively new plants, and that CEE automotive suppliers are internationalizing their clientele, the direction being the global market.
Question 11: Manufacturers expectations

What are the car manufacturers’ expectations towards their suppliers? (only car manufacturers, up to three answers)

Optimization of price and quality ranked the highest in terms of expectations of manufacturers. This expectation was stable across all the countries surveyed.

Reliability and timely delivery come before the need for long term partnership or more involvement in the production process.

Based on the interviews conducted, it appears that suppliers are not evaluated based on a single strength, rather they are expected to meet a set of requirements which are equally comprised of cost, quality and service. From the OEMs’ perspective it is essential that the suppliers aim to comply with group-wide standardization strategies (platforms, identical parts and components, model kits) and quality requirements, e.g. by setting up world class manufacturing and quality management systems on the supplier side.
Question 12: Supplier expectations

What do you expect from the car manufacturers? (suppliers only, up to three answers)

Suppliers were also surveyed as regards their expectation from manufacturers. Stability and partnership ranked above higher prices. 34% of those surveyed indicated improved prices as an aim. However, only 5% requested increased speed of payment. Predictability of orders (36%) ranked higher than improved prices. Based on these results, it appears that the predictability of orders and the planning of production over a longer period is worth more to suppliers than other issues. “These results may as well suggest that suppliers are required to have flexible production facilities to meet the “just-in-time” expectations of car manufacturers in our constantly changing world” said Marek Turczyński, Deloitte Partner and Automotive Leader in Poland.
Question 13: Innovation

Do **ongoing innovation** topics (such as electric cars, connectivity, autonomous driving etc.) **have an impact** on your business in the next 5 years?

The manufacturers and suppliers taking part in the survey indicated that innovations and new technologies such as connectivity, electric cars and autonomous driving are playing an increasing role. 43% of all respondents in the region indicated that they are focusing on the application of new technological solutions. More than 50% of respondents in Bulgaria, Hungary and Romania reflected this trend. Other areas of focus stated in the interviews were: e.g. inter-active parts (brake pads to cockpit), car-to-car communication, driver assistance components, supercharging and storage systems.

More than 50% of the respondents indicated that they are not expecting production changes over the next five years due to evolving product innovations. However, this does not imply that 50% of the participants are not taking into consideration the technology trends arising in the automotive sector. On the contrary, many of the participants expect that trends such as Industry 4.0 will shortly impact their production processes, e.g. by means of connected assembly lines. Weight reduction and the use of new materials such as carbon fibres is another important topic.
Conclusion

Based on our survey carried out in CEE it appears that the automotive industry is satisfied with the location-related conditions in Central Europe and does not intend to relocate for cost or other purposes. It also became evident that the companies hosted in CEE countries require improvement in essential areas in order to optimize and facilitate their activities. The supply of skilled labour is decreasing in well-developed countries. In the Czech Republic and Slovakia, for a majority of surveyed companies the lack of supply of skilled labour was seen as a negative factor for the automotive industry.

Improvement is also required in the area of legislation. Respondents expressed concern about the reliability of the legal system. Additionally, corruption was a prevalent issue, although its actual impact on the automotive sector is difficult to ascertain. The respective tax regime of the CEE countries surveyed also received criticism. Lack of transparency seemed to cause more concern than the levels of taxation.

The importance of grants in investment decisions is often overstated. Companies conceivably consider the country’s general and long-term conditions to be more important in terms of achieving success.

The satisfaction and loyalty of the companies surveyed with their current locations are notably high. The companies’ investment plans also supported the fact that they are largely satisfied with their current location. A substantial majority of the companies’ surveyed plan to expand capacity over the next five years, produce new products and hire staff – even in countries where this is becoming increasingly difficult. The current facilities are thus outgrowing their past role as extended workbenches for standardized, mass-produced products. Innovation and technology are becoming increasingly important to both manufacturers and suppliers. Suppliers that are preparing for this challenge can expect above-average growth in the future.

Currently the relationship between suppliers and manufacturers is decreasingly driven by price and cost pressures than it was a decade ago. OEMs and their suppliers are increasingly aiming for partnership, the joint development of new technologies, on-time deliveries and long-term business relationships.

Overall, based on the responses received from our CEE survey it appears that both medium and long-term prospects for the automotive industry in Central Europe are good. The investment plans of the CEE companies surveyed and their internationalization of customer relationships provide ample reason for optimism regarding the future of the automotive industry in Central Europe.
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