Financial Aspects of HCs Business Models

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An effective financial strategy is vital for the sustainable growth and development of any organization. It ensures that investment decisions align with the overall business strategy and allows the right mix of sources of funds to finance investments. Attracting finance is not an easy task for any company as it spills the risk-and-return discussion outside the boardroom to the premises of investors who are seeking an economically attractive investment on a long-term scale. At the same time, investors seek a transparent and understandable business. The quality of these factors, among others, affects important metrics such as the cost of capital and a level of dependency in managing a company.

This chapter begins with a summary of Simon's (1996, 2009) research surrounding the financing choices of hidden champions (HC) in developed markets. Following this outline, I examine a financial strategy dilemma of HCs and highlight the challenges of raising capital that both studies have revealed. Finally I illustrate how HCs in Central and Eastern Europe (CEE) finance their organizations. I identify the similarities and differences between the original research project and the current research.

In Central and Eastern Europe, each company works under an umbrella of national and international legislations. The level of compliance differs from country to country, economy to economy and within individual companies. I aim to outline how various HCs approach these challenges. The current trends in corporate communications indicate a shift towards integrated reporting that along with IFRS includes strategy, governance and risk disclosures and involves the external communications of the company. These are currently considered "best practices" internationally yet receive little attention in CEE. I propose that the IFRS reporting process is important for companies to grasp. They—and particularly small-to-medium-sized enterprises

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P. McKiernan and D. Purg (eds.), *Hidden Champions in CEE and Turkey*,
DOI 10.1007/978-3-642-40504-4_8, © Springer-Verlag Berlin Heidelberg 2013

Table 1 Pros and cons of various capital sources for Simon's hidden champions

Category	For	Against
Self-financing	High equity ratio Positive profit Strong cash-flow Independence from capital markets	Growth rates are sometimes higher than the required generation of internal sources. Cost of capital might be optimized with an injection of reasonable amount of inexpensive debt.
External equity financing—private equity	Funds in-flow	The owner's longer view does not match the closer view of the private equity investor and his exit strategy.
External equity financing—going public	Funds in-flow	Much higher transparency level required. Hard to achieve adequate market valuation (mainly for niche-players).
Debt financing	High equity ratio Positive profit Strong cash-flow Excellent credit ratings Low capital costs	Need for disclosure Need to comply to creditor's requirements

Source: Adapted from Simon (2009)

(SME) across the globe, such as the HCs—should begin a discussion with the investment community.

1 Original Hidden Champions' Financing Issues

In the developed markets, 78 % of HC respondents described self-financing as the most important source of financing and claim that this will remain the predominant source in the future. Traditional bank loans are in second place, and Simon suggests funding via bank loans will decrease considerably in future. Private equity financing and financing on capital markets (going public, bonds) will similarly decrease. The percentage of respondents whose companies raise private equity funds and resort to financing from capital markets is relatively low (Simon 2009). Table 1 summarizes the main pros and cons of different forms of financing for Simon's HCs.

In summary, Simon points out that increasing equity rates over the last decade have resulted in excellent credit ratings and correspondingly low capital costs. In essence, financing is not a serious constraint for the further development of HCs and it appears not to limit their leeway for strategic investment. Therefore if a typical HC (operating in the conditions researched by Simon) decides to raise capital, it may reasonably count on both debt and equity markets. For CEE's HCs this is not always the case and operational and financial ratios are not as reliable as in established markets.

Table 2 Differences between financial and strategic investors

Category	Main typical characteristics	Portrait of the ideal company for the investor
Financial investors	• Financial value maximization • Mainly financial interest • Does not strive to execute control • Does not strive to change existing management team • Plans to have loan repaid within 3–6 years • Requires regular transparent information disclosures to monitor the activity of a company	• Effective and efficient business-processes • High growth rate of business • Explicit growth strategy • High level of proficiency and commitment on behalf of management team • Internal risks are well-managed
Strategic investors	• Value maximization plus extra benefits (synergies, integration, diversification) • Strives to control the company • Takes an active part in strategic and operational management • Investment horizon depends on investment strategy	• Current situation forces the company to seek a strong partner due to any type of constraints (lack of finance, competition, government regulations) • The company faces a takeover risk • Insufficient quality of management team • Operational failures and inefficiencies

Before we examine the differences between the two studies in what influences the financial choices that HCs make, let us focus on a financial strategy dilemma. In my opinion, it is common to all HCs and reflects many challenges of raising capital for this cohort globally.

2 A Financial Strategy Dilemma of HCs

The financial strategy dilemma of HCs is the choices that they must make when considering how to finance their business, specifically when neither debt nor external equity financing (including private equity and public equity) are suitable sources of funding. In terms of this option, capital providers may be classified as “financial investors” and “strategic investors”. They are differentiated from each other by metrics, such as investment horizon, attitude towards the type and level of control that they will have over the company, their involvement in the company’s strategic processes, and the manner in which they evaluate company success, among others. Table 2 shows the main characteristics of, and differences between, financial and strategic investors.

At first glance, financial investors should be preferred. Yet the CEE research demonstrates that HCs find it difficult to secure mutually beneficial external investments and partnerships. The ideal situation would be a well-run, sustainable company that attracts funding without losing financial control. However financial investors require transparency and expect businesses to outline financial, strategic, and business-model issues explicitly. In CEE the need to comply with the requirements and demands of equity providers may destroy the competitive

advantage that HCs hold, thus decreasing their investment attractiveness. It may directly work against them when it comes to securing financing and disclosure of business strategy. We claim that HCs have a higher proportion of intangible key success factors. Therefore, the risk to a potential investor is higher than average. As a result, businesses may consider a mitigating strategy of disclosure to secure financing, which may act to commoditize and devalue key success factors.

In contrast, opting for the strategic investor option allows disclosure of information to be limited. Nevertheless, there is an unresolved question: are HC leaders ready to transfer the control of their beloved companies to new partners? They directly link their success to the company's high dependency on the owner's leadership and personality. If this dependency on the leader were reduced, an important success factor would be lost.

Another key success factor of HCs that may be at odds with the external financing process is that HCs trade in niche markets. Considering the narrowness of such markets, it can be difficult to attract external financing. In short, a fruitful partnership may be hard to achieve when a partner has little understanding of an inconspicuous market or product. For example, the markets of Russia's Grishko Ltd., a ballet a dance shoes producer, and those of Romania's Gliga Violins, a violin producer, are narrow and specific, making it difficult to secure funding from investment fund managers. This is because the factors that create the uniqueness of HCs and primarily contribute to their success, conflict with the fundamental criteria that investors traditionally use in evaluating a business. These evaluations are based strongly on classic risk assessment, a need for better understanding, transparency and control.

A key differentiator between Simon's research and the current research is that if a HC in an established market wishes to generate capital through investors it is able to count on debt and equity markets alike. In contrast, CEE's HCs have difficulty securing investment from external investors. In my opinion, the operating environments are key differentiators between these two cohorts of HCs. The HCs in the original research operate in developed Western markets. Compared to the CEE countries, these markets have effectively functioning economic and legislative institutions, which support commercial activities and ensure that business standards are followed. In contrast, CEE's HCs operate in environments characterized by a lack of established business culture, a high level of corruption and existence of black markets. These factors are accompanied by constantly changing business rules. To illustrate with a few examples, this research identified very few HCs in Kazakhstan. This can be attributed to the country's short history of a market economy and, in particular, to the young age of its companies, absence of business traditions, undeveloped markets, weak competition, corruption, and non-professional management. Similarly, one of the key challenges to the Latvian business environment and economic development seems to be the relatively high level of gray economy in the country. Among the factors explaining the large amount of tax evasion in Latvia is the "optimization" of expenses by avoiding taxes and thus increasing the companies' competitive advantage, the weak legal enforcement, the societal tradition of avoiding taxes and the low ethical standards.

In Ukraine the current fiscal, regulatory and legal framework is not conducive to the development of small and medium-sized companies as it favours the large financial and industrial groups. In numerous ratings by international research and financial institutions, Ukraine is constantly ranked low in competitiveness, simplicity of doing business, and sensitivity to corruption. The overarching differences between these economies and those in Simon's research include the inconsistency of public policy in the former as well as the reduced competitiveness of CEE companies by regulations and legal provisions, the low level of competition-boosting legislation, the low adaptation capacity of public policy to economic changes, bureaucracy, corruption, inaccessibility of stock markets, and poor methods of doing business.

Because of these specifics of the CEE environment, and the HCs' financial strategy dilemma, it is almost impossible for HCs to obtain debt or equity financing. Compared to larger companies operating in the same environment, HCs are rarely involved in debt financing, initial public offerings (IPO) and mergers and acquisitions (M&A) deals. Additionally we observe that venture financing and partnering with business angels—private companies that provide finance for business expansion—are not typical for CEE's HCs although these innovative companies might benefit from such activities. In spite of that, most of CEE's HCs continue to expand rapidly and flourish. Below, I explore how they develop and execute their financial strategies.

3 How Hidden Champions from Central Eastern Europe Finance Their Organizations

3.1 Historical Perspective of Central Eastern Europe HCs

The recent history of the CEE countries begins in the early 1990s and differs greatly from the economic environment described in the original research. It is only recently, in the 1990s, that the former socialist bloc began its transition to a Western model of market economy. The point is that the majority of HCs in the current research became incorporated only during the last three decades, although some companies trace their history prior to the launch of the reforms. A closer look at the CEE sample reveals different patterns of investment and financing, depending on the period of a company's creation.

Firstly, we can distinguish between the HCs that originated before the transition to a market economy and those that were created after the launch of the reforms. What makes these two groups very different is the way that they have obtained their initial investments and their amount. HCs established in the socialist period were created by the state and usually received large investments from it. On the contrary, companies that emerged after the reforms were created in most cases by capitalists without capital.

The companies that originated in the first decade of the transition period and those that emerged recently, in the 2000s, demonstrate very important differences

in the way that they obtained their initial capital and fueled their business in the first years of operation. In the case of the first cohort, it was typical for new ventures to exploit social capital and networks from the socialist times. These networks maintained power and were eager to support each other in their new roles, thus gaining access to resources. Trading activities were a powerful source of initial capital as any company could engage in them. In contrast, the companies that emerged in the 2000s enjoyed a more mature economic and legislative environment. This type of financial environment is much more conducive to success, and organizations are able to rely on institutions and innovations, not only on personal relationships, to succeed. In these circumstances, strategic focus is important. For example, selling clothes or even crude oil would not be helpful for backing up an IT venture. Besides, the golden times of the Internet and IT have changed the structure of the assets required to run an innovative business. It is not solely financial assets that matter; human capital and knowledge have become extremely valuable in the current economic climate. Although difficult to attract, once found they can be financed from working capital rather than long-term investments. The descriptions of CEE's HCs in this book illustrate this.

Considering these examples, I suggest the following categorizations of HCs in CEE by the period of their creation:

1. HCs that were incorporated in the socialist times before the transition process started (up until 1990);
2. HCs that were incorporated in the 1990s;
3. HCs that were incorporated from the year 2000 onwards.

Most of the companies arising from the socialist era inherited the physical capital of their predecessors. In this case capital was most commonly in the form of undervalued tangible assets. These companies were generally privatized during the first privatization campaigns in the respective countries. This type of privatization usually meant that assets were either distributed free of charge or at a cheap nominal price, and were acquired by the groups (managers, representatives of the industry regulating authorities) that were close to the company. Technology also came with that physical capital; however as the economies became more open and integrated, the technology got obsolete because of the radical change in the competitive environment and the customers' requirements. Generally, undervalued assets, with the potential to increase in valuation as markets developed, contributed to the capital gains of the new owners. They could be used as collateral or as a basis for company development and sustainability. These HCs are mainly companies from traditional industries, involved in production, trade, extraction of raw materials, and engineering. Through their position and connections with partners, these HCs were able to provide huge sales and achieve large operating volumes.

As we see in the Russian and Turkish cases described in this book, CEE HCs with more than 30 years of history are now conglomerates which were either national holdings before the 1990s or had the state as the principal stake-holder.

HCs established in the 1990s relied on social capital or technical knowledge. As funds were hardly available in the early 1990s, previous know-how and social capital were essential for entrepreneurial start-ups in most of the countries in

transition. Investing in social capital, often free of charge, the owners of these companies have built their success on leveraging networks and connections, which generally originated during the recent socialist years. Indeed, during that period social capital skills, emotional intelligence and other similar assets were fostered and developed as personal relationships with suppliers, customers, and the authorities among others, became a huge, albeit undervalued, advantage once the CEE countries began their transition to a market economy. In essence, if a start-up successfully monetized its social capital and various networks, this created a strong value stream.

Businesses from this period also leveraged technical knowledge and know-how. These assets were exploited commercially, mainly by scientists who had strong entrepreneurial skills and were employed by state scientific and research organizations. The cases of Hungarian pharmaceutical CycloLab, and JCG Nanotechnology NT-MDT of Russia, described in this book, illustrate this.

From the late 1990s to the early 2000s, HCs relied highly on knowledge and innovation, which they transformed into business models. These assets did not require high amounts of physical and financial capital, allowing companies to be created from scratch, without significant financial investments. Along the same line, the holders of knowledge assets, such as scientists, researchers and IT specialists, often became CEOs or major shareholders. The message here is that the value of the knowledge that these people possess allows their business models to function with low working capital ratios. As many of the assets are intangible and costs are fixed, specialists can maximize the assets that they have, whether they appear on the balance sheet or not. A Russian Internet search engine created by Yandex and ELEKS Software of Ukraine, both described in this book, are just two examples of this type of HC.

3.2 Initial Financing of CEE HCs Summarized

Figure 1 summarizes how HCs differ in the way that they initially financed their business depending on the period of their establishment. The "period" dimension was already explained. The "type of assets" dimension goes from tangibles to knowledge assets. The main source of funding is indicated in the appropriate sectors of the matrix.

The shift from privatization of undervalued assets to monetizing know-how can be clearly observed as the main direction of the HCs' initial funding strategies. However, further growth and development require additional funds. In the next section we take a closer look at how CEE's HCs address the challenge of financing further growth and development.

Main type of assets		Assets of certain type in itially financed by		
	Tangible assets	Privatization of assets at a symbolic price (mainly before early 1990s, rarely mid 1990s–2000s)	Amount of these assets is insignificant for the HCs originated in this decade	Amount of these assets is insignificant for the HCs originated in this decade
	Social capital and technology	Amount of these assets is insignificant for the HCs originated in this decade	Capturing technology, monetizing and commercializing social capital and technology (mainly mid 1990s – 2000s, rarely early 1990s)	
	Knowledge and innovation			Self-finance, no big initial investments required; Trade finance from a big customer
		… - 1990	1990 -2000	2000 - …
		Period of company origination		

Fig. 1 How hidden champions from CEE initially obtained funds

3.3 Financing Growth and Development: Different Routes

As I mentioned earlier in this chapter, CEE's HCs are differentiated by a much higher lack of transparency compared to the original group. This includes the interviewees' unwillingness to discuss financial issues. In a number of cases (for instance in Belarus), no information on financing was disclosed at all and in many other cases it was just stated that finance was not a problem for the company. The interviewee from CASON, in Hungary, stated that if the company managed to solve its capital constraints, growth opportunities would be nearly infinite and CASON could become a well-known champion. Other interviewees complained about difficulties in obtaining external financing, without going deeper into specific details.

Still, there is evidence that CEE's HCs use all popular forms of financing. This includes equity financing (both private and public), M&A deals, debt financing, trade financing, and self-financing from retained profit and owner's funds. It should be noted, that HCs rarely resort to M&A, IPOs or debt financing. More popular forms are trade and self-financing and companies simply limit their growth when funds are scarce. Nevertheless there are distinct patterns in the financial decisions that HCs make. To reiterate, the economic differences between the CEE countries and those in the original research were controlled for so as to make some CEE companies eligible for inclusion in this research.

The economic environments in each CEE country are diverse. They are rapidly changing and adapting to economic and legislative changes. This is important to keep in mind when generalizations are made across the CEE cohort. There are globally important companies holding a high share of export revenues alongside small companies of regional importance. For example, Albania and Croatia have a

considerate number of small businesses in our sample. Slovakia and Slovenia are represented predominantly by SMEs, whereas Turkey and Russia have powerful conglomerates. Each of these companies is categorized as a HC in this research, even though each country's business background and demographics are different. For instance, the majority of the Serbian population is employed in SMEs; in contrast, in Russia these companies accounts for only 20 % of employment. This also applies to legislation. There are countries that adopted EU legislation in the last decade and another set of countries that have not. Some—for instance Russia and Belarus—do not even expect to adopt any EU regulations.

Earlier in this chapter, I suggested classifying HCs by the decade of their origination, so as to clarify how they obtained the capital to fund the initial phase of their operations. However, the correlation between the initial investments and financial markets is low because of the future orientation of the latter. Thus the period of origination loses its relevance as an explanation of how companies finance their growth.

I propose the approach adopted during the research so as to distinguish between "strong HCs", "regional HCs", and "start-ups with an emerging competitive advantage". This could be useful for explaining patterns in the financial strategies of HCs.

1. "Strong HCs" satisfy Simon's original HC criteria. Accordingly, their financial options are better than those of the HCs in the next two categories.
2. "Regional HCs" are middle-sized businesses that are successful at a regional level. These enterprises currently lack formal governance procedures.
3. "Start-ups with an emerging competitive advantage" are small entrepreneurial companies organized around a leader-entrepreneur.

Figure 2 presents an overview of the typical financial strategies of CEE's HCs by category.

3.4 Closer Look: Self-Financing

Self-financing is the most common form of financing for all types of HCs. It consists of retained profit and the owner's contributions. Retained profit is a powerful stream of financing growth. In terms of return on assets and return on equity, HCs perform much better than the average company in their sector. Theory of financial management and corporate finance determine sustainable growth rate as such a rate that does not affect capital structure negatively (Higgins 2011; Hillier et al. 2010). A sustainable growth rate usually correlates with return on equity (ROE), provided that no profit distributions were made. As we see from the research, most of the HCs have high profits and reinvest them to achieve company growth.

In the case of ESET, a Slovakian developer of internet security solutions, the nature of the product enables the company to innovate and maintain a strong position without huge financial investments. ESET has a considerable number of product designs. This is because each additional product sold has a very little

Type of HC						
	Strong HCs	Yes	Yes	Yes	Rare	Exceptionally rare
	Regional HCs	Yes	Yes	Rare	Exceptionally rare	Exceptionally rare
	Start-ups with emerging competitive advantage	Yes	Yes	Exceptionally rare	No	No
		Self-financing	**Trade financing and partnerships**	**Debt-financing (Loans)**	**Debt-financing (Bonds)**	**External equity-financing**

Fig. 2 How HCs in Central and Eastern Europe finance their growth

incremental cost, allowing the contribution margin to be nearly equal to the selling price!

Bosnia and Herzegovina and Hungary provide more interesting business models, described in the respective chapters.

3.5 A Closer Look: Trade-Financing and Partnerships for HCs

Trade-financing is the most popular form of external financing of growth and development of all types of CEE HCs. Trade financing is organized by means of short-term financing, obtained from customers in a form of prepayment or regular payments. A stable relationship with clients makes it easier to negotiate payment terms to obtain short-term financing. Plastex of Bosnia and Herzegovina (BiH) vividly demonstrates how such a strategy works.

It is beneficial for a company to be recognized globally and in its industry as this facilitates the decision-making processes of potential investors. A good reputation can be a vehicle for securing the necessary financing as demonstrated by BiH's HCs. It is typical of CEE HCs to obtain a large share of their revenues from three to five key clients. It can be reasonably assumed that being dependent on a few strong customers does not put a company in a good position to negotiate suitable terms of payment. However, as outlined above, there is a high level of interdependency between companies and their customers. Additionally, HCs' products and services have a high value added, meaning that the cost of inputs is relatively low compared to the price of outputs. The implication is that the interdependency between a supplier, a HC, and a customer often allows the relationship between clients and providers to be counterbalanced. In sum, these factors provide an opportunity for organizations to manipulate financial decisions in the short-term and mid-term and influence the financial and operating cycle to their advantage. Examples of smart management of the operating cycle are provided by a number of participants of this study, such as Durante M-KVARDRAT of Croatia, and Grishko Ltd. of Russia.

The demand for HC products, such as Grishko's ballet shoes, creates an opportunity for companies to take advantage of the financial benefits should they need customers to pay in advance. The downside of this model is that it is not sustainable in the long term and production and sales must continue to maintain a profitable business and a good reputation. The strategy of Durante M-KVADRAT is even more straightforward. The company operates in the construction sector and from the very beginning of its operations its policy has been to sell only prepaid merchandize.

Developing beneficial partnerships with local companies is a beneficial strategy for coping with financial constraints to growth. Latvia's Aerodium, a vertical wind tunnels producer, has developed its own strategy to enter global markets. Aerodium has realized that the best strategy for penetrating new markets is forming partnerships with local companies.

3.6 A Closer Look: HCs and Debt-Financing

As outlined previously, traditional avenues of financing, such as debt-financing, are available only to strong HCs as they comply with the standards that are set by debt providers. To secure debt-financing a company must have a well-managed development and financial infrastructure, including access to financial markets and institutions. Poland represents an example of an economy where financial markets and institutions have been developing at a greater pace and to a larger extent than in other small countries in CEE. In Poland access to financial resources began to develop early in the 1990s. At that time a wide variety of credit facilities became available. A highly liquid stock exchange and the local presence of major private equity investors played a key role in the development of the economy. Currently, approximately 75 % of Polish HCs reinvest profits into the company; 67 % reported using debt-financing and respondents pointed out that they have increased their use of this source in recent years.

Regional HCs rarely qualify for debt-financing. In contrast, new start-ups are practically never eligible for debt-financing. However, neither strong, nor regional HCs experience growth when using debt-financing. Ukrainian and Albanian cases illustrate both situations. KZESO is a Ukrainian company that manufactures modern electric welding equipment, with a history dating back to 1929. Prior to the recession, KZESO had invested its own assets and bank loans into the construction of a new plant for the manufacturing of rail machines, previously imported into Ukraine. However, in general, the Ukrainian HCs do not resort to scaled credit financing, and do not attract investments from external loan markets. This makes them similar to the HCs described in Simon's book.

Concluding Remarks

As we have seen in this chapter, CEE's HCs have many commonalities with Simon's original HCs as regards financing, and a number of key differences. All HCs are faced with a financial strategy dilemma as complying with the

traditional requirements of investors is a potential threat to their competitive advantages. Additionally, most capital providers see investment in innovative companies as highly risky. Fortunately, this risk suites certain types of venture capitalists. Yet, they wish to control their investments until their exit, which may be an issue for HCs.

However, the companies in Simon's research have greater possibilities to attract external financing as they operate in developed economies with well-functioning institutions and strong business traditions and practices. For those in CEE it is more difficult to obtain finance. HCs that emerged in the 1990s have successfully privatized the assets that formed their initial capital base. In contrast, the next generations of HCs capitalized on social and intellectual capital. Along their way to success, they have managed to finance their growth largely on their own.

The CEE countries continue to be in a stage of rapid development and are still becoming fully integrated into the global economy. This environment is characterized by continuous turbulence, external shocks and a high level of uncertainty. In these economies, raising capital is a challenging task for any company, and increasingly challenging for SMEs, like most of the HCs. Therefore, it is crucial for companies seeking the right financial sources to learn the language of globalized financial markets, which is the language of transparency and understandability. For many HCs this will mean rethinking and reengineering their approach to management and implementation. In particular, their business models will at least require some of the "best practice" reporting appreciated by investors and often considered as unnecessary by SME's owners and managers. In this respect, three areas of focus could be recommended: formalization of strategic processes and execution, risk-management, and implementation of sound corporate reporting practices.

Today's best practices in corporate reporting include outlining the financial aspects of a company's performance in the language of the globally accepted standards (IFRS) in the wider context of the company's strategic processes, operating model, relationships with different groups of stakeholders and risk-management issues. This suggests a good command and regular use of sound management techniques.

The strategic processes of the HCs are often seen by external parties as something happening in a black box. Being prepared to tell the story of their own success in a way that is accepted and understood by investors could create a strong strategic advantage. Integrating strategic plans with risk-management issues and risk mitigation plans could contribute to assuring potential investors that the odds for success are high. Given the fact that the business model of a typical HC contains some very specific features, explaining how possible risks will be managed is of great importance in a fund-raising process.

Finally, preparation of financial statements in accordance with a widely accepted framework (e.g. IFRS) suggests that the presented information is reliable and explicitly indicates that the company that presents such statements fulfills the requirements of transparency expected from sound corporate governance.

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