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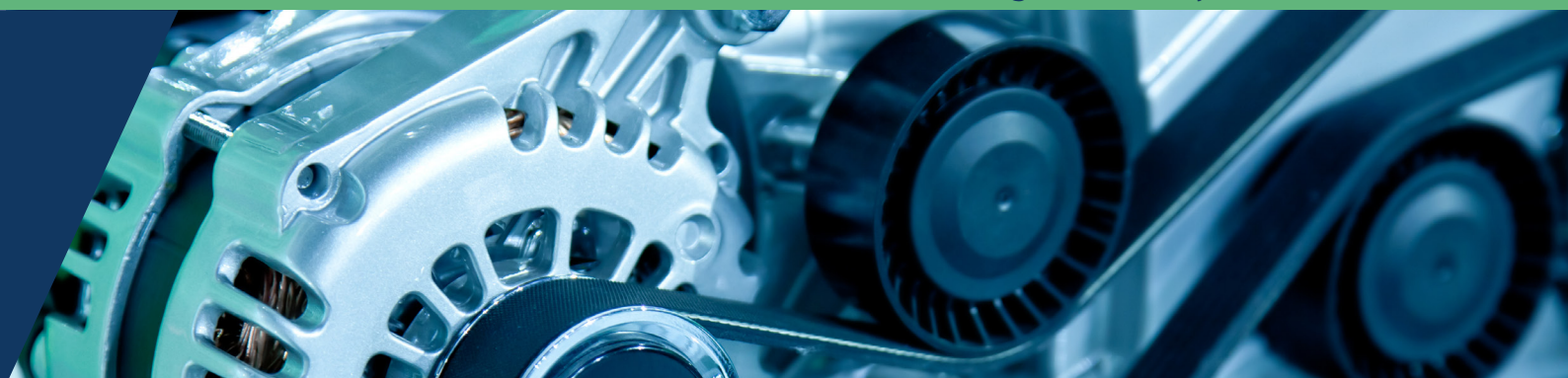
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PANORAMA OVERVIEW OF CZECH REPUBLIC

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The Czech Republic is back on fast track. After falling into recession in 2012 and 2013 due to sharp fiscal consolidation and sovereign debt crisis in the Eurozone, the economy regained momentum reaching solid growth rate of 2.0% in 2014 and should gain speed with 2.5% growth in 2015, according to Coface forecast. The improved outlook for the Czech main trading partners in the Eurozone has translated into growth of exports which are responsible for 84% of the country's GDP. A significant part of Czech exports is driven by its automotive industry which arouses to be a country's specialty. Nevertheless, the domestic demand plays a sizable role in the Czech economic growth, especially now with positive developments on the labour market contributing to rising private consumption.

The first part of the Panorama considers the Czech Republic as a manufacturing hub for German and other European investors thanks to relatively cheap and

high skilled labour force, geographical proximity to core markets, solid economic framework and fair business environment. In return for its openness and strong foreign manufacturing presence the economy is quite dependent on European markets, a few industries and global groups.

In its sectorial part this Panorama focuses on automotive and retail sectors. The automotive section especially highlights the manufacturing of passenger cars, with VW's Skoda and foreign brands making the Czech Republic the 13th world biggest producer of cars. The paper also investigates if it is a result of attractive labour costs or workforce skills. Whereas the automotive industry produces mostly for exports, the retail sector is driven by domestic demand. On one hand retail is benefiting from increased private consumption but on the other it is subject to fierce competition and low margins.

The last part of the Panorama looks into risk assessments for main sectors of the

Czech economy. Although the country is not trading significant volumes with Russia, the transport sector is impacted by deteriorated trade in the east direction due to its wide exposition to international services. The dependence on Russian oil and gas as well as ongoing geopolitical risks impact many businesses regardless of sectors. Conversely, the faster pace of Eurozone growth rising from 0.9% recorded in 2014 to 1.3% forecasted for 2015 will contribute to clearer opportunities for several sectors.

In a context of accelerating growth Coface risk assessment for the Czech Republic (A4) has been under positive watch since January 2015. The main reasons are the European automotive market recovery, a better use of EU funds leading to a rise in public investment, the solid anchorage of the Koruna to the Euro which will facilitate exports to extra Eurozone countries, and sustained household consumption thanks to rising employment and fiscal relaxation.

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“The Czech Republic holds a position of preferred location for foreign investments. Decisive criteria include geographical proximity to Western Europe, attractive labour costs as well as educated labour force.”

1 THE CZECH REPUBLIC IS INTEGRATED IN THE GERMAN-CENTRAL EUROPEAN SUPPLY CHAIN

A solid economic framework

Czech economy has grown rapidly since 2000. It was resilient during the crisis with just one year of recession (-4.5% in 2009). The slight recession in 2012 and 2013 was self-inflicted due to sharp fiscal consolidation. It regained momentum in 2014 with a 2% estimated growth and should accelerate in 2015 with a forecasted 2.5% growth. Exports are benefiting from the accelerating growth in Western Europe, particularly the revival in the automotive market, and the low level of the Koruna. Household consumption is boosted both by increasing employment and supporting fiscal measures.

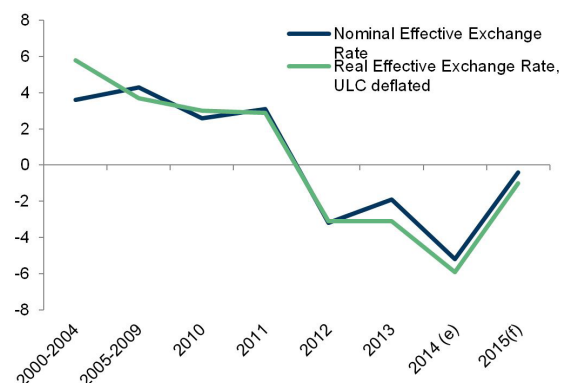
The fiscal consolidation is now over with public deficit slightly over 2% and debt representing 45% of GDP. Fiscal outlook is fine with the planned adoption of a medium term (2020) structural deficit target of 1% and a debt brake rule to play once debt reaches 55% of GDP. Public debt is overwhelmingly (86%) detained by residents and in local currency (81%). Given this sound situation, there is scope for accommodating policies. The new centre-left coalition that took over the reins of government in January 2014 under the lead of the social-democrat Bohuslav Sobotka, and consisting of Social-Democrats, Christian-Democrats and a new party, ANO, founded in 2011 by the businessman Andrej Babis as a response to ongoing corruption scandals, has already grabbed this opportunity. Allowances for families with more than one child have been increased, alongside wages in the public sector. A reduced rate of VAT has been brought in for healthcare purchases, books and products for infants. The State's contribution to sickness insurance for the elderly, students and the unemployed has been

raised. Finally, the indexing of pensions was reintroduced.

Monetary conditions should remain favourable. Whereas the real effective exchange rate of the Koruna (CZK) appreciated till 2011, it depreciated thereafter. In November 2013, the central bank committed to intervene on the market, so that CZK exchange rate against the Euro would stay at 27:1 or above. Since then, it has barely budged, including during the episode of Euro depreciation against the dollar. Given the integration into the Euro area economy, any significant appreciation would be detrimental. Whilst Euro-skepticism is not a prerequisite of the government that took over the reins following the October 2013 elections, participation in the Euro system is not on its agenda, at least for the current legislature extending to 2019. A majority of the population is still against joining and a partner of the governing coalition, ANO 2011, doesn't see it as priority.

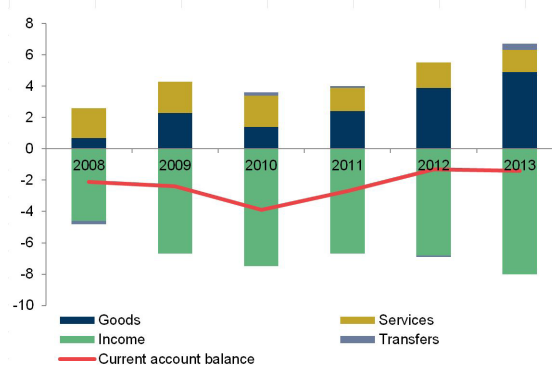
Chart 1:

Effective Exchange Rates versus 37 trade partners (y-o-y % change)



Source: European Commission

Chart 2:
Current account (% of GDP)



Source: European Commission 2014 fall forecast

External accounts are healthy. Trade balance is structurally positive (around 5% of GDP), as is the service balance (nearly 2%) despite the relative desertion of Russian tourists (2nd contingent after the German) and the competition from emerging countries in road transport. Due to important dividend repatriation by foreign investors the current account is slightly short of balance. The gap is easily financed by EU funds and foreign investment. Dependence on foreign capital is therefore very limited.

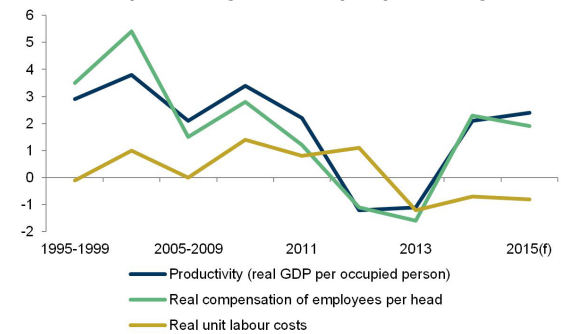
Dependence on Russian gas and oil is important (respectively 80 and 70% of Czech consumption of gas and oil), but in case of disruption some rerouting could be activated thanks to the pipes linking the country with Germany and Austria. Moreover, Czech Republic imports only 25% of its total energy needs. This is due to the fact that gas and oil count for 40% in the energy cocktail, coal and lignite for 44%, nuclear for the rest. Electricity is mostly produced from coal and lignite.

An attractive manufacturing hub for German and other Western European investors

Soon after the collapse of the communist regime in November-December 1989 Western European investors, mostly German and Austrian, have rapidly taken advantage of a relatively cheap and high skilled labour force, geographical proximity to their and other European core markets, relatively good infrastructure, likeliness in industrial structures and labour traditions, and rather widespread knowledge of the German and English languages, respectively in the regions bordering Germany and Austria, and in the capital region. Under the communists, the country kept its industrial traditions and specialization alive while providing the communist bloc with much of its industrial needs. They were fairly easy to revive. As a result, the

stock of foreign direct investment represented almost 70% of GDP in 2014.

Chart 3:
Productivity and wage trends (y-o-y % change)



Source: European Commission 2014 fall forecast

Heavy dependence on exports to Europe, from a few sectors and foreign groups

Exports represented 84% of GDP in 2014, a larger share than the EU average. This is the consequence of both the significant presence of foreign-owned factories dedicated to export and the relatively small size of domestic market (10 million inhabitants). 82% of exports go to European Union markets, 63% to Eurozone markets, and 30% to Germany alone. In reality, due to substantial re-exportation from Germany to extra-European countries, exposition to Germany must be lower. Slovakia and Poland receive respectively 9% and 6%. Russia's and Ukraine's shares are respectively 3.1% and 0.6% (3.7 and 1.0 in 2013). Although, when including indirect automotive exports through Germany, it is certainly a bit higher, the stakes are not high.

Motor vehicles and their parts represent 20% of exports. Machinery (22%) and electronics / telecommunication devices (13%) are the other big exporting sectors, reflecting the strong foreign presence, although a shift towards professional services, support activities, real estate and hostelling have been observed in the recent years. The Czech economy is, thus, highly sensitive to fluctuations in the European car markets and investment.

Skoda, Hyundai and TPCA, a joint venture from Toyota and PSA, account for all the automotive output. Skoda, a subsidiary of Volkswagen, accounts for nearly 60% of the total. The fate of a large part of the economy depends, then, on the decisions of a few global firms.

Moderate benefits from the integration in the supply chain

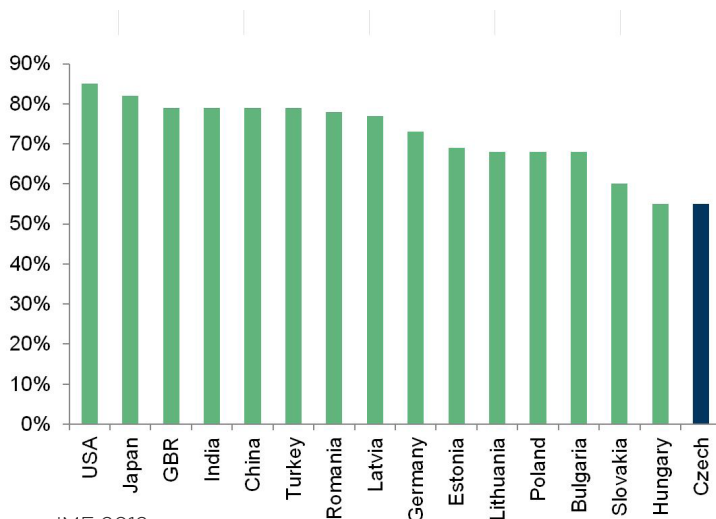
Thanks to significant technology transfers from parent companies, especially in the automotive industry, domestic value added to Czech exports has gotten more sophisticated. Nevertheless, although domestic value added in exports increased significantly as a % of GDP, it declined as a percentage of exports. These opposing trends are due to the fact that, at the same time, foreign (mostly German) added value in total Czech exports as a % of GDP rose more than twice as much and, conversely, climbed as a percentage of exports. Integration in the European supply chain was clearly beneficial for the Czech economy, but it was even more so for the outsourcing countries like Germany.

According to the IMF domestic value added to exports, which can be defined as the real contribution of exports to domestic product after having erased the impact of imported inputs, represented 55% of total export value in 2012, which was lower than in other advanced economies. This is not only a consequence of the limited content in locally produced intermediate products, but also the result of an insufficient integration of local services (research & development, marketing...) in the exported production due a lack of competitiveness and sophistication. A large share of foreign presence still relies on the assemblage of imported intermediate products and services. Unsurprisingly, imports represent 78% of GDP, slightly less than exports, and are a quasi-perfect image of the exports, and both fluctuate in parallel.

Higher sophistication of traditional exports have not necessarily lead to a corresponding leap in local technology and services, as the more advanced components are often imported and service-relying steps like conception and marketing can be performed abroad.

Chart 4:

Domestic Added Value in Exports



Source: IMF 2012

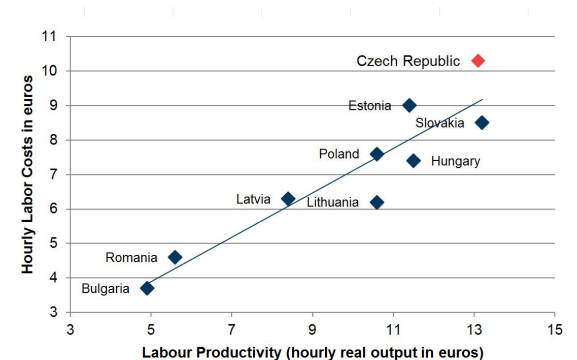
Still competitive location despite some challenges

Some of the advantages of the Czech location like the geographical situation are not to disappear, but others have to be well taken care of if the country wants to keep and extend its attractiveness. Inflows of direct investment represent over 2% of GDP and 10% of gross capital formation.

The relatively moderate cost of labour force could be threatened by **the erosion of the working age population** which could diminish by 0.36% annually between 2020 and 2050 (2012 UN Population Prospects) due to the low birth rate (1.4 children per woman), and a subsequent rise in wages. For now, it is partially balanced by the rise of the participation rate among women. Unfortunately, due to still insufficient child-care facilities, mothers with young children find it hard to participate. But, conversely, the rise of tax credit for children in 2015 could help. Fortunately, demographics are not any better in the neighbouring countries.

Chart 5:

Labor Productivity and Costs



Source: Eurostat 2013

Labour skills must be upgraded to match technology-induced changes and keep productivity gains in pace with the rise in labour costs. A lot depends on the education system which demands some improvement like the development of apprenticeship and vocational training to correct shortages in technological fields which tend to exert an upward pressure on labour costs. Advance on competitors in that field remains substantial, though.

The precedent government drastically reduced **public investment** by more than 13% annually over the period 2010-2013 in order to consolidate fiscal accounts. This has affected transportation (road, railway) and energy infrastructures development. Moreover, structural and cohesion funds allocated by the European Union for the period

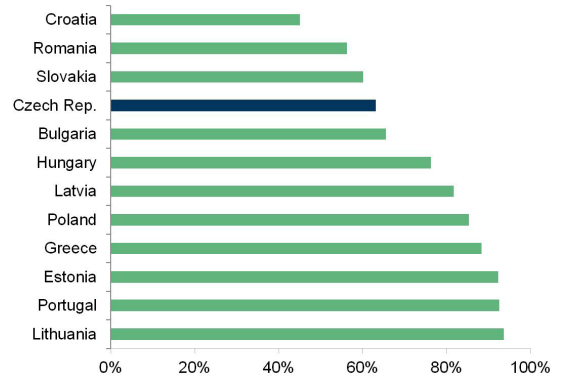
2007-2013, for which the country is the 4th recipient and serve as a significant source of financing for infrastructure, were only half absorbed due to insufficient planning and implementation of projects on regional level. This problem is more acute in competing emerging European countries. The amount of these funds should remain roughly the same over the period 2014-2020 and the new government intends to improve absorption

Research & Development and start-up money are major challenges to increase locally-added value in exports. Results will not only depend on public investment, but also on the willingness of foreign investors to locally develop that field while granting more leeway to the local management. Solid banks, 90% of which belong to foreign (Euro area) groups, with a net external asset position, local deposits exceeding loans, loans barely representing 77% of GDP (just 22% for credit to non-financial companies) and predominantly issued in local currency, and non-performing loans at 7%, have the capacity to help.

Finally, **business environment** remains much better than in emerging European countries, al-

though corruption (cf. scandals involving ministers from the previous government), red tape, political influence over civil servants in charge of EU funds management, bid rigging by cartels in public procurement are not absent.

Chart 6:
EU funds absorption rate (programme 2007-2013)



Source: European Commission

Chart 7:
World Bank Indicators

| World Bank indicators 2013 | Voice and Accountability | Political Stability | Government Effectiveness | Regulatory Quality | Rule of Law | Corruption |
|----------------------------|--------------------------|---------------------|--------------------------|--------------------|-------------|------------|
| CZECH REP. | 50 | 34 | 53 | 39 | 38 | 79 |
| POLAND | 47 | 46 | 61 | 41 | 57 | 62 |
| SLOVAKIA | 51 | 25 | 57 | 46 | 77 | 85 |
| HUNGARY | 65 | 65 | 63 | 48 | 70 | 75 |
| ROMANIA | 91 | 101 | 100 | 65 | 93 | 100 |
| SERBIA | 92 | 122 | 105 | 103 | 118 | 104 |
| GERMANY | 14 | 50 | 19 | 16 | 18 | 13 |

Source: World Bank

2 THE AUTOMOTIVE SECTOR

The Czech Republic is a relatively small country which ranks 81st worldwide in terms of population and 50th in terms of nominal GDP level. However the country is one of the major car producers. In 2013 it ranked 13th among producers of passenger cars making 1.13 million of such vehicles. With domestic sales taking only 185,000 cars, it translates into a significant dependence of the Czech automotive sector on global demand. The latter has been fluctuating in recent years. The global financial crisis impacted households' and businesses' abilities for car purchasing. In 2009 global car production fell by 13% vs. 2008 to 61.8 million units.

Production in the European Union decreased by 17.3% to 15.2 million vehicles and in the US it plummeted by 34% to 5.7 million. Emerging economies have gotten into the driver's seat in the global automotive market with China becoming the main producer as well as buyer of cars in 2013. The US market has rebounded and generates positive growth dynamics; however its past deterioration with the insolvency of flagship automotive manufacturing location, the city of Detroit, still reminds that the pre-crisis stance has not been reached. The Czech economy is open to external trade.

Chart 8:
Passengers cars - major producing countries (2013, million units)

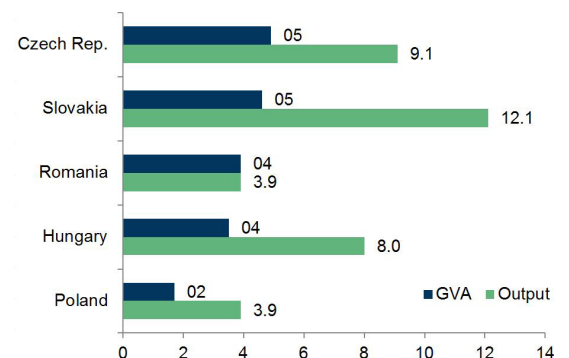
| | |
|-------------|-------|
| China | 18.09 |
| Japan | 8.19 |
| Germany | 5.44 |
| U.S. | 4.35 |
| South Korea | 4.12 |
| India | 3.14 |
| Brazil | 2.74 |
| Russia | 1.92 |
| Mexico | 1.77 |
| Spain | 1.72 |
| UK | 1.51 |
| France | 1.46 |
| Czech Rep. | 1.13 |
| Thailand | 1.07 |
| Slovakia | 0.98 |
| Canada | 0.97 |
| Indonesia | 0.93 |
| Turkey | 0.63 |
| Iran | 0.63 |
| Malaysia | 0.54 |

Source: OICA

The share of exports to GDP reached 84% last year whereas it was higher in Hungary (93%) and Slovakia (92%) but much lower in economies with a significant domestic consumer base like Romania (44%) or Poland (47%).

The Czech economy strongly relies on manufactured exports with passenger car being the flagship exported product. Manufacturing of vehicles and other transport equipment brings a substantial contribution to country's economic growth. It created almost 5% of the Czech gross value added (GVA) and above 9% of its manufactured output, or over 20% for the entire automotive industry which includes, beside OEMs¹, also suppliers of automotive systems, parts and modules. Difference between respective shares of GVA and manufacturing output is also observed in most other CEE economies. As concluded by IMF it is a result of the dominant role of car assembly within the automobile industry.

Chart 9:
Automotive sector*: share of gross value added and manufacturing output in total (%)



* Manufacturing of vehicles and other transport equipment

Source: Eurostat

Assembly accounts only for a small share of value added because the center of value added creation has shifted to auto part suppliers.

The CEE region is a preferred location for the factories of many car producers. The regional attractiveness is supported by a low level of labour costs, educated workforce, improving infrastructure and attractive geographical location connecting west and east. Therefore the regional manufacturing industry including the automotive sector is a significant part of supply chains, especially German ones.

CEE economies and their automotive sector are

dependent on demand from external markets as well as on decisions of individual car producers to locate production and assembly factories according to the tax incentives granted in each country. Car production has diversely fluctuated in CEE economies over the last years. Whereas production rose by 21% since 2013 in the Czech Republic, it decreased by 44% in Poland over the same period. The significant decrease of car production in Poland results from large European spare capacities for three producers of personal cars: Fiat, GM Opel and Volkswagen. Expansion of car production capacities with significant investments was recently performed in Hungary, Slovakia, the Czech Republic and Romania.

The Czech Republic was fortunate years ago when Volkswagen decided to bring a new breath of life to the country's domestic car brand Skoda. Under its own name, Skoda created a wide selection of car models popular not only in the Czech Republic but also on foreign markets. Only in 2014 Skoda's global sales exceeded 1 million units with 967,000 sold on foreign markets and 70,000 sold on domestic market. The 2014 Skoda's local production amounted to 736,000 units as a part of production is moved to neighbouring Slovakia as well as emerging markets where a growing share of middle class generates solid demand - factories are located also in China, India and Russia.

The popularity of Skoda cars is growing. The global sales were higher by 13% in 2014 than in previous year. Octavia and Fabia models remain the most popular among customers. Although

strengthening its solid position in Western Europe, the brand focuses also on perspective markets. China became Skoda's strongest individual market with a total of 227,000 deliveries in 2013. Over the coming years, Skoda plans to increase its worldwide sales to at least 1.5 million vehicles per year. For this purpose, a strategy of introducing a new or revised model every six months on average has been implemented.

Beside Skoda factories the Czech Republic also hosts production of other car brands. TPCA (Toyota/PSA joint venture) and Hyundai produced together nearly half million cars in 2014 in Czech factories, with a huge majority of them sent to external markets. The South Korea's Hyundai plant was set up with a EUR 1 billion investment in Nosovice, Moravian-Silesian Region, in 2006. The factory became the most important and the only (except for Eurasia plant in Turkey) European plant of the car producer. It assembles vehicles sent out to 56 countries, including non-European destinations like South Africa, Australia and the Middle East.

The Czech Hyundai factory manufactures four models of passenger car as well as transmissions not only for the Czech plant but also for its sister company Kia Motors Slovakia in Zilina. It is a mutual cooperation as the Slovak factory supplies the Czech one with motors. The Hyundai's investment, one of the biggest in the Czech Republic so far, contributed to the economic improvement. The region of Moravian-Silesian suffered from high unemployment triggered by restructuring processes in the region's traditional industries.

Chart 10:

Production of personal cars (thousand units) and labour costs as the Eurozone average

| | | Czech Rep. | Hungary | Poland | Romania | Slovakia |
|--------------|-----------------------------|-------------------|----------------|---------------|----------------|-----------------|
| Production | 2008 | 934.0 | 342.5 | 841.7 | 231.1 | 575.8 |
| | 2013 | 1128.5 | 220.9 | 475.1 | 411.0 | 975.0 |
| | 2013 (2008=100%) | 121% | 64% | 56% | 178% | 169% |
| Labour costs | % of Eurozone average | 37% | 26% | 27% | 16% | 30% |

Source: OICA, Eurostat, own calculations

Hyundai offered to create 3,400 jobs and additional 5,000-7,000 were created by component suppliers.

The Czech government and the local municipality supported the investment by creating new infrastructure, particularly roads and railways. The plant's manufacturing capacity started at 200,000 cars per year in 2008, a production level which was reached only after two years. In autumn 2011, the three-shift operation was introduced rising the maximum capacity to 300,000 cars per year. Production of 303,000 and 307,000 units in 2013 and in 2014, respectively, shows that the plant has been working at full capacity.

The joint-venture project of Toyota and PSA Peugeot Citroen was launched in a plant located near the town of Kolin, 60 kilometres east of Prague. Since starting assembling in 2005, the factory produced more than 2.5 million cars till the end of 2014. The yearly capacity of 300,000 units splits into three sister models: Toyota Aygo, Peugeot 108 and Citroen C1. The manufacturing of that city car trio with low fuel consumption and emissions is a perfect example of shifting production to countries with lower production costs which is compelling especially in the case of small passenger cars with narrow profit margins. The plant produces mainly for exports (99% of production) sent particularly to European markets: France, Italy, the United Kingdom, the Netherlands and Germany. TPCA has 3,500 employees whereas 75% of them come from the region. Roughly 80% of supplies to the factory come from the Czech Republic.

Chart 11 confirms that investments conducted by foreign manufacturers boosted the total car production in the Czech Republic amid solid manufacturing levels from domestic Skoda. The highest growth dynamics came when TPCA plant started its production in late 2004 (+34.7% in 2005 and +42.1% in 2006) whereas positive impact of initial manufacturing in Hyundai plant was compensated to some extent by lower Skoda production and the beginning of financial crisis (+4.2% in 2009 and +9.5% in 2010). Within the last ten years the only period of negative growth for car production occurred when the main trading partner of the Czech Republic - the Eurozone - fell into a double-dip recession. The contraction of car production (-1.7% in 2012 and -3.9% in 2013) was relatively soft thanks to exposition of car sales to global markets, not only Western European ones. In that period the Czech GDP growth was impacted more than the Eurozone one (-0.8% vs -0.7% in 2012 and -0.7% vs -0.5% in 2013) confirming the country's strong overall exposition and dependence on the Eurozone economy amid weak internal demand.

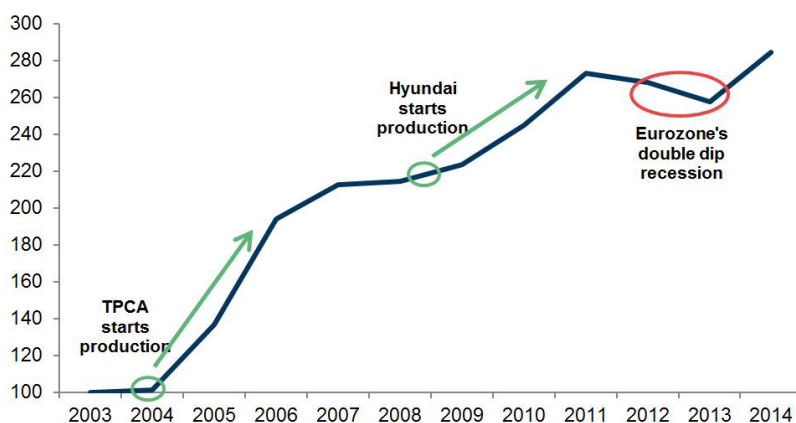
The automotive industry has become an important part of the Czech economy. Its share in total exports exceeds 20% and it employs more than 150,000 people. The high level of passenger car production makes a leadership position in the international comparison - with 108 vehicles produced per 1,000 inhabitants the Czech Republic ranks into the second position next to the 180 vehicles per 1,000 persons produced in Slovakia. The EU average stays much lower, i.e. 35 vehicles per 1,000 inhabitants.

The Czech motor production industry includes also commercial vehicles, buses and motorcycles. Those types are mainly represented by Czech traditional manufacturers like Tatra - a producer of heavy-duty trucks or JAWA - a producer of motorcycles. More than 3,000 buses were produced last year in Iveco Bus plant which is the largest factory of the Iveco Group. However passenger cars take the biggest share of motor vehicles production - 98% of units produced in 2014.

The CEE region is attractive for global car producers also thanks to its skilled labour. In the case of the Czech Republic, engineering, manufacturing and construction education accounted for 43% of total upper secondary (ISCED level 3) graduates and 12% of total tertiary (ISCED level 5 and 6) graduates in 2012.

The structure is mostly similar across CEE countries and refers mainly to a proportional number of total graduates. Whereas the number of tertiary graduates in engineering, manufactu-

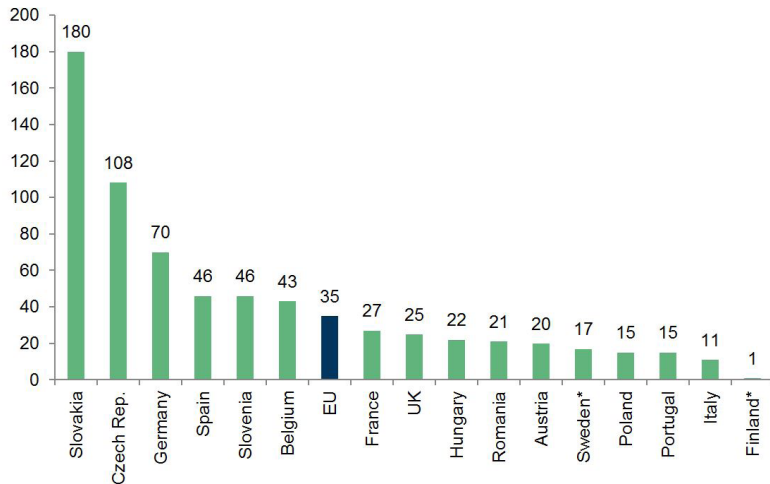
Chart 11:
Dynamics of production of passenger cars and LCVs in the Czech Republic (2003=100)



Source: Automotive Industry Association (AIA), own calculations

Chart 12:

Motor vehicle production per 1,000 inhabitants (2013)



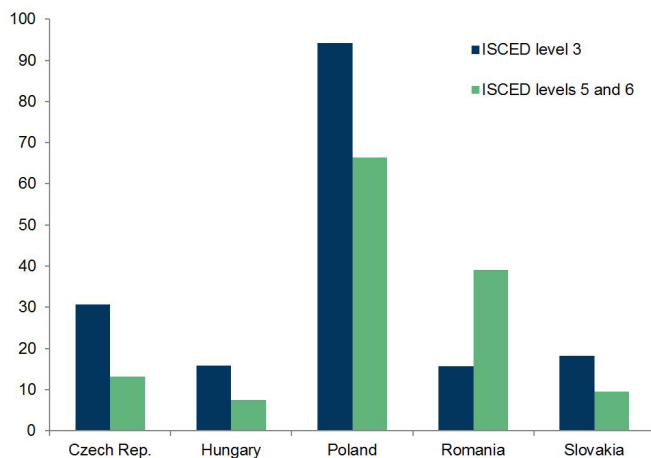
* only production of cars available in 2013

Source: Eurostat, ACEA

ring and construction has been rising over the last years (+65% in the case of the Czech Republic since 2004), the number of such technical secondary graduates has been declining (-26% in the case of the Czech Republic since 2004). The latter is often the result of the secondary education system which is insufficiently flexible to adapt to changes in the labour market and demand for employees generated by particular sectors. Nevertheless, the solid rising number of tertiary graduates is supportive for the Czech ambition of positioning the country as one of the leading European centres for automotive related design, research and development activity. Companies

Chart 13:

Graduations in a field of engineering, manufacturing and construction (thousands)



Source: Eurostat

such as MB Tech, Ricardo, Swell, Valeo, Visteon, Hella, Bosch and Siemens have developed their R&D centres in the Czech Republic. Most of technological universities have R&D centres which are aimed at operations connected with the car industry and they closely cooperate with companies from the sector. The biggest Czech universities include the Czech Technical University in Prague, the Technical University of Liberec, the University of West Bohemia in Plzen as well as the Brno University of Technology. They offer not only automotive related programmes but also cooperate with many automotive companies located in the Czech Republic, including Skoda Auto, Porsche Engineering, Honeywell, Behr, Bosch, Continental, Magna, Saint-Gobain, Volkswagen AG, Tatra, Brose, among others.

Outlook and Risks

The automotive industry is a significant pillar of the Czech economy and a driver for its exports. It corresponds with aspiration to make the country the regional leader for gathering automotive industry investments. It has already gained a leading position. The turnover of total automotive industry (which includes manufacturing of parts and components) reached EUR 33.1 billion as compared to EUR 26.6 billion in Poland, EUR 20.1 billion in Slovakia, EUR 16.1 billion in Hungary and EUR 9.7 billion in Romania.

The strong exposition of the sector to exports brings some threats. It makes the car industry dependent not only on global overall demand but also to marketing actions and particular demand for precise car brands. Therefore the sector can be a victim or, oppositely, a winner of external factors. The diversified exposition to external markets makes this risk mitigated. The current negative impact comes from the Russian market which suffers a slowdown and where new car sales are declining (-11% in 2014 vs. 2013). The Czech Republic's road vehicles exports to Russia amounted to 5.3% of Czech exports to that country in 2013 while the country's aggregated exports to Russia amounted to 3.7% of Czech exports. Moreover, the real exposition to Russia is stronger when the Czech automotive industry input to the German supply chain is included. Due to Russian recession (forecast for GDP growth -3.0% in 2015) Coface expects that car sales, there, will still be in a negative trend.

Other external markets perform better. In the European Union, passenger car sales increased by 5.7% y/y in 2014. Whereas the Western European sales recorded a fair growth of 5%, registrations in Eastern Europe soared by 14.2%. Nevertheless, a much bigger volume was sold in Western Europe - 11.7 million units as compared to 893,000 sold

in CEE countries. A variety of car scrapping schemes (implemented in e.g. Spain and UK) supports the car industry. Skoda recorded an increase in sales of 14.2% to 554,000 units in European Union countries in 2014. Sales of Hyundai and Toyota were relatively stable (+0.7% and +1.7%, respectively) whereas PSA Group's sales increased by 3.7% in the EU last year. The latter has been recently suffering from overcapacities and decided to close some Western European plants in order to reduce costs. At the same time Czech assembly lines manufacture just a few models. A deeper diversification would bring more flexibility to the production process and resistance to fluctuations of demand.

The Skoda's strongest individual market - China - recorded y/y growth of 9.9% for passenger car sales to 19.7 million units in 2014. This year sales growth in China will remain positive despite a decline in income growth and some purchase restrictions in certain first tier cities.

Last but not least, the Czech domestic market generated positive dynamics. At the end of 2014 passenger cars sales were higher by 16.7% than a year before. Although the outlook for the automotive sector is improving, the anticipated growth of sales will be insufficient for car producers experiencing overcapacities. Distributors and component suppliers could suffer from eroding margins.

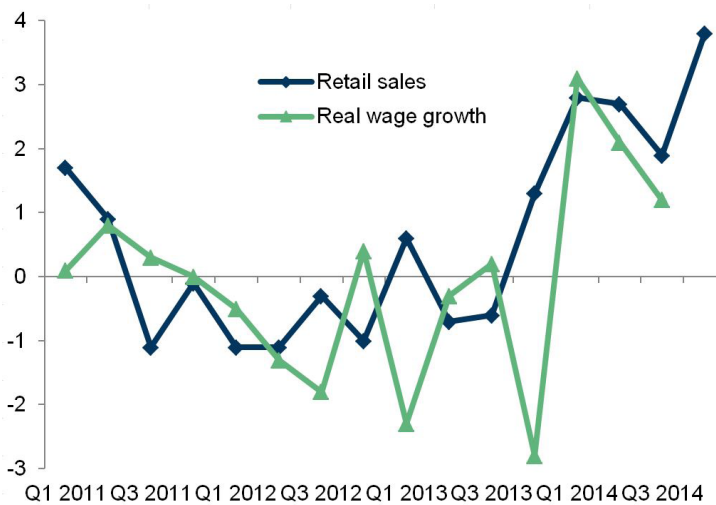
3 THE RETAIL SECTOR

In most CEE economies the main driver of economic growth has been the rebalancing from net exports to domestic demand. The household spending is supported by an increase of employment and growing wages. The very low inflation rate, even deflation in many economies, enhances the purchasing power of consumers. At the same time, it is not a 'text-book' deflation resulting from refrained spending by households but a deflation mostly implied by lower prices of commodities.

The household consumption expenditures in the Czech economy rose by 2.1% in the thirist three quarters of 2014 as compared to the corresponding period of previous year. Real wages growth has entered into positive dynamics at the beginning of last year whereas the unemployment rate reached 5.8% in December 2014, i.e. the lowest level since 2009 and one of the lowest results in the entire EU next to Germany and Austria. A further support for private consumption comes also from increasing wages in the public administration sector as well as a rise of the official minimum monthly wage from an equivalent of approximately EUR 310 to 334. Unsurprisingly, retail sales have been recently growing against the above mentioned backdrop. As it rebounded from a period of mostly negative growth in 2011-2013, the first three quarters of 2014 delivered an average increase of 2.5% y/y. Retail sales sped up in the last quarter of 2014 when they increased by 3.8% y/y.

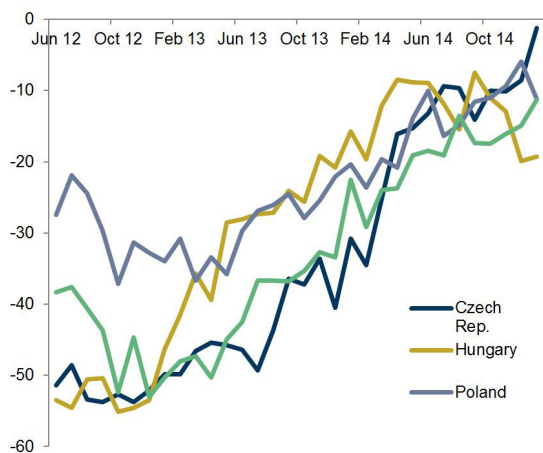
The positive developments on the labour market are accompanied by a period of low inflation which jointly further support growth of private consumption. After a double dip recession consumer surveys confirm that the confidence is rising. Actually, the consumer confidence is on the highest level among the biggest CEE economies as well as the highest level since 2006. More detailed surveys show that the number of Czech consumers who define the current economic situation as adequate to make major purchases have recently increased to a level last recorded in mid-2008.

Chart 14: Retail sales dynamics and real wage growth (% y/y)



Source: Eurostat, Czech Statistical Office

Chart 15:
Consumer survey balance – assessment of general economic situation over the last 12 months



Source: Eurostat

The foreign retail chains entered the Czech Republic and other CEE economies long before. Following the findings made by M. Machek², conditions for entering the CEE market in the mid-1990s were favourable – weak local competition without capital resources or business know-how, benevolent legislation and huge consumer appetite. The Czech Republic, Hungary, Poland and Slovakia were listed among the top 30 most

attractive emerging markets for international retailers (A.T. Kearney, 1995). Poland was positioned as one of the most interesting markets – it was in 2nd place behind South Korea; the Czech Republic was in 10th place, Slovakia in 23rd place and Hungary in 30th position. In 2010 most of Western European retailers were present in those economies. The most penetrated market was the Polish one due to its biggest consumer base. In 2014 the big chain stores still held a dominant position in the Czech retail market. According to the latest surveys 43% of Czech households indicate hypermarkets as their primary shopping points for buying FMCG (fast moving consumer goods) products due to the wide choice of goods. Discount stores maintained their second position – 25% of Czech households spend most money on food there. The remaining part of that primary shopping breakdown is taken by supermarkets (17%) and smaller shops (15%). Young consumers (under 40) with higher education prefer shopping in hypermarkets and supermarkets whereas discount stores and small shops are preferred by older customers or clients with lower education level.

There is a strong concentration in the Czech retail market. The market share of the Top 9 chain stores (Kaufland, Tesco, Ahold, Penny Market, Lidl, Globus, Billa, Spar) increased from 65% in 2011 to 70% in 2014. Kaufland (owned by German Schwarz Group) remained the largest retail chain in 2014, followed by Tesco (UK) and Ahold (Ne-

Chart 16:
International retail chains operating in Central Europe (2010)

| Chain (country) | Czech Republic | Hungary | Poland | Slovakia |
|-----------------------------|----------------|---------|--------|----------|
| Lidl (Germany) | X | X | X | X |
| Tesco (UK) | X | X | X | X |
| Kaufland (Germany) | X | X | - | X |
| Billa (Germany) | X | X | - | X |
| Penny Market (Germany) | X | X | - | X |
| Spar (Austria) | X | X | X | - |
| Ahold (Netherlands) | X | - | - | X |
| Aldi (Germany) | - | X | X | - |
| Auchan (France) | - | - | X | X |
| Carrefour (France) | - | - | X | X |
| Intermarche (France) | - | - | X | - |
| Cora (France) | - | X | - | - |
| Globus (Germany) | X | - | - | - |
| Jeronimo Martins (Portugal) | - | - | X | - |
| Leclerc (France) | - | - | X | - |
| Reitan (Norway) | - | - | - | X |

Source: M. Machek, Retail market structure development in Central Europe, Central Business Review, December 2012

² "Retail market structure development in Central Europe", Central Business Review, December 2012

therlands). In terms of numbers of stores, Penny Market is the leader with 350 discount stores, followed by Ahold (283 stores) and Lidl (229 stores).

The rising density of retail chains results also in changing the consumers' behavior. Whereas it is convenient for consumers to have access to many stores in their vicinity, they are becoming also more selective on various criteria when choosing a store. According to one of the latest shopping surveys done on the Czech retail market by Incoma GfK, the average shopper has 8 food stores within reach but regularly shops at only 3 of them. Some customers completely refuse to visit certain stores which leaves their retail potential untapped. As they do not even visit those stores, they are hardly to be persuaded with an improved offer. Among reasons indicated to be of high importance when choosing a store, the reason of store's proximity or distance was ranked on the top. The

second strongest factor impacting consumers' choice sensitiveness is the level of prices compared to competing stores. Then the next important factors were named to be: the selection of goods, shopping environment and store atmosphere and the quality of goods with the 5th importance rank. It can be concluded that retailers should be aware of reducing barriers that discourage customer shopping but also making a store comfortable and enjoyable for clients as they can easily switch to alternatives.

Besides introducing the improved store atmosphere as a part of marketing strategies of many retail brands, there is a rising number of customers who consider shopping as the annoying necessity. Many of them switch to online shopping as a way to make the process easier and faster. According to the survey made by Incoma on eShopping the Czech customers are the most willing to purchase medicines, vitamins and sup-

Chart 17

Czech retailers (FMCG - fast moving consumer goods)

| Company | Turnover (CZK billion, 2013) | Number of stores | |
|---------------------|---|--|-----------------------|
| Kaufland | 51.30 | 117 hypermarkets | |
| Tesco | 44.01 | 6 department stores, 63 supermarkets, 53 Tesco Express stores, 86 hypermarkets | |
| Ahold | 40.06 | 56 hypermarkets, 227 supermarkets | |
| Penny Market | 29.86 | 350 discount stores | |
| Makro Cash & Carry | 29.39 | 13 wholesale stores, 2 Drive In | |
| Lidl | 24.72 | 229 discount stores | |
| Globus | 23.00 | 15 hypermarkets, 3 Globus-Baumarkt | |
| Billa | 20.98 | 206 supermarkets, 5 stop & shop | |
| Geco | 17.31 | 252 newspapers and cigarettes stores | |
| Spar | 13.25 | 35 Interspar hypermarkets, 14 Spar supermarkets | |
| Hypermarkets | Supermarkets | Discount | Smaller stores |
| Albert | Albert | Coop Diskont | Coop |
| Globus | Billa | Lidl | Flosman/Flop |
| Interspar | Tesco | Norma | Hruska |
| Kaufland | | Penny Market | Jednota |
| Tesco | | | Konzum |

Source: Incoma Research

plements using the internet. Such products were bought on line by 28% of customers who have access to the internet. It represents 20% of the total Czech population as about 75% of Czechs have internet access. Other products typically bought online include cosmetics (25% of e-population), perfumes (24% of e-population) and drugstore products (21% of e-population). Food products were purchased by one in ten Czech customers. On average, food is purchased online 10 times per year and the average spent on a single purchase is CZK 500 (EUR 18). The most popular online shops for food purchases are: itesco.cz, aukro.cz, lekarna.cz, koreni.cz. At the same time, the most frequent users of online shopping are customers of Tesco and Kaufland brick and mortar chains. The survey confirmed also that several factors are crucial for internet customers: price and selection of products, transportation costs, delivery time as well as quality and freshness of purchased products. The total estimated turnover of the Czech FMCG online shopping exceeded CZK 28 billion (above EUR 1 billion) in 2014.

Outlook and risks

The household consumption in the Czech Republic is on a rebounding trend. It is supported by decreasing unemployment and growing wages which households experience also in real terms thanks to low inflation. Moreover, consumer confidence indicators which reached high levels last recorded in 2006 indicate that private consumption will still be effectively supporting the Czech economic growth. After quarters of weak or even

negative growth of household's expenditures, signs of more decisive rebound translate into better prospects for the Czech retail sector.

Over the last years the retail sector in the Czech Republic has become more matured and saturated. The afflux of foreign investors wanting to benefit from the rising share of middle class confirms a huge potential which global chains targeted. The competition became relatively fierce which contributed to a decrease in margins or even some companies going out of business. The past difficult economic conditions have still negative effect on companies' financial results whereas a certain level of fixed investments is necessary to keep the market penetration at profitable levels. Although consumers are more willing to spend money than before they are still selective and relatively price sensitive, which does not leave much room for companies to increase their margins.

The retail sector should be ready to face changing behavior and preferences of customers. Increasing access to internet, rising preference for doing shopping online instead of the traditional way, opting for time and cost cutting measures will not make shopping malls collapse. However, retail companies should not exist in internet only with their webpages and social media relations. The effective penetration of consumer base should include e-shopping as an important part of company's business providing a wide online coverage of its products. Rebounding households' consumption is supportive for the retail sector in the Czech Republic. However it should be aware that it is still the **consumer's market**.

4 SECTORIAL RISK ASSESSMENT

Metals

In 2014 the steel industry recorded a slight improvement and more positive prospects. The global crude steel production amounted to 1.661 billion tons reaching a yearly increase of 1.2%. The EU production was 169.2 million tons, i.e. growth of 1.7% y/y. The increase of crude steel production in the Czech Republic exceeded the EU average and reached 3.7%. The Czech Republic is the second biggest producer of steel in the CEE region (next to Poland) and its productions amounted to 5.4 million tons in 2014.

The construction and automotive sectors are significant clients of steel industry. Whereas construction provides so far only minor signs of recovery in many economies, the automotive industry performs better supported by incentive schemes in some countries. Risk factors for the steel sector include the supply coming from external producing countries, like China, which meets a significant part of European demand. Facing a decrease of demand on the domestic market Chinese steel producers will be more willing to extend their exports. Beside overcapacities Chinese plants are being modernized and became more modern and effective. The comparative advantage of producers from outside Europe is further enhanced by the Industrial Emissions Directive (IED) implemented last year and forcing EU steel

producers to make significant investments on the environmental protection.

Transport

In the light of improved economic prospects the transport sector benefits from growing demand for its services. Nevertheless, the international exposition of Czech transport companies is relatively high – the share of international haulage takes roughly ¾ of the total breakdown. As a reminder the embargo implemented by Russia in August 2014 on meat, fish, fruit, vegetables, milk products from EU, US, Australia, Canada and Norway as retaliation for US/EU sanctions put a significant risk not only on producers and distributors of such products, but affect also the transport sector. The share of exports to Russia is relatively low; it took 3.7% in 2013. The most important trading partner is the Eurozone with Germany as the receiver of 31% of Czech exports. Therefore the weak recovery of the Euro area brings uncertainties for the entire transport sector. According to the latest Coface forecast the Eurozone GDP growth will reach 1.3% in 2015. If the Eurozone recovers its momentum, it would lead to better prospects for the transport sector. On the other hand, the sector benefits from decreasing oil prices which contribute to reduction of operational costs of transport companies.

Energy

The significant part of energy sector – the oil industry has recently experienced a period of plummeting prices. Since mid-2014 the crude oil price has decreased by 47%. Whereas a slump in energy prices is beneficial for households and companies' operational costs, business related to upstream oil operations could suffer from the current level of prices. For the biggest refining and petrochemical group in the Czech Republic Unipetrol's (a part of Polish Orlen Group) downstream segment significantly lower crude oil price generated a positive impact on margins. Moreover increased fuel consumption and acquired stake in Ceska rafinerska from Shell contributed to higher sales volumes in 2014. Crude oil producing companies are recording fall in profits whereas competition in the sector contributes to lower margins. The US shale gas revolution changed balances in the global oil market and impacted price levels which are now questionably profitable for American producers. Nevertheless, their flexibility in closing ineffective refineries will not push US refineries out of the global business.

| Czech Rep. Sectorial Risk Assessment | | | |
|--------------------------------------|------------|------------|------------|
| Sectors | Risk level | Sectors | Risk level |
| Mechanicals | ● | Agrofood | ● |
| Construction | ● | Chemicals | ● |
| Metals | ● | Wood Paper | ● |
| Transport | ● | Energy | ● |
| Automotive | ● | Services | ● |

● Moderate risk ● Medium risk ● High risk ● Very high risk

Sectorial risk assessment methodology

Coface's assessments are based on the financial data published by companies in respective sectors. Our statistical credit risk indicator simultaneously summarises changes in four financial indicators: turnover, profitability, net indebtedness, and cash flow, completed by the claims recorded through our network.

5 CONCLUSION

The Czech economy is finally recovering from recessive effects of fiscal consolidation. GDP grew by 2.0% in 2014 whereas a higher growth rate of 2.5% is forecasted to be reached this year. As a manufacturing hub for European brands, especially German ones, the Czech Republic benefits from becoming a significant part of supply chains. Although it still relies, for some part, on the assembly of foreign imported components and services, the Czech economy has undoubtedly benefited from the strong foreign presence. Domestic added value has risen with the higher sophistication of exports through significant technology transfers. Despite some challenges like the erosion of the working population, some delay in infrastructure development or insufficient Research and Development, the Czech Republic retains its competitiveness and remains attractive for foreign investors. The dependence on external demand is strong as exports take 84% of country's GDP what makes the Czech Republic subject to economic performance of foreign economies.

The Czech exports benefit from having a national currency – the Koruna. Its depreciation made exports more competitive and this is further supported by the strategy of keeping the CZK/EUR exchange rate over 27 through foreign exchange rate interventions. Despite positive effects of that strategy, exports dynamics have been declining gradually in the course of 2014. The disappointing recovery of the main trading partner (Eurozone) and the deterioration of trade to eastern directions had a strong impact. Nevertheless, Eurozone recovery should dwarf the negative impact of low volume of exports to Russia and insure positive growth levels for exports.

The domestic side benefits from growing private consumption. It results from increasing employment and supporting fiscal measures. The unemployment rate fell to 5.8% in December, i.e. the lowest level since 2009. Solid household spending and investment appetite will support the Czech growth this year. Positive prospects for the retail sector come also from consumer confidence indicators which jumped to a level last recorded in 2006 as well as the highest level in the CEE region. The consumers' willingness to make major purchases indicates that the improvement can be considered sustainable. On the other hand, the Czech retail market is relatively saturated. It is not only difficult for companies to enter the market but those already operating in retail can still find it challenging. Low margins and ambitions of cover-

ring a part of the market as huge as possible will result in consolidations of companies. At the same time it should be noted that the market is more matured and consumers are more demanding and selective. Retail companies should be able to address changing preferences of customers including rising propensity to use online shopping instead of visiting brick and mortar stores.

Contrary to the retail sector, the automotive industry is driven by foreign demand. Less than 7% of Czech passenger car production in 2014 was delivered to domestic consumers. Skoda is the biggest brand among car producers in the Czech Republic. Its global sales exceeded 1 million units last year with China becoming the strongest individual market where Skoda sold nearly a quarter of that amount. The brand popularity resulted in setting up overseas plants including in China, India and Russia. Although Skoda's production accounts for most of car manufacturing in the Czech Republic, foreign brands have also found the country attractive for assembling their cars there. Toyota, Peugeot, Citroen as well as Hyundai chose the Czech Republic thanks to its attractive labour costs, geographical proximity and high skilled labour force. The latter is supported by the educational aimed at training technical experts with expertise acquired in lots of automotive companies cooperating with universities.

The Czech automotive industry will benefit from relative good prospects for the car industry. Our risk assessment indicates moderate risk in the automotive sector. Global sales are increasing with the highest dynamics in emerging countries where a middle class is growing. Although the Chinese economy will be growing at a slower pace this year, dynamics of car sales will remain positive. The same does not apply to the Russian market where car producers will suffer from a decreased propensity to spending, slowdown of the economy and depreciated local currency. Several other sectors will be also impacted by consequences of Russian slowdown and tight relations with the EU. It includes not only sectors directly affected by Russian embargo and lower demand, particularly transports and agro-food but also industries using commodities imported from Russia. The dependence on Russian gas and oil remains important as 80% and 70% of Czech consumption of gas and oil are imported, respectively. On a positive note the Czech Republic imports only 25% of its total energy needs and some reroutes could be activated in a case of disruptions.

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