Czech Republic

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ECONOMIC OVERVIEW

After a slowdown in 2002, economic growth picked up in 2003 thanks largely to consumer spending, which rose by 5.4% year on year. Recent growth has been broader based than in previous quarters, with healthy increases in gross fixed investment and exports complementing consumer demand.

GDP AND CPI

Both the CPI and underlying indicators were following a gradual upward trend prior to 2002 when they abruptly tailed off. The low level of inflation is attributable to: 1) low production costs, 2) a sharp decline in food prices with retail chains applying pressure on suppliers, 3) limited rises in all other sales prices, and 4) the strengthening of the Czech crown, which led to a drop in import prices. The deflation observed at the beginning of 2003 was largely underpinned by declines in food and clothing prices.

Key economic indicators	1998	1999	2000	2001	2002	2003
GDP growth (%)	-1.2	0.5	3.3	3.3	2.0	2.9
CPI (%)	10.7	2.1	3.9	4.7	1.8	0.1

Source: Czech Statistical Office (CSO)

UNEMPLOYMENT

Average annual unemployment has risen from 6.1% in 1998 to 8.6% in 1999 and subsequently 10.2% by the end of 2002. The average for 2003 came in at 9.9% and the latest available data for the first quarter of 2004 shows unemployment of 10.7%.

This negative trend may reflect pressure on productivity growth following the strengthening of the Czech crown, as well as growing market competition. Average productivity growth increased from 1.3% in 2002 to 3.6% in 2003. This trend is expected to continue as a result of EU accession.

Area ('000 sq km): 78.87
(US 9,600 – EU 2,500 – World 133,700)

Capital: Prague

Population (million): 10.2
(US 288.4 – EU 305.5 – World 6,200)

GDP (USD billion): 69.5
(US 10,400 – EMU 6,600 – World 32,300)

GNI per capita (USD): 5,480
(US 35,400 – EMU 20,320 – World 5,120)

Currency: Czech koruna (CZK)

Language: Czech

Main religions: Roman Catholic, Protestant, Orthodox, atheist

Government type: Parliamentary democracy

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ECONOMIC FORECASTS

Economic expansion should continue to strengthen in 2004 and 2005, driven by the same components as in 2003.

In 2004 GDP growth is expected to exceed the level reached in 2003. After a period of deflation at the beginning of 2003, the CPI is estimated to reach 3.4% in 2004. This will be the determining factor for the future development of the Czech economy.

	2004	2005	2006
GDP growth (%)	3.7	4.2	4.4
CPI (%)	3.4	2.3	2.0
Unemployment rate (%)	9.8	9.7	9.6

Source: Economist Intelligence Unit (EIU)

REGULATORY ENVIRONMENT

FOREIGN DIRECT INVESTMENT

Of all countries with transitional economies, the Czech Republic is one of the most attractive to foreign investors. Following the privatization of formerly state-owned companies subsequent to 1990 and the introduction of investment incentives in 1998, the country has enjoyed a massive inflow of FDI, primarily from Germany, the Netherlands, Austria, France, the United States and Japan.

The inflow continued in 2003 despite the global downscaling of investments. According to the Czech National Bank, total inflow of FDI to the Czech Republic from 1993 to 2003 amounted to almost EUR34.6 billion. Equity capital investments for 2003 amounted to EUR145 million and total foreign direct investments including reinvested earnings and other capital represented EUR2.3 billion.

There are no significant restrictions in relation to FDI. The country's legislation does not restrict repatriation of capital or dividend payments on investments in the Czech Republic. This aspect further enhances the country's reputation as a secure location for investment.

The Czech government's policy of encouraging foreign investment reflects its desire to bring the country's economy into line with Western standards.

A special purpose agency, CzechInvest, was incorporated by the Ministry of Industry and Trade in 1993 to promote the country to foreign investors and to assist foreign investors in making their decision to invest in the Czech Republic. This effort lends support to the site development program and assists local suppliers in establishing relationships with foreign investors.

In 1998, the Czech government introduced the Czech investment incentives scheme for manufacturing companies, which was further refined by the Act on Investment Incentives and the Act on Public support, effective in 2000. CzechInvest has been made responsible for handling applications for investment incentives from local and foreign investors.

In 2000, the Czech government introduced an investment incentives scheme for strategic services in the telecommunications, software development and shared service center sectors through CzechInvest.

The cheap and efficient labor force, a relatively good infrastructure and incorporation into the EU has attracted the following investors in recent years: Honeywell, Panasonic, ExxonMobile, DHL, LogicaCMG, Olympus, Mercedes, EuropAssistance. Additionally, the joint car plant built by Toyota Motors and Peugeot in Kolin in 2002 has made the Czech Republic a major player in European car making industry.

EXPECTED IMPACTS FOLLOWING THE EU ENTRY

Following the country's acceptance as a candidate for accession into the EU, Czech legislation has been gradually amended to align with EU regulations. Core acts are now in harmony with EU regulations and accession on May 1, 2004 should not bring about any significant changes in the operating practices of Czech companies.

While competition on the Czech market after accession into the EU is expected to increase, the requirements of major retail chains are not expected to change. Integration of the Czech economy within the EU creates an excellent chance for Czech producers to enter foreign markets.

No customs controls or duties apply among member states and, when trading with non-EU states, EU customs duties and quotas apply. E-invoicing is generally accepted within EU countries, including the Czech Republic. There is a new system of excise duty warehouses that enables companies to store goods subject to excise duty (e.g. alcohol) in warehouses under the supervision of the customs authority. This system helps to reduce the price of stored goods. More goods and services are now subject to the standard rate than to the reduced rate.

There are no import declarations for goods coming from EU countries. However, there are new requirements for submitting reporting and compliance documentation when goods move between member states: EC Sales Lists and Intrastat returns.

To take advantage of persistent differences in retail prices between EU member states, two new purpose-built shopping malls have been opened near the Czech-Austrian border. These should effectively help to boost consumer spending in the cheaper Czech economy. Price differences in certain retail segments are even expected to affect movements of goods between the Czech Republic, Poland and Slovakia (similar to the situation in certain areas of Western Europe).

PROPERTY / REAL ESTATE REGULATIONS

The Czech property market attracts a lot of foreign investors and the retail property market has become rather competitive in and around the large cities. Increasing numbers of large international and national developers are seeking sites for new retail, business, industrial and logistics parks. New developments are subject to local authority zoning resolutions, Environmental Impact Assessments (EIA) and building permits. Certain areas and some industry sectors may also encounter difficulties from public pressure groups. This type of pressure can result in delays obtaining zoning and building permits, municipalities may refuse to approve building permits and companies may be obliged to invest in “community projects” in exchange for building permits.

Any company registered in the Czech Republic may acquire real estate without any limitations. Foreign companies can also be permitted to hold real estate through a Czech subsidiary. Purchases or transfers of real estate must generally be registered with the relevant Land Registry. The real estate transfer tax is 3% of the selling price or the officially assessed value, whichever is greater, and is paid by the seller. Annual real estate tax is levied on land and buildings, however this is generally of a low value.

OTHER REGULATIONS

Competition

The Czech Republic has established a number of regulations related to businesses operating in the country. Legislation relating to retail and consumer sectors includes the following:

Compliance with competition legislation (Act on Protection of Economic Competition) is monitored and institutionally assured by the Office for the Protection of Competition. The Office began operating under this name on November 1, 1996, when it took on the responsibilities of the former Ministry of Economic Competition. The Office was established to create conditions to protect and support competition, and to exercise surveillance over public procurement and other activities defined by Special Acts. The Office predominantly carries out monitoring and control exercises in the following areas: state aid monitoring, public procurement and, the introduction of heavier penalties for serious violations of the Competition Act.

Tax

In 2003 legal entities were subject to corporate income tax at the rate of 31%. Following recent changes in tax laws, corporate income tax will be reduced to 28% in 2004, 26% in 2005 and 24% for 2006.

During the course of 2004, several amendments were made to Czech tax legislation. A completely new VAT Act was passed shortly before the country’s EU accession. This new VAT Act contains numerous ambiguities that complicate the economic activities of

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businesses to a significant degree. It is anticipated that this act will be amended by the end of 2004.

In addition, the tax amortization period for shopping centers was extended from 30 years to 50 years. This change does not reflect the true life-span of shopping centers (namely hypermarkets) and will have a negative effect in particular on retail chains that are investing into the construction of new shopping centers.

Certain provisions that could complicate the commercial relationships between owners and lessees of shopping centres (namely with respect to fit-out works) or, for example, the tax deductibility of building infrastructure costs that have to be financed by retailers under the conditions imposed by state bodies for the issuance of construction permits for the shopping centres continue to remain part of Czech legislation. If these issues are not duly addressed by retailers at early stages, they could lead to significant, and often unnecessary, tax losses.

Store opening

There is no specific legislation covering shop trading hours, days of operation and price surveillance. Unlike retailers in many Western European countries, many Czech retailers operate seven days a week. Some shops are even open 24 hours a day.

DEMOGRAPHICS AND CONSUMER BEHAVIOR

POPULATION

Population evolution

	1999	2001	2002
Total population (million)	10.3	10.2	10.2

Sources: CSO

Based on the 2001 census, the preliminary estimated resident population of the Czech Republic as at March 2001 was 10.2 million. This indicates that the population has decreased by about 72,000 (- 0.7%) in relation to the previous census in 1991. If foreigners with permanent residency in the Czech Republic were excluded, the decline would be around a further 70,000 people greater. Further decreases in population are projected unless the Czech Republic opens its borders to immigrants.

About 16% of the population is aged 0-14 years and the proportion aged 65 and over increased from 11% in 1999 to almost 14% in 2002. According to the Czech Statistical Office, the median age increased from 37.3 to 38 between 1999 and 2002.

About 60% of inhabitants live in towns, the rest being in the country. According to the Czech Statistical Office, about 56.8% of inhabitants work in services and 39% in industry. The remaining 4.2% are involved in agricultural work.

Population by age group

Proportion (%) of population aged	1999	2001	2002
0 - 14 years	20.7	15.9	15.6
15 - 64 years	68.3	70.3	70.5
65 + years	11.0	13.8	13.9
Median age	37.3	37.9	38.0

Sources: CSO

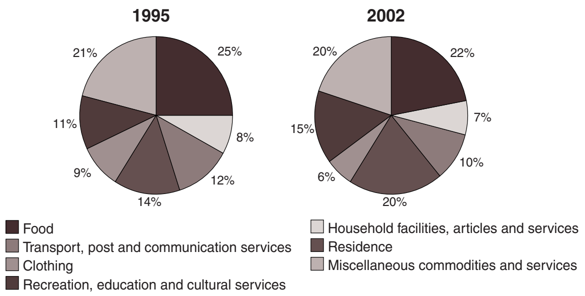
INCOME / BUYING POWER

The average monthly ordinary-time earnings of each member of an average household rose by 7% in 2003 to approximately EUR264; a full-time adult employee earned on average approximately EUR574.4 per month.

Household spending has continued to grow at a solid pace and consumer confidence has been high, despite the subdued labor market. Increases in household wealth, together with increases in income and the boost to spending power provided by lower interest rates and easier access to credit have underpinned the growth in consumption.

Consumer spending increased by 5.5% in 2003. Over the course of the year, household spending on goods increased modestly while spending on services grew rapidly.
The combination of higher consumer prices and slower growth in wages means that growth in consumer spending is projected to slow to only 2.9% in 2004 and 3.1% in 2005.

Composition of average household consumption 1995 and 2002



Source: Czech Statistical Office (CSU)

While food expenditure fell from 25% to 22% between 1995 and 2002, the proportion of household expenses increased from 14% to 20% over the same period.

CONSUMER BEHAVIOR

Retail chain expansion has significantly altered consumer behavior in the Czech Republic. Small outfits have seen a steady decline in sales as consumers switch to large shopping centers for food and consumer goods purchases. The Czech consumer is now similar in behavior to a Western consumer.

Following dramatic changes in the structure of the retail market in recent years resulting from a slowdown in the expansion of hypermarkets, the market position of certain retail formats has begun to stabilize and the shopping preferences of Czech consumers have become more distinct. Czech consumers may be divided into the following categories:

Consumer behavior categories

Behavior	% Of consumers	Overall shopping type (%)
Easily influenced shopper	15	Modern = 47%
Demanding shopper	16	
Mobile pragmatic	16	
Conservative and careful shopper	12	Traditional = 53%
Saver	13	
Loyal housewife	12	
Undemanding phlegmatic	16	

Source: Incoma Research and GfK Praha

While it is not possible to align one type of consumer behavior to a specific retail format – every format and retail chain has a specific customer structure – a combination of prevailing types can usually be distinguished for each format. According to the above research, modern consumers tend to stop in hypermarkets and cash & carry retail formats while traditional shoppers prefer convenience stores and counter-sales formats. This second type of store – the so-called “corner shops” – will typically sell a mix of food and non-food items and is present mainly in smaller towns or large city centers.

RETAIL & CONSUMER SECTOR PERFORMANCE

MAJOR CONSUMER GOODS PLAYERS

The major consumer goods industries of the Czech Republic include food and beverage and clothing production. One of the fastest developing industries is the production of consumer electronics.

Multinational companies that have invested large amounts of capital into local production capacities over the past decade are dominating the Czech consumer goods market.

The main reasons for this investment are low labor costs, a highly skilled work force, low operating costs and EU membership from May 1, 2004. This has made the Czech consumer goods market highly competitive and entrance rather difficult for companies that are not locally based. Given transportation and duty costs, imported consumer goods may not be able to compete on a price level with similar products manufactured in the Czech Republic. However, in some circumstances, quality and uniqueness can make up for these import drawbacks.

At the same time, imports of cheap and low quality goods from Asia have started representing a serious threat for producers in certain industries with price-sensitive consumers. Like many other countries, the Czech Republic has been swamped by cheap clothing imports from China, which creates significant competition for local producers. This trend is expected to stop now that the Czech Republic has joined the EU, because the EU restricts the minimum price and quantity of certain imports.

Food & beverages

Food and beverages represents a traditional manufacturing industry for the Czech Republic.

The beer market is the largest sub-industry of the beverages group in the Czech Republic. In 2003 the country had 54 breweries producing 18.5 million hectolitres, a rise of 500,000 hectolitres year-on-year. Leading companies in this market include SABMiller (breweries Plzensky Prazdroj, Velke Popovice, Radegast, Gambrinus), Interbrew (brewery Staropramen), state-owned Budejovicky Budvar, Heineken Group (Starobrno brewery) and Dr. Oetker (brewery Kralovsky pivovar Krusovice). These products are becoming increasingly popular on the international market. Export in 2003 increased by 8% compared to the prior year, reaching 2.13 million hectolitres.

Other sub-industries of the beverages group in the Czech Republic include the production of wine - mainly in the South-Moravian region (approximately 550,000 hectoliters a year with expected growth to 700,000 hectoliters a year), spirits (approximately 529,000 hectoliters a year) and soft drinks.

In terms of food products, the largest sub-industry in the Czech Republic is the production of meat and meat products, the main retailers being Kostelecke Uzeniny (meat products and poultry processing), Schneider Plzen (meat processing), Prochazka (meat processing) and Masny prumysl Krasno (meat processing).

Clothing

In 2003 sales in the textile and clothing industry decreased by 2% compared to the previous year to reach EUR1.97 billion. The clothing industry is labor intense, involving a high proportion of manual labor. With the clothing industry it is important to note the high level of cooperation with external customers, particularly from EU member states. This industry is most prevalent in the Vysocina, Moravia-Silesian and South Moravian regions. The most important domestic manufacturers of clothes include OP Prostejov (clothing), Triola (underwear), Otavan (work and, more recently, fashion garments), Pleas (leisurewear) and Jitex Pisek (garments made from yarns and knitted fabrics).

Electronics

Electronic goods manufacturing is one of the fastest growing industries in the Czech Republic; this growth is mainly driven by foreign investment. In 1996, Japanese Matsushita Electrics set up production facilities in Plzen and has since become the largest producer of consumer electronics in the country. Additionally, a number of suppliers of consumer electronics have invested in the Czech Republic; among others LG Electronics and Philips have invested over EUR200 million into building a TV tube production plant in Hranice na Morave.

MAJOR RETAIL PLAYERS

Retail sales

In 2000, retail space per 1,000 inhabitants was approximately the same as is available to inhabitants of other EU countries (up from 365 square meters in the 1980s to 1,000 square meters per 1,000 inhabitants in 2000).

In 2001 and 2002, Czech retail markets encountered significant development of hypermarkets and so-called “shop-in-shop” stores. Due to the development of hypermarkets and the reconstruction of building premises in the centers of large cities, there is sufficient retail space mainly for non-food retailers aiming to expand in the Czech Republic.

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Top 10 retailers

The major retail players in the Czech market have remained relatively unchanged over the last couple of years. In 2003, the market share of the top 10 retail companies in the Czech fast-moving goods market exceeded 53% and their sales growth came in at 5.4%, compared with 5.0% for the overall retail market increase.

Ranking	Group name	Store brands	Retail formats	Number of stores	2003 Sales (EUR million, incl. VAT)
1	Makro Cash & Carry CR (Metro)	Makro	Cash and carry	10	1,097
2	Ahold Czech Republic	Hypernova Albert	Hypermarkets Supermarkets	43 177	998(1)
3	Schwarz CR (Lidl & Schwarz)	Kaufland Lidl	Hypermarkets Discount stores	53 50	860(1)
4	REWE CR	BIG Billa, Billa Penny Market	Supermarkets Discount stores	72 131	700(1)
5	Tesco Stores CR	Tesco	Hypermarkets Department stores	16 6	599
6	Globus CR	GlobusBaumarkt Globus	Hypermarkets DIY	10 6	559
7	Tengelmann CR	Plus OBI	Discount stores DIY	104 16	544(1)
8	Delvita (Delhaize Group)	Delvita Proxy and Sama	Supermarkets Convenience stores	74 20	338(1)
9	Carrefour CR	Carrefour	Hypermarkets	9	307(1)
10	Spar CR	Interspar	Supermarkets Discount stores	14	276(1)

(1) Incoma Research Estimates
Source: Incoma Research

The table above shows how the multinational chains dominate the Czech retail market. Makro Cash & Carry, a member of the Metro group, became the market leader shortly after its entry in 1997.
Geco Tabak was ranked the 10th largest local retailer until 2002 and has gradually expanded its original activities of tobacco and wholesale press into a chain of newspaper stands in large shopping centers. Other local retail players include companies created from the former state-owned retail chains Jednota, Konzum and COOP partnerships.

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Food retail channels

Market shares by retail channels

(%)	Hypermarkets	Supermarkets	Discount stores	Convenience stores
2002	33	24	18	25
2003	39	19	20	22

Hypermarkets

Hypermarkets enjoyed their fastest growth in the Czech Republic at the end of 2001 and the beginning of 2002. Over the course of 2003, 25 new hypermarkets were opened in the country, taking the total to 145 at the end of the year. According to recent surveys, consumers continue to prefer hypermarkets. In 2003 their market share came in at 39% (up 6 points in relation to the previous year). This retail format dominates in the vast majority of cities with populations exceeding 20,000.

Top 10 locations in terms of hypermarket surface area per inhabitant

Location	Sales area of hypermarkets per 1,000 inhabitants (in square meters) as on January 1, 2003
Ústi nad Labem	239
Hradec Kralove	185
Ostrava	177
Pardubice	145
Mlada Boleslav	131
Teplice	121
Opava	102
Decin	99
Prostejov	91
Olomouc	91
Czech Republic average	**62**

Sources: Incoma Research and GfK Praha

Supermarkets

Supermarkets remain the most common shopping format in Prague. However, their share of total retail sales decreased to 19% in 2003 (down by 5 points compared to 2002). Among the largest supermarket chains are Billa, Delvita and Spar.

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Convenience stores, small food stores

The self-service and counter-sale formats have seen their market share fall considerably, from 55% in 2001 to 22% in 2003.

Discount stores

Discount stores are targeted by price-sensitive shoppers who represent 20% of households (up by 2 points compared with 2002). This retail format is most popular in towns with populations of between 5,000 and 20,000 and its popularity is expected to rise over the coming period. Discount stores operating in the Czech market include Penny Market, Plus Discount, Kaufland and, from June 2003, the German discount retail chain Lidl. The opening of 50 new discount stores and the competitive prices introduced by Lidl on the Czech market represent tough competition for the established discount store operators.

Non food retail channels

Specialists retailing in the Czech Republic include groups and alliances of retailers and related businesses, functioning as a franchise or similar concept under one brand name. This system is popular for many types of goods ranging from drugs to construction materials, and clothing to specific types of food.

DIY

Do-it-Yourself (DIY) stores are very popular among Czech households and small local construction companies. As far as total turnover and total sales area are concerned, the DIY market is dominated by OBI, a chain of 16 stores (Tengelmann CR). Baumax, on the other hand, has the highest number of stores of all DIY chains with 23 stores. Hornbach stores have the largest average store sales area with four stores in the Czech Republic currently generating 10% of their worldwide turnover. Bauhaus, Globus Baumarkt and Mountfield (specialized in selling gardening tools and machines) complete the picture for players operating in this segment.

Electronics

Significant changes have been observed in the electronics segment. Following an aggressive price war among electronics retailers, Electrocity (owned by Europe Technic) withdrew from the Czech market at the beginning of 2004. Current market players include Electro World (Dixons), Datart (Kingfisher), Okay Elektro and, more recently, the Hele alliance, which is formed from approximately 300 smaller independent stores. The Hele alliance, which controls over 10% of the market, has developed advantages by centralizing procurement and promotion functions, and establishing common transport and warehousing systems.

Drugstores

Major pharmaceutical retailers mainly consist of foreign companies Drogerie Markt, The Drogerie (Droxi stores), Rossmann and p.k.Solvent (Teta drogerie stores). Schlecker, the discount drug store, is also expected to expand into the Czech market.

Other specialty stores

Recent newcomers to in the fashion store segment include Takko with two stores in Prague, Deichmann with one store in Plzen (shoes) and Debenhams in Prague (opened in May 2004). All these newcomers expect to expand further into the Czech market in the near future. Specialist sport fashion and equipment retailers include Gigasport (Kastner + Ohler) and, as of 2003, Hervis with one store in Prague.

Fierce competition has also been observed among low cost furniture retailers like Ikea, Sconto Nabytek, Asko Nabytek and Europa Mobel.

E-commerce

The largest domestic Internet shop, Internet Mall, saw a fourfold increase in revenues in 2003. The other two players in this market are Obchodnidum.cz and Internet Shops group. With total Internet sales up by 50% in relation to the previous year and more than 1.5 million customers, the Internet has clearly become one of the most widespread retail channels. The majority of goods sales handled over the Internet are generated by books and electronics. Meanwhile, internet services are dominated by accommodation booking and the purchase of goods via Internet auctions.

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RETAIL & CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

CHALLENGES

Retail chains' pressure on local suppliers

The strong position of retail chains in the Czech market allows them to put greater pressure on local suppliers. As a result, suppliers have to face smaller margins and longer credit periods. On the other hand, suppliers will be able to take advantage of their experience negotiating with the retail chains now that the country is part of the EU.

Trade Unions' pressure

The Czech Confederation of Commerce believes trade unions will have more power following the country's accession into the EU and that the unions will attempt to regulate the currently flexible company opening hours and align Czech labor legislation with that of some of the less liberal EU members. This is expected to result in additional costs to retailers; there will be stricter rules on paying overtime and retailers will need to employ more staff.

OPPORTUNITIES

Shopping centers

New shopping centers are not only being built on the outskirts of large towns but also in town centers. The number of projects offering other facilities such as multiplex cinemas, restaurants, leisure activities and petrol stations alongside core retail activities, has increased significantly over the last five years. The boom is attributed to the popular global trend of "fun shopping" or "destination shopping". While the largest number of such projects has been completed in Prague, the trend has started to catch on in other cities.

Small & medium cities

Given that all major players entered the most lucrative parts of the country first, hypermarket penetration differs considerably from region to region. This means there is further expansion potential in the remaining local markets that are currently controlled primarily by small-format shops.

Quality expectations

Shopping centers will have to refocus their strategy from quantitative growth to quality development aspects. In essence, customers will start to opt for complexes offering varied shopping, restaurants and entertainment facilities in addition to hypermarkets.

Retail brands

The analyses show that there is huge potential for retail brand products. Furthermore, retail brands allow retail chains to distinguish themselves from the competition and improve customer loyalty.

EMERGING TRENDS

Change in focus

The expansion of food retail chains and corresponding revenue growth have already started to slow as the market reaches saturation. Given that fast-moving consumer goods now offer only limited scope for further sales growth, the focus will have to shift to increasing revenue per square meter. Non-food retail specialty fashion, shoes and furniture chains are expected to register significant growth upon the Czech Republic's accession into the EU.

Hypermarkets have already started adapting to this trend by attaching equal importance to non-food goods – these goods previously only existed to complement the food ranges.

Since 2003, there has been a marked rise in interest for building stores in areas that have previously been ignored. Both hypermarket and supermarket concepts are being scaled down to make them feasible to operate in areas where customer numbers are smaller.

Increasing pressure on prices

Electro World (Dixons), which entered the Czech consumer electronics retail market in late 2002, has placed significant downward pressure on prices. Pressure has also been encountered in the food sector with Lidl introducing the first hard discounts in 2003.

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