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Slovak Republic

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ECONOMIC OVERVIEW

Slovakia is beginning to achieve its deserved recognition at an international political and economic level, particularly with its entry into the European Union (EU) in May 2004. Economic reforms have been systematically put into practice during the past several years to increase economic levels nationwide and decrease regional disparities. In addition to increasing the country's standard of living, the reforms have focused on supporting high and sustainable economic growth. These reforms, which started in 2003, include changes to tax, pension and health systems in order to consistently achieve parity with the EU standard of living. Improvement of the business environment is another essential component for increasing competitiveness, efficiency and economic productivity.

GDP and CPI

GDP growth in 2004 was the greatest in four years and was influenced by several factors. In spite of the EU's unfavourable situation in 2003 and the possible stagnation of its economic development, the Slovak economy experienced growth mainly due to the demand from outside the country.

The substantial difference between the price levels of 2002 and 2003 was due to a variation in price regulations and an increase in indirect taxes. Price development in 2003 was influenced by contradictory domestic and external factors. While domestic factors influenced mainly the increase of price levels (administrative measures implemented to modify the regulated price, changes in consumer tax levels, increase of VAT), external factors exhibited a muting effect (a strengthening of exchange rate). Falling food prices primarily caused the fast deceleration in headline inflation rate. Due to increasing competition in the food retail market and last year's favourable harvest, food prices have declined month-on-month since July 2004.

GDP and CPI

	2001	2002	2003	2004
GDP growth (%)	3.8	4.6	4.5	5.5
CPI (%)	7.1	3.3	8.6	7.5

Source: EIU, August 2005



Area ('000 sq km)¹: 49

(US 9,600 – EU25 3,981 – World 133,700)

Capital²: Bratislava

(Number of inhabitants: 428,672)

Population (million)³: 5.4

(US 293 – EU25 456 – World 6,376)

GDP (USD billion)³: 41

(US 11,735 – EU25 12,723 – World 39,503.5)

GNI per capita (USD)¹: 4,940

(US 37,870 – EU25 22,810 – World 5,110)

Currency: Slovak Koruna (SKK)

Languages: Slovak (official), Hungarian

Main religions: Roman Catholic (60.3%), Protestant (8.4%), Greek Catholic (4.1%)

Government type: Parliamentary democracy

Sources: CIA Factbook; (1) World Bank 2005; (2) City Population; (3) Economist Intelligence Unit 2004 data

Unemployment

The private sector, especially industry, compensated the rise in unemployment as the state administration and other public sectors lost some jobs. This is primarily due to foreign direct investments, mainly in the automotive industry, and the improved business environment.

Unemployment

	2001	2002	2003	2004
Unemployment rate (%)	18.3	17.8	15.2	14.3

Source: EIU, August 2005

Economic forecasts

The EIU expects the Slovak economy to grow by 5.3% this year and 5.6% in 2006. The expansion in domestic demand that began in the first half of 2004 has gathered pace and GDP growth is expected to remain in the 4-6%

range over the projection horizon. Financial analysts say that private consumption will push the growth. Real GDP growth this year and the beginning of next will probably be driven by domestic demand, especially investment and private consumption. Further ahead, in 2007 and 2008, significant contribution to growth will come from the rise in export capacity connected to the production of newly established FDI-controlled manufacturing plants. Wages in real terms probably grew around 7% in the first quarter of 2005 and our forecast for the full-year should gain around 5%, about twice as much as last year.

Key economic forecasts

	2005	2006	2007
GDP growth (%)	5.3	5.6	5.4
CPI (%)	2.9	2.8	2.3
Unemployment rate (%)	15.0	14.3	14.1

Source: EIU, August 2005

REGULATORY ENVIRONMENT

Foreign direct investment

The World Bank rated the Slovak Republic as the most reformed country in terms of its investment environment. Slovakia was included among the 20 leading world economies, which created favourable conditions for business. It is expected that this will be reflected in consecutive increases in economic growth.

Slovakia's favourable conditions include the elimination of administrative barriers that presented a hurdle for establishing and starting new companies; increased flexibility in labour market relations; a streamlined tax system; decrease of direct taxes; and investment incentives that gave investors the opportunity to create new jobs. Reforms undertaken so far have led to increased stability in the economic environment and growth. Many reforms are breaking new ground in Europe (retirement and social reforms, introduction of the flat income tax and VAT) and, thus, have significantly increased the attractiveness of the Slovak business environment, strengthening Slovakia's position in Central Europe.

The amount of foreign direct investments (FDI) in Slovakia is growing steadily. It offers the good investment environment with qualified low-cost labour, low tax burdens, a strategic position in Europe and an industrial tradition. Germany is the leading investor country, with the largest amount of FDI going to the manufacturing industry and the Bratislava region. (In administrative terms, Bratislava, the capital city, is divided in five districts and 17 city parts.)

FDI

	2001	2002	2003	2004
FDI (SKK bn)	42.11	114.09	16.78	31.58
FDI (USD bn)	1.48	4.01	0.59	1.11

Source: EIU, August 2005 (Exchange rate: December 31, 2004)

Impact following EU entry

The impact so far has been positive, with increased FDIs, higher utilisation of EU funds, improved position of agricultural entities, higher competition in the market and improved purchasing power for customers.

Property/Real estate regulations

The tax reform put into effect in 2003 intended to eliminate the shortcomings of the tax system. The basic goal of the reform was to shift the tax burden from direct to indirect taxes. The reform is part of a set of broader reforms focusing on stabilising and increasing the attractiveness of the business climate. The goal is to introduce economic incentives that will lead to higher and more sustainable economic growth.

A significant factor for improving the quality of the business environment was the introduction of the flat tax, meaning all income and profit made by businesses and individuals will be taxed at the single rate of 19% - one of the lowest rates in the EU. It is because of this that Slovakia is often called the Ireland of Central Europe.

Slovakia cancelled taxation of dividends, which resulted in lower taxes for companies and enabled them to reinvest their disposable resources. Slovakia is the only country in the Visegrad Group (the V4 includes Hungary, Poland, Czech Republic and Slovakia) that completely withholds dividend taxation.

In the area of property taxes, the reform cancelled heritage and gifts tax because they were viewed as double taxation. Indirect taxes were unified at a single rate of 19% VAT.

Another positive aspect of the reform was the significant simplification of the entire tax system, which eliminated an abundance of exemptions, such as income items that are not really a part of taxable income, and so on. Reform steps also have had an impact on employers who now pay lower deductions. However, deductions for employees have risen slightly. The retirement age for men and women will gradually increase to 62. Simplicity of the system together with the low rate represents the advantages that Slovakia has compared with other countries.

Entrepreneurs, as well as many international institutions including the World Bank and OECD, see the business climate in Slovakia as constantly improving. One of the reasons for this is the elimination of various administrative barriers to operating a business. For example, legal

measures have increased the effectiveness of the Commercial Register and sped up and simplified the entire registration process. The Commercial Register Law contains a clause about a fixed, five-working-days time limit for company registration, provided that the application is correct and complete.

Another step to eliminate administration barriers is the accessibility of the Cadastre of Real Estate on the internet, which should eliminate the long processing times at cadastre offices.

Businesses embraced enactment of a broad amendment of the Labour Code, which moved industrial relations closer to market principles. There is now more flexibility in hiring and firing employees. Industrial relations should be as flexible as possible to enable both affected parties to react to a situation in the market. Absence due to illness was reduced because of a regulation that requires employers to pay benefits only during the first 10 days of sick leave.

Other regulations

Tax and VAT

The new Income Tax Act regulates personal and corporate income tax and includes many significant changes. Both personal and corporate income tax is fixed at a flat rate of 19%. There is no tax on dividends, whether received from a resident or a non-resident company (dividends paid out of profits earned after 1 January 2004).

A 3% real estate transfer tax was levied on the sale or transfer of real estate until the beginning of 2005 when it was abolished. Real estate tax includes tax on land, buildings, on apartments and non-residential premises in an apartment house, common premises of an apartment house and common facilities of an apartment house and parts thereof.

Tax on land rates depends on the type of the land or building. Annual tax rates are up to 0.25% or 0.75% of the tax base (arable land, hop yards, vineyards and fruit plantations; permanent lawns; forest land with forest plantations for business purposes, ponds with fish-breeding farms, and other lakes used for business purposes); 0.10 SKK for each sq m or part of it (gardens, built-up areas and courtyards, areas other than building land); and 1 SKK (building land).

The annual tax rate of land is multiplied by a given coefficient. The coefficients range from 1.0 up to 4.5 according to the number of inhabitants (1 for smallest villages and 4.5 for Bratislava).

Road tax is levied only on specific road motor vehicles and trailer vehicles used for, or in connection with, business

activities. The road tax also applies to those taxable persons who use motor vehicles for both private and business purposes.

Value Added Tax in the Slovak Republic includes one unified tax rate of 19% applied to all taxable supplies.

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

Population

After a three-year decline, there was a slight natural increase in the Slovak population to almost 5.4 million people. The average age of both women and men in Slovakia is rising. The life expectancy for men has, for the first time in Slovakia's history, crossed the 70-year mark; for women it is approaching the 78-year mark. However, the positive trend reflected in the growing population is, according to prognoses, temporary. By 2050 Slovakia will have reduced its population by almost 12% to 4.7 million, according to the EU.

Population evolution

Population

	2001	2002	2003	2004
Population (m)	5.4	5.4	5.4	5.4

Source: EIU, August 2005

Population by age group

Age profile

% of total population	1998	2003	2008 (f)
0 – 14 years	20.7	17.8	15.7
15 – 64 years	68.0	70.5	71.9
Over 65 years	11.3	11.7	12.4

Source: EIU, April 2004

Urbanisation of the population

Urban/Rural split

% of total population	1998	2003	2008 (f)
Urban	57.2	58.0	59.0
Rural	42.8	42.0	41.0

Source: EIU, April 2004

Income/Buying power

The Slovak labour force is one of the least expensive in Central Europe, with comparable productivity levels that keep increasing. The cost of labour and the average wage is several times lower than in the EU, with an average nominal monthly wage of SKK14,541 (EUR358). However, there are regional differences in the average wage. In Bratislava and its surrounding areas, the average monthly wage is 34% higher than the national average. The highest wages, at SKK32,631 (EUR804), are earned in financial services and exceed the national average by more than 120%. The minimum wage in Slovakia is SKK6,500 (EUR163), which is approximately 42% of the average. This is the third-lowest minimum wage in the EU and the lowest in the V4 countries.

Annual average income, expenditure and savings rate per capita

	2001	2002	2003	2004	2003 – 2004 (%)
Income (SKK)	89,347	94,030	99,443	105,728	1.06
Expenditure (SKK)	88,052	91,149	97,132	107,042	1.10

Source: Statistic Office

Consumer behaviour

Average household spending patterns

As a share of total spending, food consumption, will remain high. Consumer spending on food, beverages and tobacco is forecast to rise strongly from 2005-09 in line with a rise in private consumption per head from an estimated EUR3,437 in 2004 to EUR5,595 by 2009. The large rise is partly attributable to exchange rate effects, yet the retail market for food, beverages and tobacco will remain about one-third smaller than in EU countries such as Denmark and Finland that have similar-sized populations. Incomes are forecast to remain disproportionately concentrated on basic items such as food, with food expenditure as a percentage of total household spending to decline modestly to 23% by the end of the forecast.

In 2004, household expenditure rose by 7.5%. This year's growth in household consumption is expected to slow to 4% and 3% in 2006.

Wages accounted for the larger share of income (50.9%) with the remainder coming from mixed income, social benefits and income from property. The high headline inflation, however, meant that real income actually declined by 0.3% year-on-year (YoY) for the period.

More importantly, the household income data clearly shows the favourable effect of the tax reform on living standards. While real current income fell, real disposable income increased by 3.2% YoY on account of the slow growth of household tax payments. Thus, in our opinion, the implementation of the flat tax rate from the beginning of last year contributed for the relatively high economic growth during the period by stimulating private consumption.

Another factor was the change in the use structure of household income, with a higher share going on consumption than on saving, compared to the corresponding period of 2003. In part, this explains the widening of the current account deficit as more foreign savings were needed to finance domestic investment. Purchases of food represented the main consumption expenditure during the period (25.3%), while households spending on health care exhibited the fastest growth of 31.6% YoY.

Lifestyles/Shopping habits

In the food market, 57.2% of people spend most of their grocery money in hypermarkets, 22.1% in supermarkets, and only 8% in self-service shops in 2004. Last year's survey showed that, in 2003, 28.5% of the participants bought food in self-service shops as compared to 27.7% in supermarkets and 14.5% in hypermarkets.

RETAIL & CONSUMER SECTOR PERFORMANCE

Major consumer goods players

Electronics

Slovak companies in the electrical engineering industry closed 2004 with a pre-tax profit of SKK2.95 billion, which represented a significant drop from SKK4.85 billion in 2003. Total revenue in the sector without VAT and excise taxes totalled SKK107.02 billion, rising by SKK30.92 billion from 2003. Costs in the sector increased by 39.5% to SKK116.07 billion and revenue grew by 35.1% to SKK119.03 billion. Last year the number of employees in the sector slightly increased to 54,018 compared to 50,630 in 2003, while the average monthly wage grew by 10% to SKK15,238. The productivity of labour from sales per employee increased by 31% to SKK1.98 million. Investments per employee reached SKK212,800 in 2004 compared to SKK109,500 in 2003.

Clothing

Clothing companies (members of the Slovak association of textile and clothing industry, ATOP) reported sales from own products and services in total of SKK2.51 billion. The final result was a total loss of SKK69.8 million. Total revenues of companies reached SKK2.75 billion, added value amounted to SKK1.34 billion. Total revenues were influenced by increasing imports from China. The sale of products was SKK2.496 billion in 2004; of this more than 85% was exported. Domestic sales achieved were SKK358.4 million. Companies in the clothing sector employed 7,150 people at the end of 2004, with an average salary of SKK10,331. The list of clothing companies includes Ozeta Neo, OZKN Prešov, Odeva Lipany, Svik Svidník and Vzor Zvolen.

Major retail players

Retail sales

Total retail sales growth

	2001	2002	2003	2004
Total sales (EUR bn)	2.6	3.2	3.6	3.7
Growth rate (%)	13.7	12.3	11	2.8

Source: TERNO (market research agency)

Breakdown by number of stores

Number of stores	Hypermarkets	Supermarkets	Discount stores	Convenience stores
2004	77	238	63	1,875
2003	57	204	31	2,217
2002	50	255	49	2,496

Source: TERNO (market research agency)

Food retailers

Key food retailers

Retail formats	Group name	Store brands	Number of stores (2004)	2004 net sales (EUR m)
FOOD				
Hypermarkets	Tesco	Tesco	25	492
Hypermarkets	Carrefour	Carrefour	4	158
Supermarkets	Billa	Billa	65	268
Supermarkets	Ahold Retail	Hypernova	19	163
Discount	Schwarz	Kaufland	23	210
Discount	Schwarz	Lidl	39	N/A
Convenience stores	M-Market	M-Market	122	126
Convenience stores	COOP Jednota	Jednota	More than 2,300*	789*
Cash & carry	Metro Cash & Carry	Metro	5	326
Cash & carry	Prima Zdroj Holding	Prima Zdroj	87	N/A

*2002 data

Source: Annual reports

Structure of retailers

	2003 (%)	2004 (%)	2004 Sales (EUR m)
International companies	16	26	2,000
COOP associations	50	38	700
Slovak companies	34	36	1,000

	2004 Sales (EUR m)
Retail	2,500
Cash & carry	580
Wholesale	690

Source: TERNO (market research agency)

Key specialty stores

Retail formats	Group name	Store brands	Number of stores (2004)	2004 net sales (EUR m)
SPECIALTY STORES				
DIY	Baumax	Baumax	10	96
Electrical	NAY	NAY	13	84
Textile	Quelle Neckermann	–	1	34
Electrical	Datart	Datart	7	34
Furniture	Ikea	Ikea	1	29

Source: TERNO (market research agency)

Food retail channels

Supermarkets and hypermarkets are increasingly crowding out small retailers, especially self-service food shops. A record number of new hypermarkets were opened in Slovakia in 2004 compared with the previous years, most of them being smaller hypermarkets not exceeding 3,500sq m in area. There were 18.5 hypermarkets per one million inhabitants in Slovakia last year, a ratio comparable with neighbouring countries. Sales area of Slovak retailers grew by almost 200,000sq m last year. The top-ten retailers increased their sales area by 69,000-616,750sq m.

Retail chain Tesco Stores maintained its top position among Slovak retailers by sales last year, boosting them 5.1% YoY to SKK18.7 billion. Metro C&C, which raised 2004 sales by 14.1% in the year to SKK15.5 billion, came second, followed by Billa with sales worth SKK10.2 billion, up by 9.6 % against the previous year. Sales of the ten biggest retailers in Slovakia increased by 6.1 % to a total of SKK80.4 billion last year. The turnover of multinational chains grew in 2004, while the sales of Slovak companies remained flat.

Food retail sales in 2004 (among top-50 retailers)

	2004 Sales (EUR m)	2004 Sales (%)
Hypermarkets	875	49.3
Supermarkets	750	42.2
Discounts	150	8.5
Total	1,775	100

Source: TERNO (market research agency), converted from SKK at 40SKK/1EUR annual exchange rate

Non-food retail channels

In 2004, other progressive changes occurred in the non-food trade. Besides the increased total turnovers of dominant players on the market and other steps leading to the concentration of previously independently operating retail businesses, there were many changes in the assortment offer. Statistical reviews show that the highest growth in expenses was reported in household equipment and common consumer goods. It seems that Slovaks, on top of buying day-to-day products and running households, also started investing money into durable goods, thus, increasingly accepting the lifestyle of European countries. However, in addition to household purchases, increasing trends in hire purchases contributed significantly to higher sales. In the previous year, the aggressive offer of hire-purchase companies could manifest itself in the population's attitude towards purchasing non-food products.

Large-scale shopping centres or department stores offer the largest variety of goods and a complete assortment of non-food products. While Baumax, NAY and IKEA shopping centres and large-area department stores such as Datart and Intersport dominated in Slovakia in 2003, this shopping network was even more extended last year. In the middle of 2004, the German Hornbach opened its first large-scale shop with an assortment of goods for homes, gardens and DIY. The Gigasport network started offering sports equipment, Europa Möbel furniture, thus we could have a wider selection.

After years of chaos, retail businesses with non-food products were organised more logically in the new millennium. Large-scale shops are built near main thoroughfares, or as part of a shopping or entertainment centre, thus creating a desirable shopping atmosphere with a full scale of branded and specialised outlets. On the other hand, groupings of independent businesses offer a large assortment of everyday items and household products under a common marketing strategy in smaller Slovak towns or villages.

E-commerce

The estimated number of internet users in Slovakia increased by 86% YoY to some 2.4 million in 2004, according to the country's Telecommunications Office. The Slovak Telecommunications Office expects a further rise in the number of local internet users in 2005. The

total number of internet access service subscribers in Slovakia increased by 106% YoY to 386,900 in 2004. A total 48.2% Slovak citizens over the age of 15 have access to the internet. Most Slovaks access the internet from work and only 13.4% can access it from home. The capital Bratislava and Kosice in eastern Slovakia, have the country's highest internet penetration rates.

M&A activity

M&A activity in 2004

Year	Acquiring company	Acquiree/JV company	Nature of business	Equity stake
2004	Billa	Delvita	grocery	N/A

Source: PwC Slovakia

RETAIL & CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

Challenges

New retail chains

New retail chains arriving in Slovakia are following Lidl's strategy in the retail discount chain sector. On the contrary there are anticipated closings of some unprofitable stores. The arrival of the retail discount chain Lidl to Slovakia was a much-expected event. Kaufland is planning further expansion in 2005. Aldi is also planning to enter the market through its Hofer hard discounters.

There is still place in Slovakia for both the arrival of new retail chains and the growth of established companies. The average selling area in Slovakia is not even half of the EU standard. Slovakia is missing improvement in distribution network quality. Stores with domestic capital need investment for reconstruction and survival is dependent on trading alliances.

Local retailers strategy against competition

Coop Association does not plan to open hypermarket-like stores, but it is going to restructure its retail network. It may close small stores, restructure, expand, and build new supermarkets. In 2004, it recorded a drop of turnover, but the number of customers stayed the same, giving it hope for the future.

Opportunities

Hypermarkets

Hypermarkets in Slovakia should increase their dominance even more this year, as they open new stores. Regarding small shops, which face evermore competition from discount stores such as Lidl or Kaufland, the only survivors will be those that do not try to make a large profit at their customers' expense.

Market leader Tesco has 25 hypermarkets and five departmental stores in Slovakia. In 2004, it opened seven new hypermarkets. Tesco's new distribution centre in Beckov (Trencin region) will be its largest investment in Slovakia. The distribution store for non-perishable groceries, industrial products and textiles will be finished in June 2005 and will create 400 jobs.

Middle or small stores in shopping centres

Major retail stores have already entered the biggest cities. The only space left is for small and medium-sized businesses that are looking to work with other companies in order to provide other services to customers. An example is Tabak Barczi, which is one of the top ten Slovak companies. As a result of its cooperation with shopping centres, it has shown that even a small player on the market can be successful.

Cost of labour

The hourly cost of labour is about EUR3.3 – the lowest among the V4 countries. Slovakia also offers a 42.5-hour working week, comparable with those of other countries. In 2003 and the first months of 2004, the growth of productivity was higher than the growth of wages, which signals a very positive development. It is expected that productivity will continue to exceed the growth of wages. Real wages will grow in the future, but they are not expected to exceed the growth in productivity.

Emerging trends

Small hypermarkets

Even supranational chains want to meet customers' requirements, changed strategy from building big hypermarkets with selling areas of 7,500-12,000sq m to building smaller formats with selling areas of around 3,500-5,000sq m. Companies react to the economical potential of inhabitants in smaller cities and regions with higher unemployment, they also react to shopping habits in each area. In small cities they need to offer wide ranges of merchandise and to compete on price through discounts.