

## **IV. Structural changes yielded profits of hundreds of billions for companies in the Czech economy**

Expansion of companies financed from outside financial resources and shareholders' equity and reserves yielded profits of hundreds of billions. Owing to structural changes, the corporate sector has seen a dramatic improvement since the second half of the 1990s, as regards financing from shareholders' equity and reserves and from outside financial resources: while in 1997 outside financial resources (limited to long-term and short-term liabilities in terms of bookkeeping) amounting to CZK 100 generated a loss of CZK 4, the same amount of finance in 2004 yielded a profit of roughly CZK 12. What significantly decreased between 1997 and 2004, however, is the weight of bank loans in the total of outside financial resources for financing companies in the Czech Republic. At the same time, there was a marked increase in the use of suppliers' credits and alternative sources of financing, namely in that part of the corporate sector which is not Czech-owned.

### **The turn from loss to profits**

A comparison within the period of years 1997-2004 shows a significant shift in corporate management in the Czech economy. According to annual figures<sup>4</sup>, the corporate sector<sup>5</sup> (excl. companies of financial intermediation) reached a profit in excess of CZK 278.5 billion in 2004. Companies controlled by domestic capital made a profit of CZK 128.1 billion, i.e. nearly half of the total amount goes to Czech-owned companies. The period 1997-2004 thus saw a significant change towards profit making: in 1997, for which the first comparable data on the corporate sphere are available, the corporate sector as a whole made a loss of CZK 59.7 billion. This loss is by far attributed to domestic private companies, which were CZK 55.1 billion in the red in 1997.

### **Structural changes of ownership and industries**

For a relatively long period of time covering at least the first half of the 1990s, the Czech economy was actually untouched by structural changes. In spite of the waves of voucher privatisation, strategic investors with a clear plan for the company's future were missing. The absence of structural changes was proved among other things by relatively low unemployment rates. Structural changes were delayed also by a number of failed sales to companies' management, bankruptcies and instances of tunnelling out investment funds. Structural changes at the micro-level, which usually comprise the application of clear ideas for the company's future (market-attractive production programme, cutbacks in inefficient production, optimal number of workers, cost cutting in general, maximal efficiency of resources, etc.) were followed by structural changes at the macro-level resulting in changed weights of individual economic sectors (the fast growing share of services) and industries ("lightening" of the Czech economy).

While in 1997 the aforementioned total loss of the corporate sector was accompanied by bank loans for companies totalling CZK 830.7 billion (of which CZK 590.9 billion was granted to domestic companies) and the bank loans in relation to short-term and long-term corporate liabilities thus made up nearly a half (48.7%), the gap between the two types of outside financial resources used for financing enterprise widened further in 2004. While the amount of bank loans decreased (CZK 690.3 billion), the volume of short-term and long-term corporate liabilities grew to CZK 2,629.0 billion – and bank loans in relation to them made up roughly as little as a quarter (26.3%).

At the beginning of the 1997-2004 period, economic results of the corporate sector were unfavourably affected also by the high price of money required by commercial banks for granted loans (in the first half of the 1990s, interest rates on client loans provided predominantly by small and medium-sized banks were well above 10% p.a.).

As to the corresponding figures for the sphere of domestic private companies, there was a fall from 48.3% in 1997 to 21.8% in 2004. They suggest that the shift of financing towards bank loan alternatives took place above all in that part of the corporate sector which was not controlled by domestic capital, because, seven years later, purely domestic private companies report nearly the same volume of short-term and long-term liabilities (CZK 1,251.2 billion in 2004 as against CZK 1,222.4 billion in 1997). The "rest" of the corporate sector, which besides foreign-controlled companies also includes so-called public enterprises with steadily decreasing share in the economy, thus obviously uses alternative sources of financing much more intensively.

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<sup>4</sup> Based on data from statistical reports used by the CZSO for collecting selected data from balance sheets – the years 1997 and 2004 were taken with regard to availability (1997 was the first year for which data from statistical reports were available, 2004 is the last year for which semi-definitive data are available after refinement of preliminary data). The data source were annual reports P5-01, section A037, item economic result of current year (at current prices), equity capital and total liabilities. The set of companies includes all legal entities incl. natural persons using double-entry bookkeeping according to CZ-NACE divisions (two-digit level), aggregates for CZ-NACE sections and subsection. Data on enterprises with 100+ employees are collected by a 100% survey, on enterprises below 100 employees by a sample survey with subsequent imputation, and on enterprises below 20 employees through estimates.

<sup>5</sup> To comply with the need of distinguishing domestic enterprises, the set was divided by institutional sectors, namely into i-sector of public enterprises, i-sector of private national enterprises and i-sector of private foreign-controlled enterprises. The share of i-sector Employers and self-employed persons is small as regards the volume of liabilities, equity capital and economic results as well.

## **Strengthening productivity of the industrial leader**

In 1997, the car industry, classified to CZ-NACE<sup>6</sup> DM 34-35 called 'Manufacture of transport equipment' recorded a loss exceeding CZK 5.2 billion, of which CZK 4.9 billion was negative economic result of domestic private companies. In 2004, however, this industry generated a profit of CZK 15.6 billion, of which domestic private companies CZK 1.1 billion. This result was achieved in the conditions of less dependence on outside financial resources – in comparison to companies controlled by Czech capital, foreign-controlled car makers reached roughly thirteen times higher volume of profits, while the amount of bank loans was only seven times higher and the amount of outside financial resources in the form of short-term and long-term liabilities nine times higher. Foreign-controlled companies' ability to generate profits in the car industry results from high productivity, because also the volume of shareholders' equity and reserves used was by only six times higher than in domestic companies.

A very significant shift occurred in metallurgy (CZ-NACE DJ 27-28 'Manufacture of basic metals and fabricated metal products'), which was able to turn the loss of CZK 1.997 billion reported in 1997 into a profit of CZK 8.9 billion in 2004 (profits of domestic private companies reached CZK 3.7 billion), also thanks to booming metal and particularly steel prices in world markets.

## **Increasing capitalisation even in industries in recession**

The textile industry (CZ-NACE DB 17-18 'Manufacture of textiles and textile products'), which suffered most from the loss of competitiveness due to cheap imports of textiles from Asia and experienced dramatic changes in production, reached profit (CZK 1.6 billion in 2004 as against loss CZK -1.3 billion in 1997). The debt of the textile industry with banks amounting to nearly CZK 18 billion in 1997 decreased to CZK 10.9 billion in 2004, while the amount of short-term and long-term liabilities remained roughly the same (CZK 22 billion). Also in the textile industry the decreasing volume of outside financial resources leads to higher profits. In total, this industry "shrank" between 1997 and 2004, when its total resources decreased from CZK 70.4 billion to CZK 67.0 billion and capitalisation grew (shareholders' equity and reserves increased from CZK 28 billion to nearly CZK 32.8 billion). A more detailed view of financial development in the corporate sphere is given in the CZSO case study called The Role of Domestic Capital in the Transformation of the Czech Economy published at the start of 2006.

## **Growing profits in public services**

Also companies engaged in activities traditionally perceived as the public services sector, which are not considered to be the backbone of the economy and where the private sector has a relatively short tradition, achieve good results. They encompass education, health and social work, and other community, social and personal service activities (which also include statistically measured, e.g., recreational, cultural and sporting activities or technical work related to refuse disposal, sanitation and similar activities, etc.). These services are still predominantly controlled by domestic companies, because total resources for all the above-mentioned public services stood at CZK 130.8 billion in 2004 and for domestic private companies at CZK 94.3 billion (compared to CZK 72.4 billion and CZK 60 billion respectively in 1997).

A turn took place from the loss of CZK 3.6 billion in 1997 to a CZK 9.0 billion profit in 2004. However, this loss was still considerably affected by that part of this sphere which was in public ownership, nevertheless the loss made by private Czech companies engaged in education, health and other community, social and personal service activities was also significant (CZK -1.4 billion). 'Health and social work', at that time insufficiently privatised, made a loss of CZK 66 million, and total resources were CZK 14 billion and shareholders' equity and reserves CZK 4.1 billion. Seven years later, however, the companies reached a total profit of CZK 9.0 billion and private domestic companies CZK 7.4 billion. In 2004, Czech private entities engaged in health and social work generated a CZK 1.5 billion profit – if the part under foreign control (CZK +0.3 billion) and the rest under "public" control (CZK -0.02 billion) are included, the 2004 profit of all companies in 'health and social work' was CZK 1.8 billion.

## **Tens of billions in wholesale and retail trade and utilities....**

The imposing volume of profits produced in trade (CZK 42.2 billion in 2004, of which CZK 26.3 billion by domestic companies) is attributable mainly to wholesale (CZ-NACE G 51 'Wholesale trade and commission trade, except of motor vehicles and motorcycles') where profits reached nearly CZK 34.2 billion in 2004. Profits in retail trade, which includes dominant chain stores, are substantially lower (CZK 3.6 billion), probably due to the pressure on trade margin and the tremendous competition, which keeps the level of consumer prices relatively very low and creates a situation where the CR's convergence to the EU 25 price level tends to be slow (the price level in the CR is at 55% of the EU 25 average).

## **... with electricity supply clearly dominating**

Electricity supply and other utilities (CZ-NACE E 40-41 'Electricity, gas and water supply') belong to economic activities generating the biggest nominal value of profits, which shot up to nearly CZK 45.6 billion in 2004 (domestic companies reached CZK 21.5 billion). At the same time, they belong to the few CZ-NACE activities which were profit-making already in 1997 (CZK 7.3 billion, domestic private companies CZK 3.6 billion) – they are mining and quarrying, transport and communications, and fishing whose weight in total resources is very low.

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<sup>6</sup> The mentioned set of all legal entities and natural persons using double-entry bookkeeping creates a space for inaccuracies in classification to divisions of the Statistical Classification of Economic Activities (CZ-NACE) due to the proportion of principal activities and their changes which may not be timely and precisely recorded in the Business Register. The CZ-NACE classifies enterprises according to their principal activity.

An important actor is the ČEZ company, which according to the latest annual figures (2005) reached a consolidated net profit of CZK 22.3 billion, i.e. nearly three times more than in 2000. That is the reason for the immense share of electricity supply (CZK 32.0 billion) in total profits generated in CZ-NACE 40-41, when alone CZ-NACE 41 called 'Collection, purification and distribution of water' made a profit of CZK 1.8 billion in 2004.

Typical of electricity supply, as of the whole corporate sector of the Czech economy, is that the volume of bank loans used in the 1997-2004 period dropped. This applies to loans granted to domestic companies (from CZK 20.7 billion in 1997 to CZK 11.2 billion in 2004) as well as to all companies engaged in CZ-NACE 40 (from CZK 46.1 billion in 1997 to CZK 38.3 billion in 2004). These figures show that foreign-controlled electricity companies borrow more – their indebtedness made up CZK 15.2 billion in 2004.

### **Rapid development of mobile operators.....**

While CZ-NACE I 60-64 'Transport, storage and communication' produced a moderate profit already in 1997 (CZK 1.2 billion) thanks to communications which were not yet privatised (profits in communications were CZK 5 billion, of which CZK 5.1 billion was generated by the state-owned part), the total economic result of CZ-NACE 60-64 in 2004 shot up to CZK 29.6 billion. Alone 'post and telecommunications' reached a profit of CZK 18.1 billion, 'land transport; transport via pipelines' CZK 8.0 billion and 'supporting and auxiliary transport activities; activities of travel agencies' CZK 3.5 billion.

### **... secured profits for telecommunications**

The dominant position of CZ-NACE group 'telecommunications' in total profits produced in CZ-NACE 60-64 is attributable to the immense penetration of mobile phones in the Czech market, which took place during a relatively short period and exceeds 100% (the number of mobile phones is higher than the CR's population). This situation has an impact on other indicators, e.g. the structure of household expenditures – while expenditures on final household consumption in the CR grew by 2.9% p.a. on average in 1995-2004 (the figure shows growth of consumption at constant prices, i.e. excl. effect of growing prices), then constant price expenditures on telecommunications alone increased by more than 9% p.a., which was more than any other kind of household expenditures. For example, average expenditures on food grew by only 2.1% p.a. over the same period, on alcoholic beverages and tobacco products by 1.5% p.a. and on transport by 2.2% p.a. The Eurotel company, one of the mobile operators, figured out profits at CZK 510 per client per month in 2005 and CZK 526 in 2004. The smallest operator Oscar (before the takeover by Vodafone) had a profit of CZK 679 per client per month<sup>7</sup>.

High profits in the telecommunication business are obvious from economic results of individual companies: in 2005 the Český Telecom company reached consolidated profit CZK 6.2 billion (unconsolidated profit CZK 7.2 billion), in which mobile operator Eurotel participated by half. Spanish Telefonica O<sub>2</sub>, as the strategic partner that purchased the Český Telecom company (whereby it became the first integrated telecommunication operator in the CR), recently received retained earnings of the Eurotel company, which constituted the mobile branch in Český Telecom, amounting to nearly CZK 16 billion. The new Spanish owner figured out the benefit of merger of Eurotel and Český Telecom at CZK 8.5 billion.

Participating in profits produced in telecommunications are of course Internet development and the weight of profits from data services corresponding to Internet development at the expense of voice services at other access providers.

### **Financing from outside financial resources and shareholders' equity and reserves**

The expansion of the corporate sector in the Czech economy, which resulted among other things in a strong growth of external trade and improvement of the trade balance, is financed through the intensified use of outside financial resources on the one hand, and from the growing volume of shareholders' equity and reserves on the other.

A factor analysis reveals that, in the economy as a whole, the growth of corporate resources (profit rate parameter) was more contributed to by shareholders' equity and reserves than by outside financial resources in the form of short-term and long-term liabilities – if total resources for the corporate sector in the CR increased by more than 70% in 1997-2004, then it was the result of growth of the above specified outside financial resources by 39% and increase in shareholders' equity and reserves by 65%. Bank loans as a further outside source for financing expansion fell by 17% in the 1997-2004 period. A significant part of the growth is probably due to higher productivity.

### **External partners' investments pay off**

The growing capitalisation is apparent mainly in the sector of foreign-controlled companies. The volume of profits that these companies repatriated to mother countries in the form of dividends reached CZK 73.5 billion in 2004 and was nearly as high as the volume of profits reinvested in the Czech economy that stood at CZK 75.8 billion (corresponding preliminary figures for 2005 are CZK 63.1 billion and CZK 78.5 billion, respectively). Thanks to excellent economic results of the companies, foreign direct investments pay off – the rate of return was 12% in 2004 and 10% in 2005.

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<sup>7</sup> Data source: companies' annual reports and press releases

Profits flowing out of the Czech Republic represent an unfavourable factor deteriorating external disequilibrium in the long term. In the future, this negative aspect could be partly reduced by opposite capital flows, because direct investments of Czech companies in other countries have a growing trend since 2000 – they were CZK 26.1 billion in 2004 and CZK 20.5 billion in 2005; in the first half of 2006 they reached nearly the amount invested in January-December 2005 (CZK 20 billion). However, the time lag between investment and significant generation and repatriation of profits may be rather long.

#### Resources and profits of the corporate sector in the CR's economy: by CZ-NACE activity, 2004

CZK billion

	CZ-NACE	Liabilities total	Equity capital total	Profits total	Profits of domestic private companies total	Long- and short-term liabilities total	Long- and short-term liabilities domestic companies	Bank loans total	Bank loans domestic companies
A	Agriculture, hunting and forestry	228,7	156,3	5,8	5,2	49,4	45,9	15,2	14,3
B	Fishing	3,2	2,1	0,1	0,1	0,5	0,5	0,3	2,0
C	Mining and quarrying	134,2	91,7	10,0	7,0	17,0	9,2	4,3	2,7
D	Manufacturing	1913,7	872,3	114,6	34,3	736,4	291,9	200,8	97,2
E	Electricity, gas and water supply	629,1	381,6	33,8	11,0	161,1	61,9	38,3	11,2
F	Construction	260,2	82,3	11,9	10,5	143,3	113,6	12,4	11,3
G	Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	924,2	289,1	42,2	26,2	497,2	278,6	95,4	56,7
H	Hotels and restaurants	70,1	16,2	1,7	-0,2	31,2	18,4	18,8	3,5
I	Transport, storage and communication	631,0	394,1	29,6	16,0	164,6	67,9	40,8	22,1
K	Real estate, renting and business activities	948,3	246,8	17,2	10,5	566,9	321,6	102,1	46,7
M-O		130,7	57,7	9,0	7,5	54,3	41,6	9,6	6,9
<b>Total</b>									
<b>A-O</b>		<b>5873,4</b>	<b>2590,2</b>	<b>275,9</b>	<b>128,1</b>	<b>2421,9</b>	<b>1251,1</b>	<b>538,0</b>	<b>274,7</b>
M	Education	2,7	0,9	0,1	0,1	1,3	1,1	0,1	0,1
N	Health and social work	30,4	14,5	1,8	1,5	9,9	7,3	3,7	3,1
O	Other community, social and personal service activities	97,6	42,3	7,1	5,9	43,1	33,2	5,8	3,7
<b>M-O</b>		<b>130,7</b>	<b>57,7</b>	<b>9,0</b>	<b>7,5</b>	<b>54,3</b>	<b>41,6</b>	<b>9,6</b>	<b>6,9</b>

Source: CZSO, calculated from primary data