THE PROFITABILITY OF NON-FINANCIAL COMPANIES IN V4 COUNTRIES

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The Financial Stability Report for 2005[1] indicates a certain imbalance in the development of profitability in the non-financial sector. Growth in the profitability of the non-financial sector as a whole slowed down year-on-year, and profits in manufacturing even fell slightly. Disparities in the profitability of individual industries widened, when the profitability of the generation and distribution of electricity, gas and water moved further away from profitability of other industries.

According to data from the Statistical Office of the Slovak Republic (ŠÚ SR), the year-on-year increase in profits generated by non-financial corporations accelerated to 17.4% in the first half of 2006. At the same time, we could see a modest growth of profitability of the non-financial sector, with a simultaneous rise of profitability of manufacturing. Although differences in profitability from one sector to another have not deepened, they continue to remain very significant.

It is interesting to compare the development in Slovakia with that in other EU countries, in particular with the situation in the V4 countries, which are at a similar economic level and are affected by the same regional factors. Since the results of the individual industries sum up the results of specific entities, many important factors in the development of the Slovak non-financial sector can be revealed by a simple glance at the composition of the most significant companies in the V4 countries. The factors enabling companies to achieve above-average profits are the key issue in this respect.

The situation in V4 countries

Given the multitude of various factors that are particular to a country, the rate of profit growth differs among EU countries. As in other areas of economic and social life, we can see a process of convergence in the performance of corporate entities, arising from the fact that Slovakia has proceeded from a relatively low initial level. According to Eurostat data for 2003, the average profit per employee in the then EU countries was around EUR 21,000; the average in the V4 countries for 2003 was less than EUR 7,000.[2]

For at least the last five years, a substantial difference in the rate of profit growth has been evident between the old and new EU countries. The double-digit rate of profit growth in the Slovak non-financial sector is not substantial when compared with the other new EU Member States. In terms of improving profitability, the clear leaders are the Baltic states, followed by the V4 countries with Slovakia at the forefront. The highest rate of growth among the old EU countries is being maintained by Spain and Greece. Ireland, which until recently was reporting the top growth in the non-financial sector, has experienced a substantial slowdown.

The profits in the Slovak non-financial sector are mostly made by large companies. It is therefore not surprising that the most profitable industries are those in which large companies predominate. In every EU country, the generation and distribution of electricity, gas and water is either the most profitable, or one of the most profitable industries. Even so, the profitability of this industry in Slovakia is outran only by that in Cyprus, Spain and Finland. Where profitability in Slovakia notab-

Table 1 Profit growth in the non-financial sector of EU countries1[1]

Latvia	13.8	Denmark	5.4
Lithuania	12.1	Belgium	5.4
Estonia	11.4	Sweden	5.3
Slovakia	11.3	Czech Republic	5.1
Poland	8.9	Ireland	3.6
Slovenia	8.7	Germany	3.5
Grece	8.4	France	3.1
Spain	7.8	Netherlands	2.8
Hungary	7.7	Cyprus	2.3
Luxembourg	7.4	Italy	2.3
United Kingdom	6.0	Finland	1.3
Austria	5.5	Malta	0.1

1) Average year-on-year increase in the gross operating surplus for the years 2003 to 2005.
Note: In the case of Portugal, only the data for 2003 was available and it showed a slight decline in the gross operating surplus.
Source: Eurostat.

[1] Financial Stability Report for 2005, published by the NBS in August 2006.
[2] The analysis of profitability in the corporate sector at the macrolevel, as well as at the level of individual industries, is limited by the low accessibility of data. Our analysis is based on gross operating surplus data, which is used in macroeconomic analyses as a substitute for pre-tax profits and roughly represents earnings before interest, taxation, depreciation, and amortization (EBITDA). Because of the unavailability of data on assets, the analysis of industry profitability uses sales revenues measured in terms of the gross operating surplus as a percentage share of sales.

Table 2 Profitability of the main non-financial industries in the V4 countries[1]

	C	D	E	F	G	H	I	K
Czech Republic	15.5	12.4	21.4	10.1	5.7	14.2	20.5	21.4
Hungary	18.9	11.1	12.5	6.7	4.1	4.6	16	14.4
Poland	15.8	18.3	20.6	12.8	5.9	14.2	22.7	17.8
Slovakia	24.2	8.1	26	6.2	4.2	11.2	18	17.9
EU average	25.7	9.13	18.1	11.8	5.4	15.4	16.1	23.1

1) Percentage ratio of the gross operating surplus to sales (2003).
Source: Eurostat.

Table 3 Main non-financial industries in the V4 countries by share of profits[1]

	C	D	E	F	G	H	I	K
Czech republic	1.4	36.6	8.2	7.1	16.9	1.9	14.0	13.9
Hungary	0.4	44.6	6.9	4.4	16.1	0.6	12.7	14.3
Poľand	1.8	43.1	9.5	5.0	19.1	0.8	11.9	8.9
Slovakia	1.3	35.8	25.5	2.8	13.9	0.5	11.9	8.3

1) Percentage ratio of the gross operating surplus to sales (2003).
Source: Eurostat.
Key to tables 2 and 3: C – Extraction of mineral raw materials; D – Manufacturing; E – Generation and distribution of electricity, gas and water; F – Construction; G – Wholesale and retail trade, and the repair of motor vehicles, motorcycles and consumer goods; H – Hotels and restaurants; I – Transport, warehousing, posts, and telecommunications; K – Real estate, renting, and business activities.

ly lags behind in comparison with other EU countries is in construction and most service industries. In addition, the most recent data for 2003 shows Slovakia's profitability in manufacturing to be significantly lower than that in the other V4 countries. The only average, or slightly better than average, figures that Slovakia reported for manufacturing were in the production of metals and metal products, the production of other non-metal mineral products, and the production of coke, refined oil products, and nuclear fuel.

As regards the generation and distribution of electricity, gas and water, its share of the total profits generated by non-financial companies is far higher in Slovakia than in the other EU countries. The share of this industry in the profits of the non-financial sector is also substantially lower in the other three V4 countries.

Profitability of leading companies

Also in global terms, the largest and currently the most profitable companies are those engaged in the extraction and processing of oil and gas. In the list of the 500 biggest companies in the world drawn up each year by the Financial Times newspaper – the "Global 500" – oil and gas companies occupy four of the top ten places.[3] The rest are taken by two industrial conglomerates, two banks, one trading company, and of course, the software corporation Microsoft.

Besides the Global 500, the Financial Times compiles a list of the 500 largest European companies – the "Europe 500".[4] Oil and gas companies have the leading places at the European level, too. The only difference is in the strength of companies operating in the pharmaceutical, biotechnology, and telecommunication industries. The top ten includes four drug firms and is completed with a mobile operator.

The scope of business of the largest companies in the V4 represents to some extent an intersection of the business specializations of the largest world and European companies. The superiority of energy companies and oil-refining companies is a matter of course. In the V4 countries, however, it would be hard to find top pharmaceutical or software companies in the leading places. The telecoms sector does though, have one representative in the top ten of each V4 country. As for the leading ten companies in each of the V4 countries, the lists differ in terms of industry focus only in respect of one or possibly two companies. In Hungary, the electro-technical industry has a slight predominance, while in Poland the mining industry does so.

Hungary's top ten includes mostly industrial companies established through foreign direct investment, not simply by the transfer of property rights on the basis of privatization contracts. These companies typically have a high ratio of exports to output, but at the same time a relatively low profitability. In Poland, by contrast, the strong domestic monopolies that dominate the top ten companies and focus mainly on the internal market are more profitable. Regardless of business specialization, the average profitability of the top ten companies in 2005 was highest in Slovakia.[5] This was given mainly by high profitability of the monopoly provider of gas transmission and distribution, and also by high profitability of the leading mobile operator.

These companies are not lagging behind leading rivals from other foreign countries. The profit per employee in the mentioned companies is clearly higher than the average in the old EU countries. The fact that the ten largest companies in Slovakia have a strong influence is confirmed by the fact that the value added by them represents

3 According to the 2005 data, the largest company was the energy corporation Exxon Mobil, with a market value of USD 371.6 billion, turnover of more than USD 358 billion, and a gross profit of 9.8%. By comparison, Slovakia's GDP for 2005 was less than USD 48 billion.
4 A drawback of both lists is that they include only publicly listed companies, and therefore exclude many large European corporations.
5 Our basis was pre-tax profit as share of sales revenues. In this case, pre-tax profit provides more objective information on the performance of companies since it does not take into account the rate of taxation, which varies from one V4 country to another.

Table 4 Largest companies in the V4 countries and their profitability

Czech Republic		
Position	Name of company	Profitability[1]
1.	ŠKODA AUTO, a. s.	5.4
2.	ČEZ, a. s.	21.8
3.	UNIPETROL, a. s.	5.3
4.	RWE Transgas, a. s.	10.0
5.	AGROFERT HOLDING, a. s.	6.6
6.	ČESKÝ TELECOM, a. s.	14.3
7.	OKD, a. s.	8.1
8.	Siemens Group ČR	8.3
9.	MORAVIA STEEL, a. s.	4.3
10.	FOXCONN CZ, s. r. o.	1.2

1) Percentage ratio of pre-tax profits to sales (2005)
Source: CZECH TOP 100.

Hungary		
Position	Name of company	Profitability[2]
1.	Mol Magyar Olaj és Gázipari Rt.	13.4
2.	Audi Hungária Motor Kft.	8.4
3.	Flextronics International Kft.	2.3
4.	Magyar Telekom Távközlési Rt.	8.5
5.	GE Hungary Rt.	24.5
6.	Philips Magyarország	–
7.	Magyar Villamos Muvek Rt.	2.6
8.	Tesco – Global Arukazak	1.9
9.	Panrusgáz Magyar-Orosz Gázipari Rt.	0.2
10.	Eon Hungaria	6.7

2) Percentage ratio of pre-tax profits to sales revenues (2004)
Source: Figyelö

Poland		
Position	Name of company	Profitability[3]
1.	Polski Koncern Naftowy Orlen SA GK	16.5
2.	Telekomunikacja Polska SA GK.	14.2
3.	Polskie Sieci Elektroenergetyczne SA GK	6.8
4.	Polskie Górnictwo Naftowe i Gazownictwo SA GK	9.0
5.	Grupa Metro w Polsce	-
6.	Grupa PKP SA	-
7.	Grupa Lotos SA GK	11.5
8.	KGHM Polska Miedź SA GK	30.3
9.	Volkswagen Poznań sp. z o.o.	9.4
10.	Kompania Węglowa SA	2.5

3) Percentage ratio of pre-tax profits to sales revenues (2005)
Source: Rzeczpospolita

Slovakia		
Position	Name of company	Profitability[4]
1.	Volkswagen Slovakia, a. s.	3.1
2.	Slovnaft, a. s.	10.4
3.	U. S. Steel Košice, s. r. o.	16.4
4.	Slovenský plynárenský priemysel, a. s.	29.7
5.	Samsung Electronics Slovakia, s. r. o.	1.8
6.	Slovenské elektrárne, a. s.	4.9
7.	Západoslovenská energetika, a. s.	15.5
8.	Tesco Stores SR, a. s.	1.6
9.	Orange Slovensko, a. s.	26.8
10.	OMV Slovensko, s. r. o.	–

4) Percentage ratio of pre-tax profits to sales (2005). The data on U.S. Steel Košice, s.r.o. and Tesco Stores SR, a.s. are for 2004.
Source: Trend

10% of GDP. Among the other V4 countries, the influence of the largest companies on the economy is about one half lower.

An interesting result is reached by categorizing the largest companies in the V4 according to the industry in which they operate. According to 2005 data, the leading Slovak companies in terms of profitability are from the energy, telecommunications, and metal industries. The conclusions from the analyses of individual pieces of data therefore correspond to the conclusions of the industry analyses indicating that the industries in which Slovakia has above-average profitability are the generation and distribution of electricity gas and water, and the production of metals and metal products. The individual data also revealthe high profitability of the telecoms subindustry – it is hidden behind the less profitable transport and posts, which together make up the industry of transport, posts and telecoms.

These conclusions about the better than average profits of the mentioned three Slovak companies apply not only to the returns on their business activities but also to the rate of return on invested capital. The companies dominate the respective sector also in terms of the ROA and ROE ratios.[6]

Sources of high profitability

Above-average profits are mostly related to the successful exploitation of competitive advantage. They may be linked with a higher quality of output, and the higher prices that can be demanded for this output, or they may be linked with access to cheap production factors. There is also currently increasing discussion about innovation and other factors of higher profits. Ideally, above-average profits should attract investors, and, in the absence of artificial barriers to entry, it would be possible to expect the arrival of new competitors and a subsequent decline in the profitability of the given industry. This does not, however, concern the previously mentioned companies, the majority of which have a monopolistic or

[6] In order to preserve the higher comparability of industry and corporate profitability, preference is given to return on sales, because the values of assets and equity are not available at the industry level.

Table 5 Comparison of the main price and non-price factors of profitability in V4 countries

	Price of gas[1]	Price of electricity[2]	Energy intensity[3]	Price of petrol[4]	Price o of telephone calls[5]	Share of the leading operator[6]
Czech Republic	8.4	0.083	851.8	982.6	1.15	47
Hungary	6.4	0.090	534.1	1105.0	1.22	48
Poland	7.8	0.092	596.6	1020.4	1.1	38
Slovakia	9.1	0.122	854.3	977.5	1.22	56
EU average	9.9	0.108	204.9	1081.9	0.9	49

1) Price for households in EUR per 1GJ as at 1 January 2006.
2) Price for households in EUR per 1kWh as at 1 January 2006.
3) In kilograms per EUR 1,000 in 2004.
4) Price per 1,000 l of unleaded petrol (95 octane).
5) Price in EUR for a 10-minute domestic call in 2004.
6) Percentage market share of the leading operator in 2004.
Source: Eurostat.

oligopolistic position in the market. The main source of their higher profits is the market structure itself.

In Slovakia, the profitability of the generation and distribution of electricity and gas is not based on cheap domestic production sources. The trend increase in prices of energy sources in recent years has affected profits more in the other direction. Input costs have been considerably affected by the exchange rate of the US dollar, which has kept down the rise in gas prices in recent years. Given the level of employment in this sector, the comparatively low wage costs have not been significant, even though the rate of wage growth is outstripping the decline in the employment numbers. To argue that higher quality or innovation of output is having an effect would be even more difficult. It is only in the past year that this sector has recorded a more substantial increase in investment. The main factor of profitability appears to be the ability to pass on rising costs, including a possible reserve, to the production price, and this is related to the dominant position of the selected entities in the market. Electricity and gas prices are now at the levels of the richest EU countries, and in certain segments they are substantially above the level in the V4 countries. This points to a shortcoming in regulation. Besides the production prices, the high profitability is maintained also by a high energy intensity in Slovakia, in fact the third highest in the EU and four times greater than the EU average.

The profits of mobile operators are raising similar concerns about an inappropriate rate of profitability. Although the prices of telephone calls are not rising, they are currently among the highest in the EU. At the same time, this industry is not seeing any significant increase in investment,[7] and therefore as the number of customers increases, along with sales, it is profiting from initial investments and insufficient competition. This is also shown by the fact that the leading mobile operator has a market share of 56% – only the leading operators in Slovenia and Cyprus have a higher one.

The oil refinery Slovnaft's often mentioned domination in profit generation in the Slovak non-financial sector does not seem so excessive when compared with the profitability of its rivals. It is, however, difficult to imagine that the year-on-year decline in its profits resulted from an awareness of the misuse of its dominant position. It is more likely that it reflects the growing influence of its rival – OMV Slovensko s.r.o., which recorded annual increase in sales of more than 30% in 2005 and ranked among the ten largest companies in Slovakia. The year-on-year decline in the profit generated by this industry has not been prevented even by the sharp growth in production prices or the fast average growth in investment of the last several years. According to Eurostat data on the prices of petrol and diesel in 2005, petrol prices in Slovakia were lower than the EU average and the lowest among the V4 countries, while diesel prices were at the EU average and somewhat higher than those in the Czech Republic and Poland.[8]

According to data for 2005, the largest corporation in Slovakia, Volkswagen Slovakia, a.s., seems to have only middling profitability, and not only in that year. The competitive environment does not allow for excessive price increases, and, unlike in other industries, above-average investment aimed at cutting costs has not brought above-average profits. The extensive investment made in this industry will probably soon be reflected in revenue and profit growth, though it is questionable whether the industry of transport means production will at the same time increase its profitability.

The main sources of profitability and competitiveness is an issue that would demand more in-depth analysis, though the stated facts indicate that the main source of above-average profitability among the largest Slovak companies is a monopolistic or oligopolistic market position, which allows them to set prices in excess of the EU average. This gives rise to the question of an appropriate level of profit for a regulated natural monopoly, considering that it is sometimes more accurate to speak of the unnatural profits of natural monopolies.

The sustainability of high profits

The pressure of public opinion on Slovak companies is felt mainly by the largest companies serving the final con-

[7] In 2005, the leading mobile operator recorded a several-fold increase in investment, while the second mobile operator reported a substantial decline in investment.
[8] In terms of purchasing power parity, petrol and diesel prices in Slovakia, like gas prices, were the highest among EU countries.

Table 6 Main macroeconomic factors in the development of selected industries in 2005[1]

	D	DF	DI	DJ	E	I	IC
Investments (three-year average)	12.3	57.6	3.1	3.0	2.4	-3.1	-15.7
Average number of employees	4.1	–	–	–	-6.8	-1.4	-6.1
Average wage	7.5	–	–	–	8.8	8.5	8.9
Consumer prices	–	–	–	–	7.9	0.6	-0.7
Production prices	2.1	24.8	2.8	7.2	8.3	–	–
The SKK/EUR exchange rate	3.6						
The SKK/USD exchange rate	3.8						

1) Percentage change year-on-year.
D – Manufacturing; DF – Production of coke, refined oil products, and nuclear fuel; DI – Production of other non-metal mineral products; D J – Production of metals and metal products; E – Generation and distribution of electricity, gas and water; I – Transport, warehousing, posts, and telecommunications; IC – Telecommunications.
Source: ŠÚ SR, NBS.

sumer. In connection with the decline in oil prices in the second half of 2006, Slovnaft has proceeded to substantial reduction of the prices of petrol and diesel. Considering the fall in the industry's profitability in the first half of 2006, the industry may be expected to report lower profits for the whole calendar year. Given the high frequency of adjustments to the retail prices of petrol and diesel, it is difficult to gauge the extent to which these adjustments have taken account of the historic decline in oil prices or whether the margin has narrowed. Except for Slovnaft, which has long been under the scope of the Slovak Finance Ministry and whose profitability is not above-average, at least in the V4 context, several largest companies continue to account for a considerable share of the profits in Slovakia's non-financial sector. The positions they hold in their respective industries means the development of their profitability may be treated as an adequate indicator of the profitability of the whole industry.

Fixed costs are high in the generation and distribution of electricity and gas, and they predetermine the presence of natural monopolies in this industry. Even with the ongoing liberalization of the industry, there are no prospects of substantial growth in competition. With effect from 1 July 2006, the transmission and distribution activities of the gas company SPP were unbundled by law, and two subsidiaries were established – SPP – preprava (transmission) and SPP – distribúcia (distribution). As a result, it should in future be easier to ascertain the extent to which the company's profit derives from gas transmission abroad and from distribution to domestic customers. It will be clearer whether its main competitive advantage is geographic location or a monopoly position. Given the decline in prices of energy sources in the second half of 2006, SPP may report an annual profit even higher than that for the previous year. The notified decline in natural gas prices could be reflected in profitability from year 2007. As for the generation and distribution of electricity, the profitability of the leading companies increased only slightly in 2005. The sharp rise in electricity prices in the first months of 2006 may indicate a rise in profits, although the expected increase in costs in regard to the reduction of emission quotas will have an opposite effect.

The current two mobile operators will soon have a new rival, this should lead to a weakening of their oligopolistic position. The result could be a decline in their sales, and especially their profitability.

Indications of the future development of Slovakia's most profitable industries would not be complete without mentioning U.S. Steel Košice, s.r.o., the main representative of the production of metals and metal products industry. Provided that the prospective increase in subsupplies for the automobile industry materializes, the better than average profitability of this company and the industry is likely to be maintained.

The high profits of Slovakia's largest companies are arousing ever more interest. The plans and first steps of the new government indicate that the profits of large companies with a dominant market position have reached a peak. It remains to be seen in what way they will be forced to lower their above-average profitability, which is, at least in regard to the rising prices of their output, having an adverse effect on other entities. The new government seems to have realized that the possible introduction of a special income tax would not be the most suitable route, since it could be perceived by potential investors as a deterioration in the business environment. A better solution could be to increase the competences and the powers of the regulatory authorities in charge of monitoring abuse of dominant positions and developments in network industries.

Conclusion

Year-on-year profit growth in the non-financial sector in Slovakia is higher than in the other V4 countries. In comparison with the rest of the V4, and with the whole EU, Slovakia is achieving much better than average profitability in the generation and distribution of electricity, gas and water. Slovak industries with average or slightly above-average profitability include the production of metal and metal products, the production of other non-metal mineral products, and the production of coke, refined oil products and nuclear fuel. An analysis of profitability at the company level also confirms the better than average profitability of the largest entities in Slovakia's telecoms industry. The main source of the higher profits in these industries appears to be the dominant market position of their largest companies. Having a stronger and more competent regulator could help to address this situation. Some of the current and announced changes in the largest companies and in related industries will probably be reflected in greater transparency and a decline in profitability. A reduction in the inter-industry profitability imbalance of Slovakia's non-financial sector could be supported by the steadily increasing importance of manufacturing.

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