

# The Estonian Economy

## Winds of change in the retail market

- Profitability remains a concern
- Developments across sub-sectors vary
- Challenges ahead

### Sales are on the rise, but profitability remains a concern

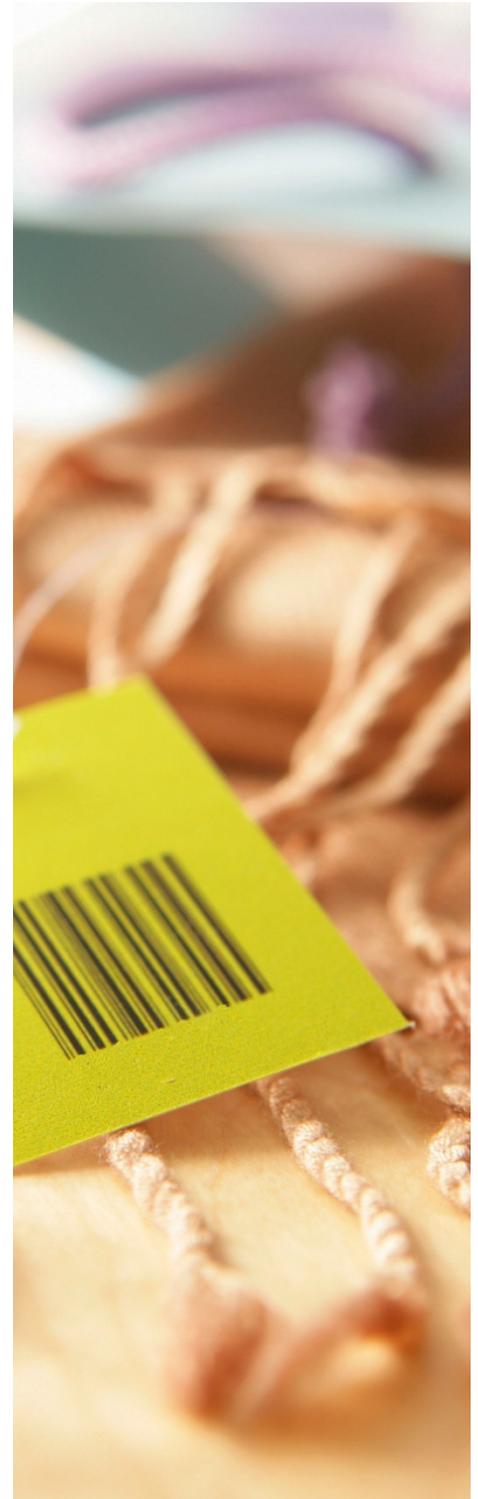
Retail trade enterprises expect their sales to rise (by 6.1% in 2017, according to a recent Swedbank survey) and they plan to employ more people in the near future just like in previous years. The profitability is still a concern, however. Profit to turnover has been on a declining trend in recent years. Surging labour costs hamper profitability like in other sectors in Estonia. According to a Swedbank's survey, 32% of retailers had at least one shop operating with a loss (every 7th store was non-profitable). First quarter financial data of retailers shows a somewhat better picture than one year ago. Unlike past three years, sales grew faster than expenditure, and, therefore, profitability improved.

### Developments across sub-sectors vary

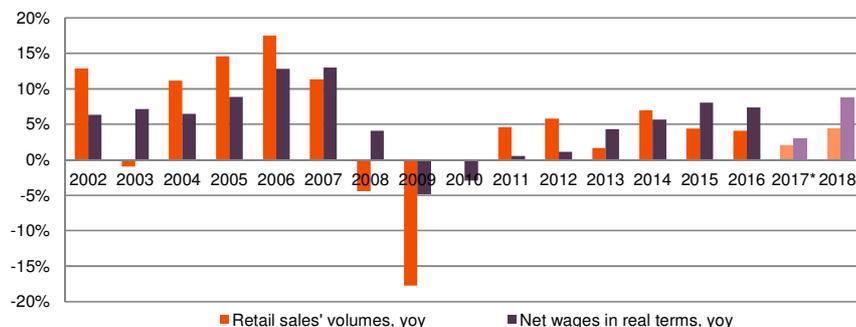
While the sales of primary necessities, including food and motor fuel, still constitute the largest part in consumers' basket, people spend more and more on entertainment, hobbies, etc. In 2016, profit's share in turnover was the smallest among pharmacies, clothing and footwear stores, supermarkets, and gasoline sellers. Profitability is higher among online retailers (where costs are probably smaller), and other specialised stores (where competition could be less fierce than in the supermarket segment, for example).

### Challenges ahead

Situation in the retail market is only becoming more challenging in the future. Firstly, the purchasing power of wage-earners will grow much less this year than in the past. This, in turn, would limit households' consumption. Secondly, competition will grow. In addition to the increasing popularity of e-commerce, new retailers could enter the market. Also, a continuous expansion of retail space could mean lower sales in some locations that might be hard to leave from due to binding rental agreements.



Retail sales and wage-earners' purchasing power



Source: Statistics Estonia, Swedbank's forecast

Liis Elmik  
Senior Economist  
+372 888 7206,  
liis.elmik@swedbank.ee

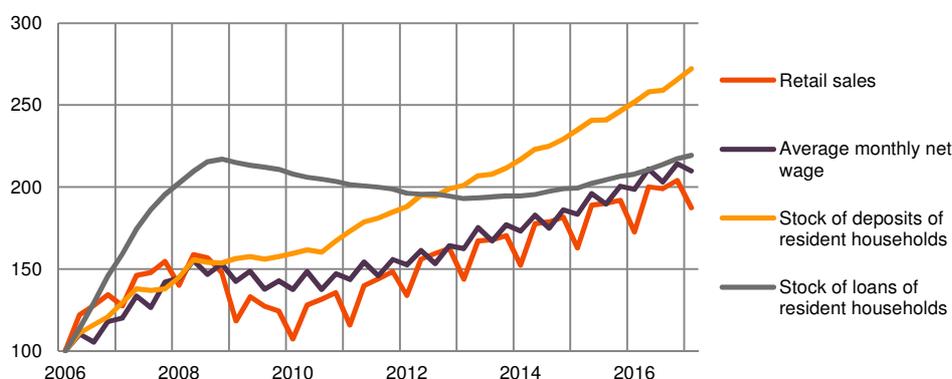
## Winds of change in the retail market

**Retail trade enterprises expect their sales to rise but the profitability is still a concern. Profitability could be hit further in the future if supply will grow more than demand.**

### Sales are on the rise, but profitability remains a concern

Retail sales has benefitted from an improved financial situation of households. Due to a fast growth of wages, households' deposits are growing faster than their loan portfolio. Households' debt burden as a share of their income has reached the lowest level in ten years. Retail sales are also supported by the expenditure of tourists. More than one million foreigners visited Estonia in the first quarter of 2017, which was 6% more than in the same quarter of 2016. The Bank of Estonia estimates that visitors spent a total of 200 million euros in Estonia in the first quarter, up by 5% (although the majority of this amount is probably spent on services rather than goods). Estonia's EU presidency will probably add to higher tourist figures in the second half of 2017.

**Retail sales and households' finances (Q1 2006=100)**

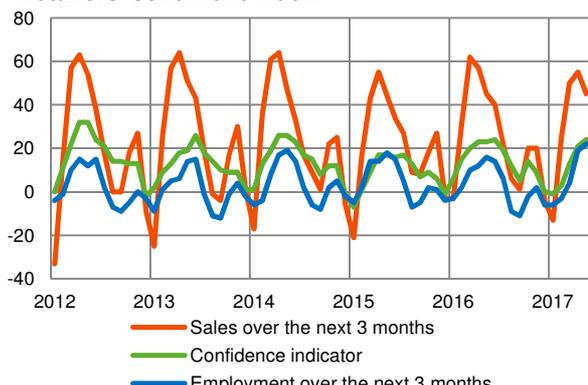


Source: Statistics Estonia, Bank of Estonia

Monthly surveys by the Estonian Institute of Economic Research show that the sentiment of retail trade enterprises has remained upbeat. Companies expect their sales to rise and they plan to employ more people in the near future just like in previous years. Swedbank's recent retailers' survey also showed that retailers are optimistic about their future. 65% of respondents expected higher sales in 2017 (+6.1%, on average).

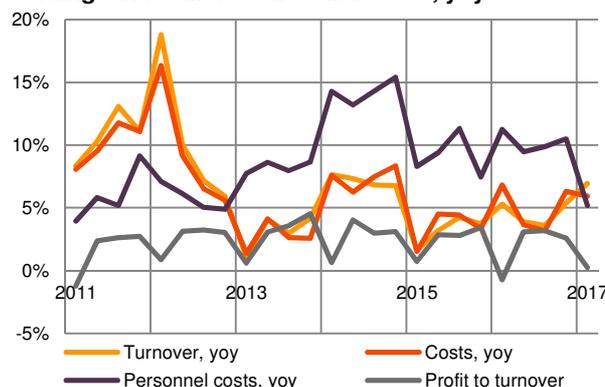
First quarter financial data shows a somewhat better picture than one year ago. Unlike past three years, sales grew faster than expenditure, and, therefore, profitability<sup>1</sup> improved. In the first quarter of 2017, the turnover of retail trade<sup>2</sup> grew 6.9%, and costs 5.9%, over the year. Retail trade companies' profit to turnover jumped from -0.7% in the first quarter of 2016 to 0.2% in the first quarter of 2017. Profit to turnover has been on a declining trend in recent years, falling from 3.0% in 2013 to 2.1% in 2016. Surging labour costs hamper profitability like in other sectors in Estonia. Personnel expenses constitute an important part of total costs in this field, forming 9.7% of total expenses in the first quarter. As Estonia's labour market is tight and wages have been growing rapidly, retailers are investing in different self-service devices.

**Retailers' sentiment index**



Source: Estonian Institute of Economic Research

**Change in retailers' sales and costs, yoy**



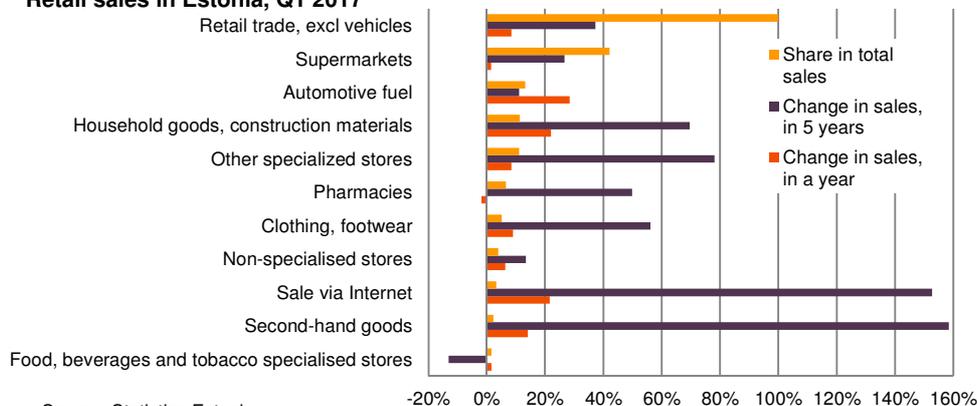
Source: Statistics Estonia

<sup>1</sup> According to Statistics Estonia, profit/loss = turnover – total costs

<sup>2</sup> except of motor vehicles and motorcycles, where the majority of turnover comes from wholesale.

Developments across sub-sectors vary, however. While the sales of primary necessities, including food and motor fuel, still constitute the largest part in consumers' basket, people spend more and more on other goods. Currently, supermarkets amount to around 40% of the total retail sales in Estonia. Automotive fuel comes second with a 13% share, followed by stores specialising on household goods, construction materials and other goods. The purchasing power of Estonian consumers has risen rapidly in recent years due to a strong wage growth and stable prices, and, therefore, people can afford to spend more on entertainment, hobbies, etc. Sales of convenience goods has grown much less than the sales in stores specialising on non-essential goods, compared to one year or five years ago.

**Retail sales in Estonia, Q1 2017**

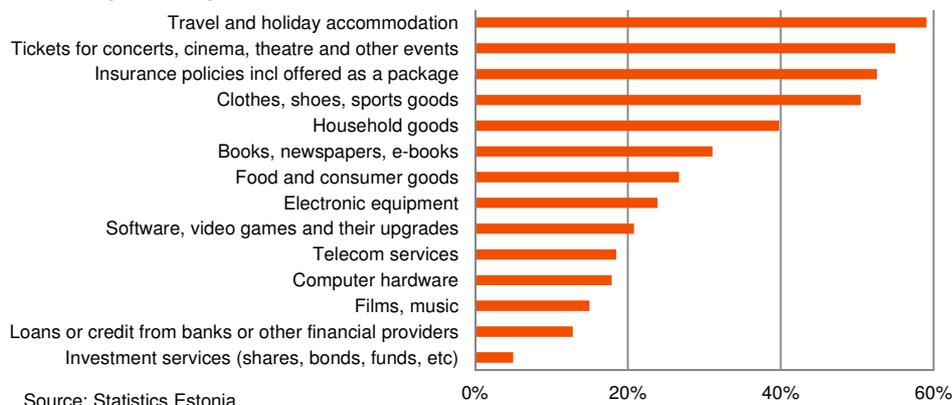


Source: Statistics Estonia

Another important trend is sales via Internet, which is becoming increasingly popular. Statistics Estonia estimates that Estonian online retailers (whose main economic activity is online sales) sold 159 EUR mln worth of goods during the past 12 months (from Q2 2016 to Q1 2017; around 3% of total retail sales in the first quarter of 2017). As there are retailers who earn part of their turnover through online sales, and Estonians also order goods from abroad, the actual share of e-commerce is much higher than 3%. According to a recent Swedbank survey<sup>3</sup>, 39% of retail trade enterprises were engaged in e-commerce, mostly to support traditional sales.

57% of people aged 16-74 bought something online during the past 12 months and 45% purchased something in the last three months (2016 data from Statistics Estonia)<sup>4</sup>. 59% of the online buyers in Estonia booked travel/accommodation, 55% bought tickets to different events, 53% bought travel or other insurance (sometimes as a packaged deal with their travel arrangements). Among goods, people more often bought clothes, shoes, sports goods; household goods; books, newspapers; and food and consumer goods. The Bank of Estonia's data shows that the majority of online purchases are done from Estonian online stores (72% in the first quarter of 2016) and much less from foreign online stores (28% of the total turnover of online purchases in the first quarter of 2016).

**Percentage among the users of e-commerce in Estonia**



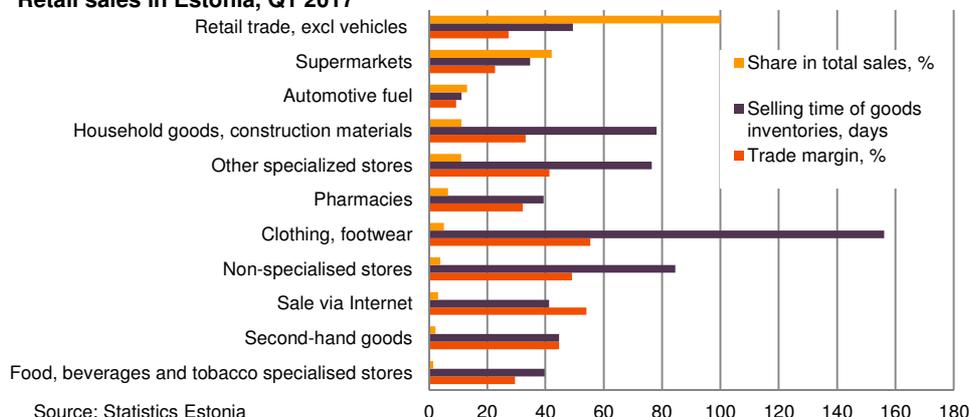
Source: Statistics Estonia

<sup>3</sup> Respondents were 193 retail trade enterprises with total sales of 2.4 EUR bln in 2016 (38% of total retail sales in Estonia).

<sup>4</sup> The survey was conducted in the second quarter of 2016.

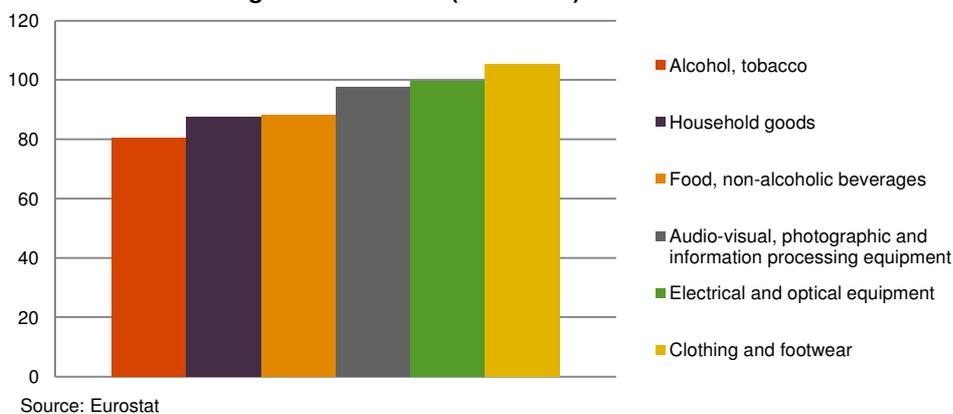
Trade margins<sup>5</sup> in shops specialising in non-essential goods are much higher than the trade margins in stores specialising on food, fuel. Trade margins grew in most sub-sectors in 2016 and in the first quarter of 2017, except in stores selling clothes and footwear, where competition has increased substantially in recent years with more brands and more retail space. Price increases that started towards the end of last year seem to have helped to lift the trade margins among retailers.

**Retail sales in Estonia, Q1 2017**



Trade margins<sup>6</sup> are the lowest in motor fuel sales and the highest among clothing and footwear sellers, where strong seasonality and unpredictable weather mean a long sales cycle. Clothing and footwear retail sales is one of the few sectors in Estonia where the average price level is above the EU28 average (105% in 2015). Prices of alcohol, tobacco; household goods; and food, non-alcoholic beverages amounted to 80-90% of the EU average, and consumer electronics around 100% of the EU average in 2015. Prices in Estonia are relatively high compared to our living standard because wholesale prices for Estonian buyers are relatively high due to small quantities sold in their shops, and costs are high due to relatively big retail spaces and long opening hours throughout the week.

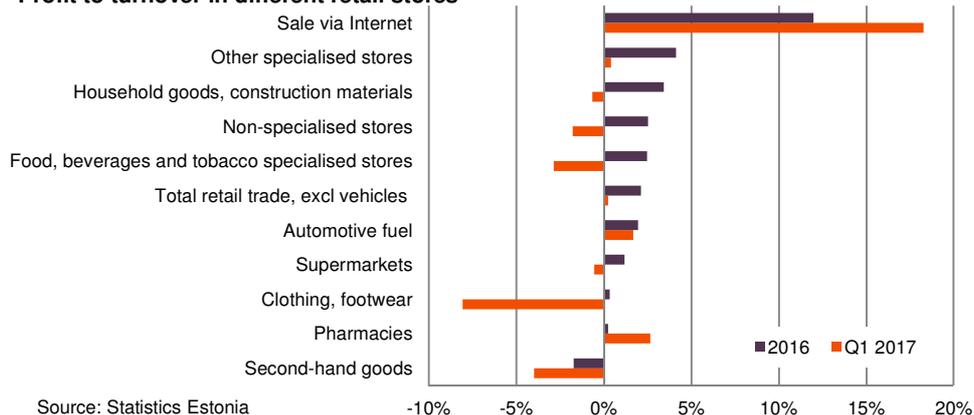
**Price level of certain goods in Estonia (EU28=100)**



Higher trade margin does not necessarily result in higher profitability. Clothing and footwear stores' profit to turnover ratio was among the smallest in 2016 and in the first quarter of 2017. Profit's share in turnover was rather low also among pharmacies, supermarkets, and gasoline sellers. Profitability seems higher among online retailers (where costs are probably smaller), and other specialised stores (where competition could be less fierce than in the supermarket segment, for example).

<sup>5</sup> Statistics Estonia calculates the trade margin as a difference in the turnovers of goods purchased and goods sold.

<sup>6</sup> Again, as a difference in the turnovers of goods purchased and goods sold.

**Profit to turnover in different retail stores**

Swedbank's recent survey among retailers also showed that the profitability of some stores is a concern. According to the survey, 32% of retailers had at least one shop operating with a loss (every 7<sup>th</sup> store was non-profitable). Among the respondents whose sales exceeded 10 EUR million, already 62% of enterprises had non-profitable stores. 36% of enterprises planned to renegotiate their rent terms during next 12 months.

**Challenges ahead**

Situation in the retail market is only becoming more challenging in the future. Firstly, the purchasing power of wage-earners will grow much less this year than in the past. In 2017, the growth of the average wage in real terms is expected to slow to around 3% (2013-2016 average was 6.4% per year), as nominal growth of wages will be somewhat slower and prices will rise. The real growth of the average net wage rose by only 2.6% in the first quarter of this year. This, in turn, would limit households' consumption. The substantially slower growth of wage-earners' purchasing power will be smoothed by an increase in social transfers to pensioners, low-wage earners and children. Still, the annual growth of retail trade volumes decelerated to 2.0% during the first four months of 2017.

Secondly, competition will grow. In addition to the increasing popularity of e-commerce, the media speculates on the possible market entry of the German supermarket chain Lidl. Currently, the supermarkets' sector is quite evenly distributed among four-five big players. The possible entrance of Lidl would increase competition and put further pressure on stores' profitability. Another risk is a continuous expansion of retail space, especially in Tallinn, where several new shopping areas have been opened recently or are in the development or construction phase. New shopping areas could mean that some existing locations might face lower sales. As rental agreements are usually agreed for a longer time period, it could be difficult to leave a certain location when sales have fallen, and, therefore, the share of stores earning a loss could grow. On the other hand, bigger competition among real estate developers could mean lower rents for retailers.

Liis Elmik

## General disclaimer

This research report has been prepared by analysts of Swedbank Large Corporates & Institutions' Macro Research department. The Macro Research department consists of research units in Estonia, Latvia, Lithuania, Norway and Sweden, and is responsible for preparing reports on global and home market economic developments.

### Analyst's certification

The analyst(s) responsible for the content of this report hereby confirm that notwithstanding the existence of any such potential conflicts of interest referred to herein, the views expressed in this report accurately reflect their personal and professional views.

Research reports are independent and based solely on publicly available information.

### Issuer, distribution & recipients

This report by Swedbank Large Corporates & Institutions Macro Research department is issued by the Swedbank Large Corporates & Institutions business area within Swedbank AB (publ) ("Swedbank"). Swedbank is under the supervision of the Swedish Financial Supervisory Authority (Finansinspektionen).

In no instance is this report altered by the distributor before distribution.

In Finland this report is distributed by Swedbank's branch in Helsinki, which is under the supervision of the Finnish Financial Supervisory Authority (Finanssivalvonta).

In Norway this report is distributed by Swedbank's branch in Oslo, which is under the supervision of the Financial Supervisory Authority of Norway (Finanstilsynet).

In Estonia this report is distributed by Swedbank AS, which is under the supervision of the Estonian Financial Supervisory Authority (Finantsinspeksioon).

In Lithuania this report is distributed by "Swedbank" AB, which is under the supervision of the Central Bank of the Republic of Lithuania (Lietuvos bankas).

In Latvia this report is distributed by Swedbank AS, which is under the supervision of The Financial and Capital Market Commission (Finanšu un kapitāla tirgus komisija).

In the United States this report is distributed by Swedbank First Securities LLC ("Swedbank First"), which accepts responsibility for its contents. This report is for distribution only to institutional investors. Any United States institutional investor receiving the report, who wishes to effect a transaction in any security based on the view in this document, should do so only through Swedbank First. Swedbank First is a U.S. broker-dealer, registered with the Securities and Exchange Commission, and is a member of the Financial Industry Regulatory Authority. Swedbank First is part of Swedbank Group.

For important U.S. disclosures, please reference:  
<http://www.swedbankfs.com/disclaimer/index.htm>

In the United Kingdom this communication is for distribution only to and directed only at "relevant persons". This communication must not be acted on – or relied on – by persons who are not "relevant persons". Any investment or investment activity to which this document relates is available only to "relevant persons" and will be engaged in only with "relevant persons". By "relevant persons" we mean persons who:

- Have professional experience in matters relating to investments falling within Article 19(5) of the Financial Promotions Order.

- Are persons falling within Article 49(2)(a) to (d) of the Financial Promotion Order ("high net worth companies, unincorporated associations etc").
- Are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) – in connection with the issue or sale of any securities – may otherwise lawfully be communicated or caused to be communicated.

### Limitation of liability

All information, including statements of fact, contained in this research report has been obtained and compiled in good faith from sources believed to be reliable. However, no representation or warranty, express or implied, is made by Swedbank with respect to the completeness or accuracy of its contents, and it is not to be relied upon as authoritative and should not be taken in substitution for the exercise of reasoned, independent judgment by you.

Opinions contained in the report represent the analyst's present opinion only and may be subject to change. In the event that the analyst's opinion should change or a new analyst with a different opinion becomes responsible for our coverage, we shall endeavour (but do not undertake) to disseminate any such change, within the constraints of any regulations, applicable laws, internal procedures within Swedbank, or other circumstances.

Swedbank is not advising nor soliciting any action based upon this report. This report is not, and should not be construed as, an offer to sell or as a solicitation of an offer to buy any securities.

To the extent permitted by applicable law, no liability whatsoever is accepted by Swedbank for any direct or consequential loss arising from the use of this report.

### Reproduction & dissemination

This material may not be reproduced without permission from Swedbank Large Corporates & Institutions. This report is not intended for physical or legal persons who are citizens of, or have domicile in, a country in which dissemination is not permitted according to applicable legislation or other decisions.

Produced by Swedbank Large Corporates & Institutions.

### Address

Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.  
Visiting address: Regeringsgatan 13, Stockholm.