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Why is the Central European consumer goods and retail sector so interesting?

A private equity perspective.

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Our recent sector credentials

 <p>Penta Investments</p> <p>Commercial and financial due diligence of a food producer</p> <p>2008 Hungary</p>	 <p>Makro Cash and Carry</p> <p>Analysis and redefinition of organizational function related with human resources management</p> <p>2007 Poland</p>	 <p>Kofola</p> <p>Procurement and controlling processes optimization</p> <p>2007 Czech Republic</p>	 <p>SAB Miller</p> <p>Financial advisory in acquisition of Slovakian beer producer Topvar</p> <p>2007 Slovakia</p>
 <p>Carlsberg</p> <p>Development and implementation of Shared Services Centre in Poland</p> <p>2007 Poland</p>	 <p>Oaktree Capital</p> <p>Commercial and Financial due diligence of alcohol drinks producer Polmos Lublin</p> <p>2006 Poland</p>	 <p>Intersport</p> <p>Due diligence of a chain of retail stores</p> <p>2005 Poland</p>	 <p>Coca-cola</p> <p>Financial advisory in acquisition of a Serbian water group Vlasinka</p> <p>2005 Serbia</p>

Introduction

Macroeconomic drivers in CE create an attractive environment for the development of the Consumer Goods and Retail sector.

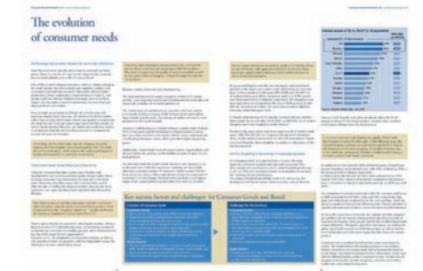
- In 2007-2009, the disposable income in CE is expected to grow by ca. 8%, compared to 1.9% in EU-15. Along with low household debt these drivers are expected to drive retail sales growth.
- The retail sales per capita in CE amount to at most 62% of the EU-27 average, which indicates the potential scale of growth.
- Bulgaria, Romania and Slovakia are considered to be 5-10 years behind the CE leaders on the retail maturity curve.
- Romania and Bulgaria will be the CE stars in terms of retail sales growth, although leveraging off a relatively low base.
- As the capital cities in the mature CE countries become saturated, the development of retail is expected to move to regions and tier-two cities.



For detailed analysis of consumer goods and retail market drivers please see pages 2 – 3.

Consumer needs are evolving, which creates new challenges for the industry.

- The consumer is becoming more affluent, value-led and, thanks to technology development, better informed.
- Price alone is not a competitive advantage anymore. Consumers take good price, value for money and convenience as given.
- More is expected from the “shopping experience” – quality and brands are gaining in importance among customers in CE.
- Modern trade channels are developing, with aggressive expansion of discount stores. Moreover, modern trade is pushing out the traditional stores in terms of non-food products.
- Premium products represent a high growth opportunity even though the segment size is relatively small
- Online shopping is experiencing a rapid increase in popularity.



For an in-depth view of customer perspective evolution please see pages 4 – 5.

Private Equity funds have tried out a range of investment strategies.

- One of the investment strategies that has proved successful is to invest in a local brand in an underdeveloped and underpenetrated market segment in one of the faster growing countries in the region (i.e. Bulgaria, Romania etc.) and achieve high returns thanks to rapid market growth rates.
- Another strategy that can be considered successful is identifying strong, local independent brands across the region and creating a consolidation platform. The value is created through growing a multi-brand and multi-country player that would have considerable scale thanks to combining local market shares.
- An overview of recent M&A activity shows that the interest is not limited to certain segments but covers a wide range of consumer goods producers as well as various retailers (from food & beverage to consumer electronics).



For a closer look at PE strategies, consumer goods & retail success stories and overview of latest deals in CE in the sector please see pages 6 – 7.

Drivers of change in the Consumer Goods and Retail sector in CE

Macroeconomic drivers



Central Europe will experience high retail sales growth in the coming years. Since EU accession consumers in the region are enjoying high rates of economic growth, resulting in higher disposable incomes and more optimism compared to their Western European counterparts.

Consumer spending is a major driver of high economic growth that the CE region is experiencing. The annual GDP growth in CE is expected to reach ca. 5% in the following years, more than twice as high as the EU-15 average.

The growth of disposable income affects not only the scale of consumer spending, but also spending structure and customer buying behaviours.

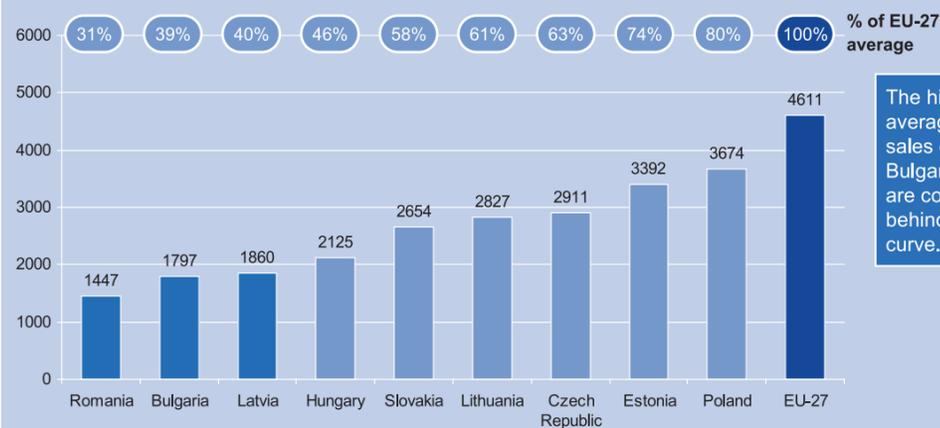
Further growth of consumer spending in CE is likely to be much more resistant to the credit crunch and the US slowdown, than economies in Western Europe.

The lifestyles of CE consumers are changing and increasingly more is expected from the "shopping experience".

However, the scale of opportunity differs significantly across the region and the adage "Think globally, act locally" seems more relevant today than ever.

In 2007-2009, disposable income in CE is expected to grow by ca. 8% annually, compared to ca. 2% in EU-15. Moreover, the ratio of household debt to GDP is much lower in the CE region – ca. 17% compared to ca. 54% in EU-15 in 2006.

Retail sales per capita in CE vs. EU-27, 2007 [EUR / per capita]



The highest gap to the EU-27 average in terms of per capita retail sales can be observed in Romania, Bulgaria and Latvia. These countries are considered to be 5-10 years behind Poland on the retail maturity curve.

Source: Deloitte calculations based on EIU.

Recent M&A activity in the sector

A number of M&A deals involving financial investors in Consumer Goods and Retail sector could be observed recently in the CE region:

Target	Country	Buyer	Date	Value [USD m]	Comments
Żabka Polska	Poland	Penta Investments	May 2007	175	A Private Equity fund bought a chain of food and beverage stores.
Agros Nova	Poland	Sonda	Mar 2007	85	A PE fund had divested its shares in Agros Nova to a strategic investor.
Extreme Digital	Hungary	SoftCon	Nov 2007	n/a	An investment firm acquired a 25%+1 minority stake in a Hungarian electronics e-retailer.
Komfort	Poland	Enterprise Investors	Apr 2007	83	A PE fund bought shares in a major furniture retailer.
Artima	Romania	Carrefour	Oct 2007	79	A PE fund had divested its shares in food and beverage stores network to a strategic investor.
Domo	Romania	Equest Investment Balkans	Oct 2007	86	A financial investor bought a network of electronics and appliance stores.
Mercator	Romania	Infond Holding Company	Sep 2007	237	A financial investor bought a 12% minority stake in a Romanian retailer.
Mecom Humenne	Slovakia	Penta Investments	Feb 2008	n/a	A private equity group bought a food processing company.
Natura	Slovakia	Arca Investments	Jan 2008	n/a	A private equity investor bought a food processing company.
Palma Tumys	Slovakia	Slavia Capital Group	Aug 2007	n/a	An investment house bought a remaining 28% stake in a food processing company.
ETA	Czech Republic	Benson Oak	Jun 2007	n/a	A financial investor bought a household appliance producer.
Valmiera Piens	Latvia	Inpo 7	May 2007	n/a	A financial investor bought a leading Latvian dairy products manufacturer.
Albalact	Romania	Augustus Asset Managers	May 2007	3.9	A financial investor acquired a minority stake (5.7%) in a Romanian dairy producer.

Looking at the M&A deal table, two segments of consumer business had a dominant share in recent transactions: retailers and food & beverage producers. Apart from the transactions completed by financial investors, there has been a number of strategic transactions in the consumer business segment.



A number of trends related to regional development can be observed. More mature CE markets, such as the Czech Republic, Hungary and Poland, experience the refocus of interest in the development of modern retail space – shopping centres and modern trade outlets will be increasingly developed in tier-two cities and regions outside the capital cities. The capitals are becoming saturated, while the regions and rural areas are still underdeveloped.

This is not yet an issue in countries like Bulgaria or Romania, where the retail system is less developed, but these countries are likely to follow the trends observed in more affluent CE countries.

The analysis of retail sales growth forecasted by regions indicates a number of high growth regions other than in Romania and Bulgaria. It is worth noting that expected growth rates in the regions are mostly close to the expected national average, indicating that the growth is likely equally spread within each country.

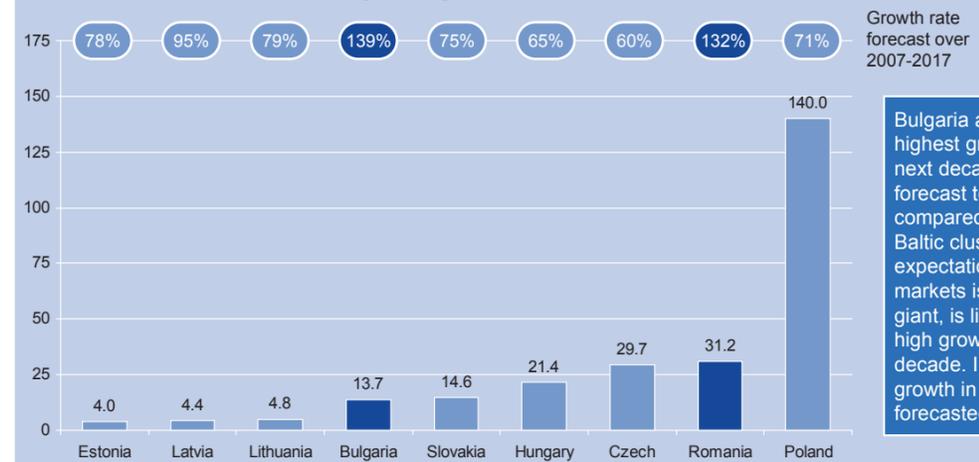
Apart from regional “stars” – Romania and Bulgaria – the Baltic states and a number of regions in Slovakia, Poland and Hungary present great opportunities for consumer business development. However, one needs to note that the growth in Bulgaria, Slovakia and Romania is leveraged off a relatively low base.

Highest retail sales growth prospects by region (excl. Romania and Bulgaria)

Region	Key town	NUTS2	Country	Population [k]	Retail sales growth forecast [2007-2017]
Latvia	Riga	LV00	Latvia	2,299	95%
Lithuania	Vilnius	LT00	Lithuania	3,419	79%
Bratislavsky kraj	Bratislava	SK01	Slovakia	600	79%
Warminsko-Mazurskie	Olsztyn	PL62	Poland	1,427	78%
Estonia	Tallinn	EE00	Estonia	1,344	78%
Vychodne Slovensko	Kosice	SK04	Slovakia	1,565	77%
Kozep-Dunantul	Szekes-fehervar	HU21	Hungary	1,110	75%
Zapadne Slovensko	Nitra	SK02	Slovakia	1,862	74%
Stredne Slovensko	Zilina	SK03	Slovakia	1,351	73%
Dolnoslaskie	Wroclaw	PL51	Poland	2,890	73%
Mazowieckie	Warsaw	PL12	Poland	5,140	72%
Podkarpackie	Rzeszow	PL32	Poland	2,095	72%
Wielkopolskie	Poznan	PL41	Poland	3,361	71%
Eszak-Alfold	Bekes	HU32	Hungary	1,540	70%
Lodzkie	Lodz	PL11	Poland	2,585	69%

Source: Deloitte calculations based on King Sturge, EIU.

Total retail sales value in CE, 2007 [EUR bn]



Bulgaria and Romania have the highest growth potential over the next decade, with retail figures forecast to more than double compared to today's values. The Baltic cluster also has high growth expectations but the scale of these markets is small. Poland – a regional giant, is likely to experience relatively high growth of ca. 71% over the next decade. In comparison, the expected growth in EU-27 until 2017 is forecasted at only 25%.

Source: Deloitte calculations based on EIU, King Sturge.

The evolution of consumer needs

Technology has a major impact on consumer behaviour

Apart from economic growth and increasing consumer spending power, there are a number of major trends impacting the consumer business both globally and on the Central European level.

One of them is technological innovation, which is notably reshaping the retail industry. New technologies give suppliers, retailers, and consumers unprecedented access to information, driving higher productivity, closer collaboration, improved decision-making, and greater customer intimacy. Digital technologies and connectivity impact not only what consumers want to buy, but how they learn about products and retailers.

New concepts are progressing through the growth stage and reaching maturity faster than ever. The desire to be first to market with a new concept and to reach critical mass quickly is compressing the retail lifecycle. Financial market expectations for fast growth, as well as shorter product lifecycles, are additional contributing factors. A compressed retail lifecycle is putting pressure on companies to increase the pace of innovation.

Technology and the information age are reshaping the retail industry both from the retailer's and consumer's perspectives. The retail lifecycle is accelerating, which requires market participants to be fast and innovative in a changing environment.

Consumers want more than just a low price

Today, the consumer has taken centre stage. Retailers and manufacturers can no longer produce goods and just expect them to sell, as consumers have advanced to the lead role in this retail triad. They know what they want and when and how they want it. After decades of settling for whatever retailers chose to give them, customers now expect products that respond to their demanding lifestyles.

Price alone is not a competitive advantage anymore. Consumers take good price, value for money and convenience as given. More is expected from the "shopping experience" – quality and brands are gaining on importance among customers in CE.

There is also a lifestyle shift observed in developed countries, which is likely to occur in CE in the following years. An increasing number of consumers have more than one holiday per year, eat in restaurants and buy top of the range items in supermarkets. However, in CE, the polarization of consumers is higher, as there is still a significant share of population with low disposable income, for which price remains a determining factor.

The increasing share of the premium segment represents a real growth avenue. More consumers are buying top-of-the-line products. They begin to appreciate the quality of services provided, as well as ease and comfort of shopping, instead of simply the value for money factor.

Modern sales channels are developing

The rapid development of modern shopping centres in CE creates a better, more organized and focused infrastructure for retail sales and impacts the evolution of consumer preferences.

The market share of small businesses, groceries and local markets is constantly declining in favour of the homogenized supermarkets, hypermarkets and discounts. This change of market structure is most prominent in the Czech Republic.

However, small businesses in Poland still keep a market share of about 50% in rural areas and the development of hypermarkets is not as high as in other countries in the region. What is more, small stores are consolidating into larger chains, which gives them higher bargaining power.

Additionally, modern trade channels (supermarkets, hypermarkets and discount stores) are pushing out the traditional stores in terms of non-food products.

The structure inside the modern retail channel is also changing in CE, as discount stores with their aggressive marketing are successfully attracting increasing numbers of customers. Partly because of lower levels of income, price is still a major decision factor for a large part of customers in Central Europe. Discount stores are likely to gain bigger shares of the market and to expand further into more CE countries.

Modern trade channels are developing rapidly in CE (slightly slower in the case of Poland), with aggressive expansion of discount stores. Moreover, modern trade is pushing out the traditional stores in terms of non-food products.

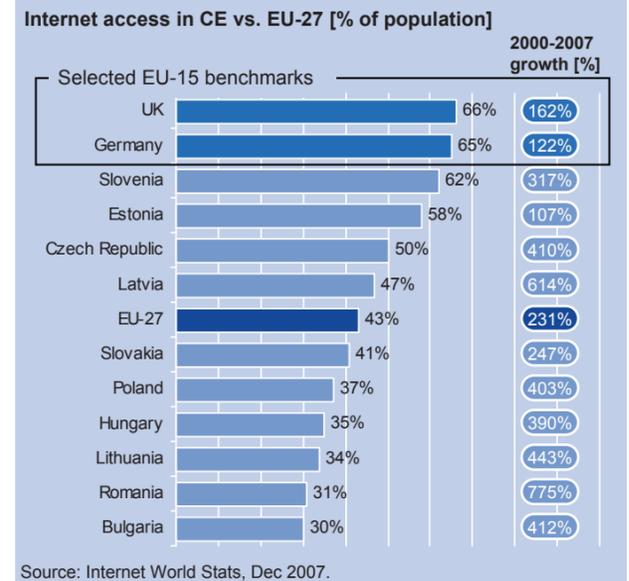
Romania and Bulgaria currently have the largest retail investment pipelines in the region and modern trade will develop at a very fast pace. In Romania alone, in the years 2007-2008 over 750 000 m² of modern letting area will be completed, which is 113% growth over total current stock. In Bulgaria, respectively, the shopping centre area expected to be completed by the end of 2008 amounts to 200 000 m². According to Colliers, the same amount will be added to Lithuania's total retail space stock.

In Poland, retail development is already moving to tier-two and tier-three smaller towns and cities. In H2 2007, ca. 600 000 m² of modern shopping space was completed outside of Warsaw.

Slovakia is also expected to experience rapid growth of modern retail space, with 250-300 000 m² of space in the pipeline in Bratislava alone. As the market is perceived to be still 5-10 years behind Poland and the Czech Republic, there should be no problem in absorbing the fast development.

Online shopping is becoming increasingly popular

On a European level, it is expected that in 2 years, the value share of e-commerce in total retail sales will account for 15%. The UK is a leader of e-commerce in EU-15, while Poland leads the way in CE. Ca. 70% of e-commerce retail is concentrated in 4 countries: UK, Germany, France and Belgium. The analysis of internet penetration levels in CE shows very fast development of internet access. Some countries, such as Slovenia,



Estonia, the Czech Republic and Latvia are already above the EU-27 average in terms of internet penetration, however other countries in the region still have room for development.

E-commerce turnover is developing very rapidly. Poland leads the CE region in terms of online sales. In the following years, Central European countries are expected to experience a wave of fast development of online shopping. CE retailers therefore face a new challenge – pressure to introduce a multichannel strategy is a must to connect with today's consumer.

According to Gemius research, 66% of Internet users in Poland have bought something online at least once, with 32% in Lithuania, 29% in Romania and 29% in Ukraine respectively. In Poland alone, the turnover of online stores and auctions in 2007 reached EUR 2.1bn, which is 60% growth compared to the previous year. E-commerce in Poland is expected to grow by ca. 60% a year until 2009.

For comparison: e-commerce turnover in the UK, Germany and France in 2006 amounted to EUR 45bn, 22bn and 10bn respectively. Italy, Spain and Holland are considered to be the next countries, which are about to experience boom in the following years. Poland and other CE countries are expected to follow in terms of online retail development.

As far as the consumer is concerned, the majority of online shoppers are satisfied with the services, however there are still some fears of that form of shopping. Many people find the lack of direct buyer-seller contact disturbing. The buyers, apart from low prices, are looking for safety, speed and convenience of the transaction, as well as hard-to-find merchandise and information supporting the choice of a certain product.

Consumers see a number of problems that online stores have to resolve. The weakest link in the shopping process is product delivery. Sometimes it is the couriers' fault, but increasingly the blame is on the stores. The future is brightest for the online stores, which cope with the difficult logistics of the e-commerce sector. Another fear of shoppers is buying security and privacy, which to some extent hinders the online retail development.

Key success factors and challenges for Consumer Goods and Retail

Evolution of consumer needs

Consumer Goods

- The consumer is becoming more affluent and more value-led.
- Thanks to technology development, customers are better informed and demanding than ever before.
- More is expected from a shopping experience than just low price, quality and brands are becoming more important.
- Top premium products represent a high growth opportunity.
- Consumers are becoming more health and environment conscious.

Retail channel

- The preferred shopping outlet is no longer a small convenience store, modern retail such as shopping centres, hypermarkets and discount stores are becoming the venues of choice.
- Online shopping is experiencing a rapid increase in popularity.

Challenges for the business:

Consumer Goods

- Develop effective differentiation strategies delivering more value than just favourable price. Focus on customer experience. Product quality is important.
- Develop strong local / regional brands. As retailers become principal holders of relationship with the consumers they need to develop their marketing skills.
- Look for a market niche and target a more focused group of consumers.
- Increasing importance of social responsibility.

Retail channel

- Establish presence in the right distribution channels.
- A multichannel strategy is a must. E-commerce represents an area of great opportunity.