

Arion Research expects further growth in tourism

Arion Research published a report in September on the outlook of the tourism industry in Iceland and the challenges the industry faces. We expect further growth of the industry in the coming years and estimate that the total number of visitors will reach 1.77 million in 2016 and roughly 2.25 million in 2017. A considerable appreciation of the króna, investment in infrastructure and accommodation impose challenges for the industry in years to come and in order to fund public investment in infrastructure it is vital to reach a consensus on a fair fee system in our opinion.

Investment picks up steam

Statistics Iceland published GDP data for Q2 in September along with revised numbers for 2015. GDP increased by 4.1% in the first half of 2016 compared to the same period in 2015. The increase was mainly driven by private consumption and investment growth. The increase in investment pleasantly exceeded our expectations and investment level as a percentage of GDP has surpassed its long-term average.

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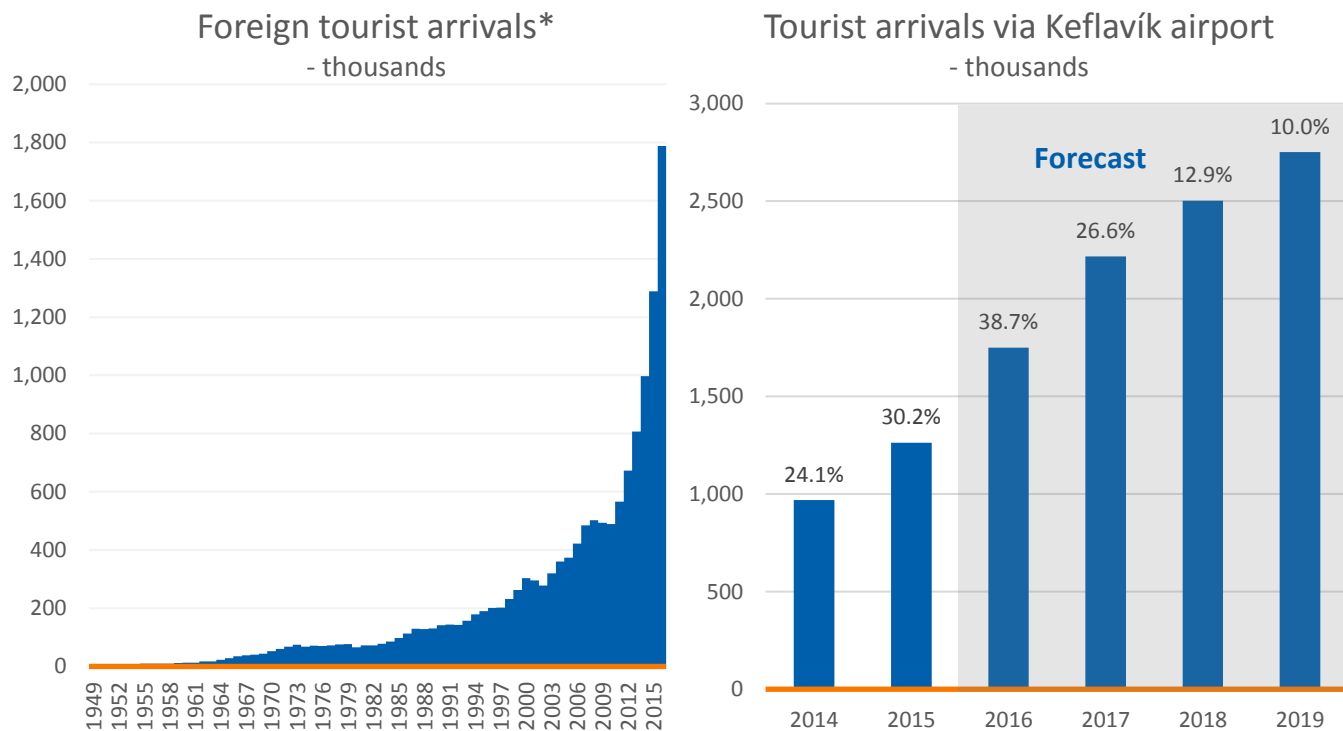
Provisional release:

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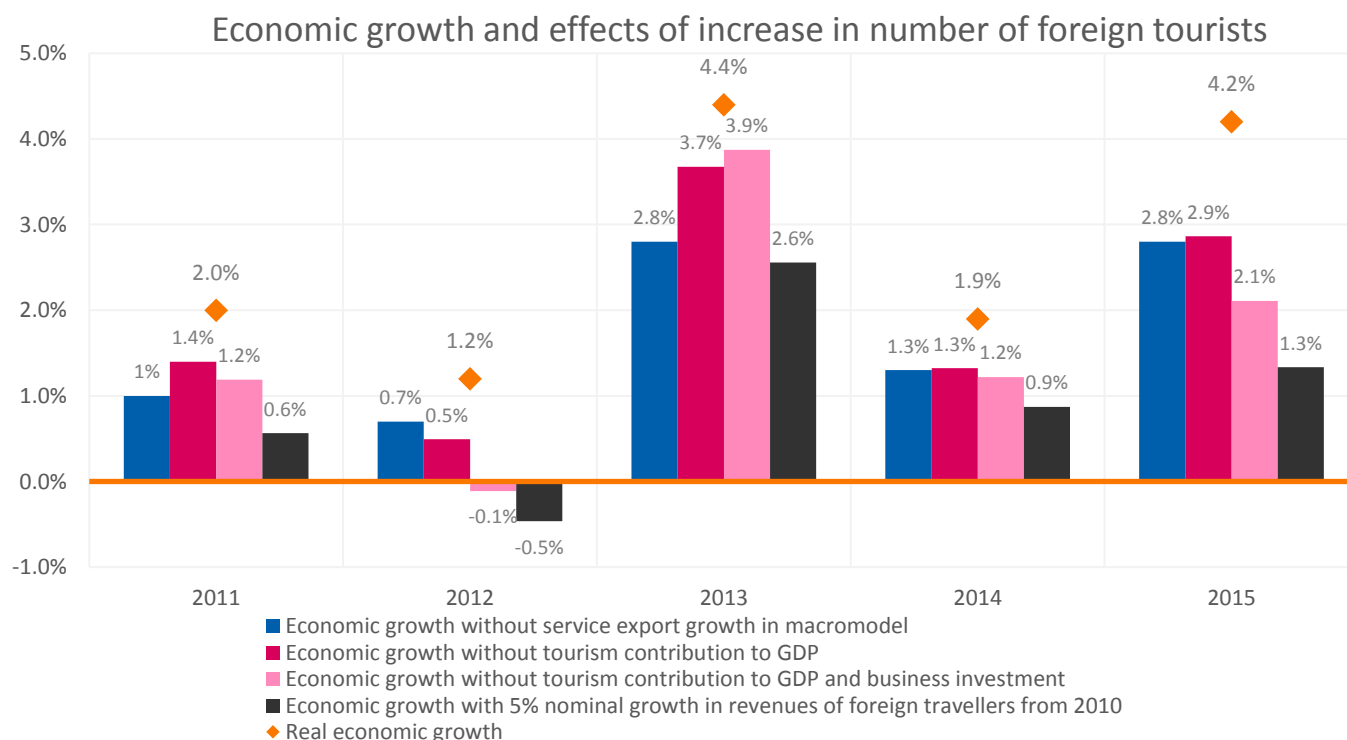
Arion Research has for the fourth consecutive year in a row published a report on the tourism industry in Iceland. Highlights from the report in English can be found [here](#) while the full report in Icelandic can be found [here](#).

In a macroeconomic context tourism has become one of the main pillars of the Icelandic economy, fueling GDP growth and speeding up the recovery process from the economic collapse in 2008. In 2015 roughly 1.25 million tourist visited Iceland, a 30.2% increase from 2014, while numbers for 2016 indicate even more growth this year and that total tourist arrivals will amount to 1.77 million, a roughly 39% increase from 2015. Tourist arrivals in Iceland have grown exponentially in recent years and to put things in to context the number of tourist traveling to Iceland in the last 9 years topped the total number in the previous 59 years before that.



Sources: Icelandic Tourist Board, Arion Research *forecast for 2016.

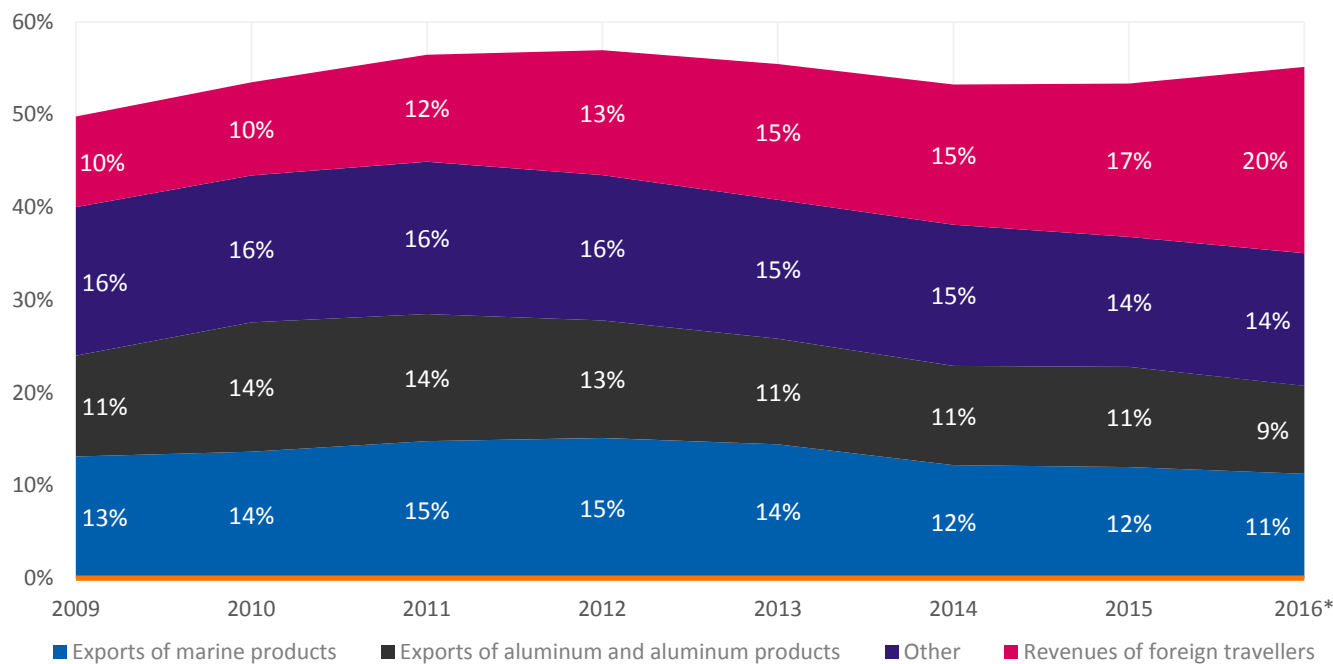
As stated earlier, the contribution of tourism to GDP and business investment has been growing in recent years. Based on various measurements GDP would be an estimated 4-8% (80-180 bn. ISK) lower if it hadn't been for the boom in tourism.



Sources: Icelandic Tourist Board, Arion Research

In terms of exported goods and services as a percentage of GDP, tourism is the leading source of export revenue. In 2013 revenues from foreign travelers became the single largest contribution of export related industries to GDP, contributing 15% to GDP. In the first half of 2016 export revenue from tourism has contributed roughly 20% to GDP, overshadowing other export industries such as marine and aluminum industries.

Exports of goods and services as percentage of GDP

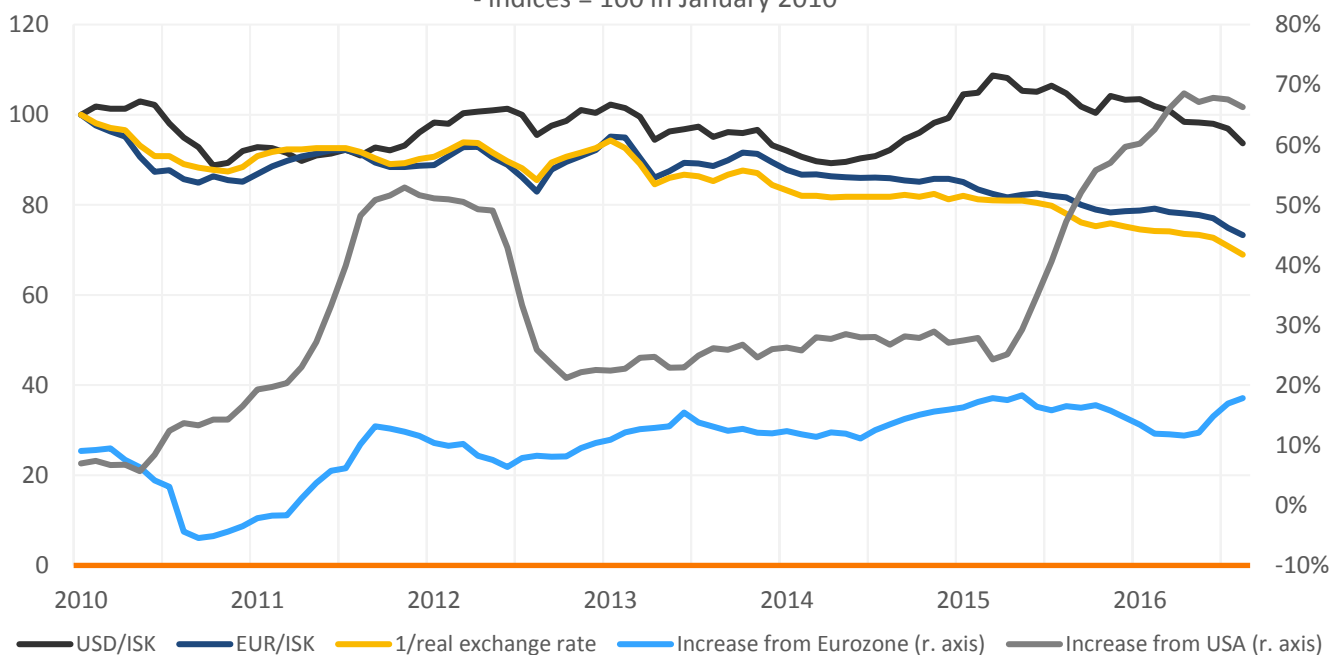


Sources: Icelandic Tourist Board, Arion Research **According to Economic Outlook by Arion Research

The considerable appreciation of the exchange of the króna has been mentioned as a possible limiting factor on the number for foreign travelers and their spending. Nevertheless, a stronger króna has so far had little impact on consumption by tourists. The impact is, however, noticeable and could magnify if the exchange rate continues to appreciate. YTD the króna has strengthened 13.4% against the dollar and 9.9% against the euro, while the real exchange of the króna is at its highest levels since March 2008. One might wonder if signs of the “Dutch disease” will start showing, i.e. negative impact on the economy due to one industry giving rise to sharp currency inflows, leading to currency appreciation and lessening the competitiveness of other export related industries.

Exchange rates and increase in tourist arrivals*

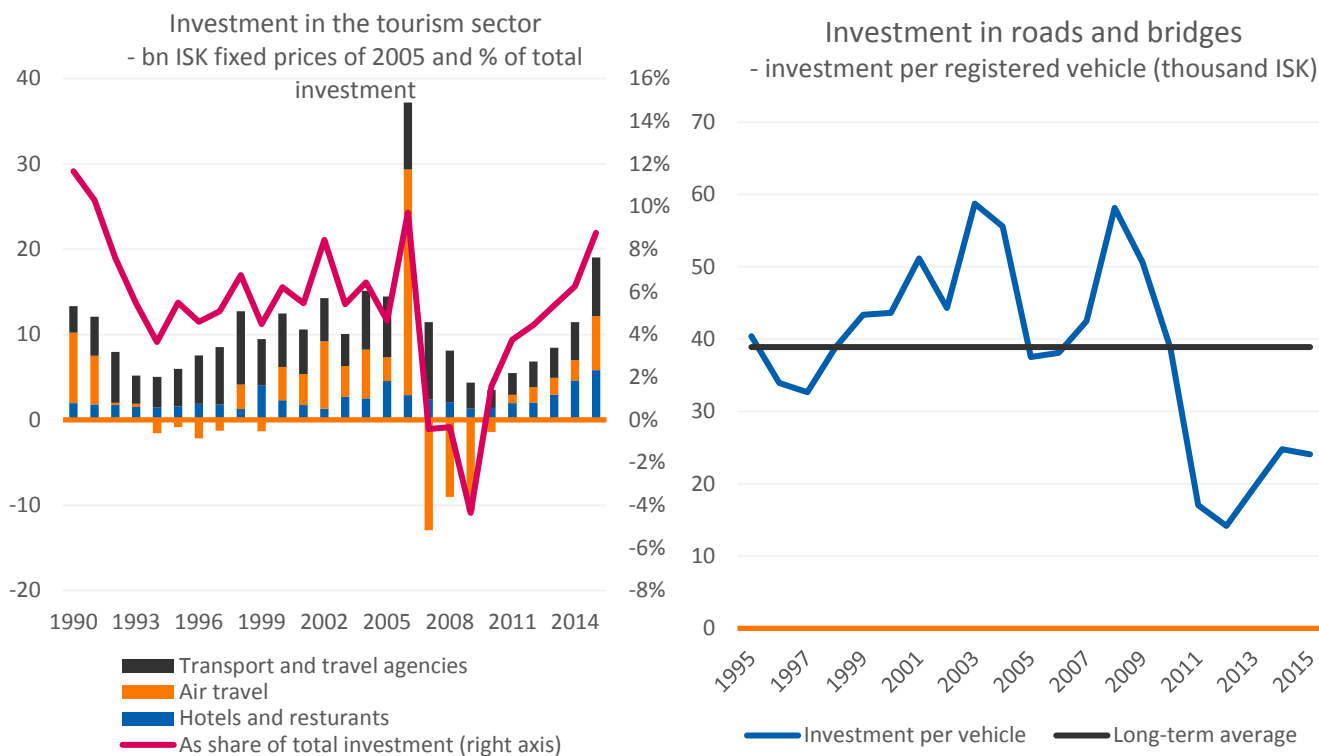
- indices = 100 in January 2010



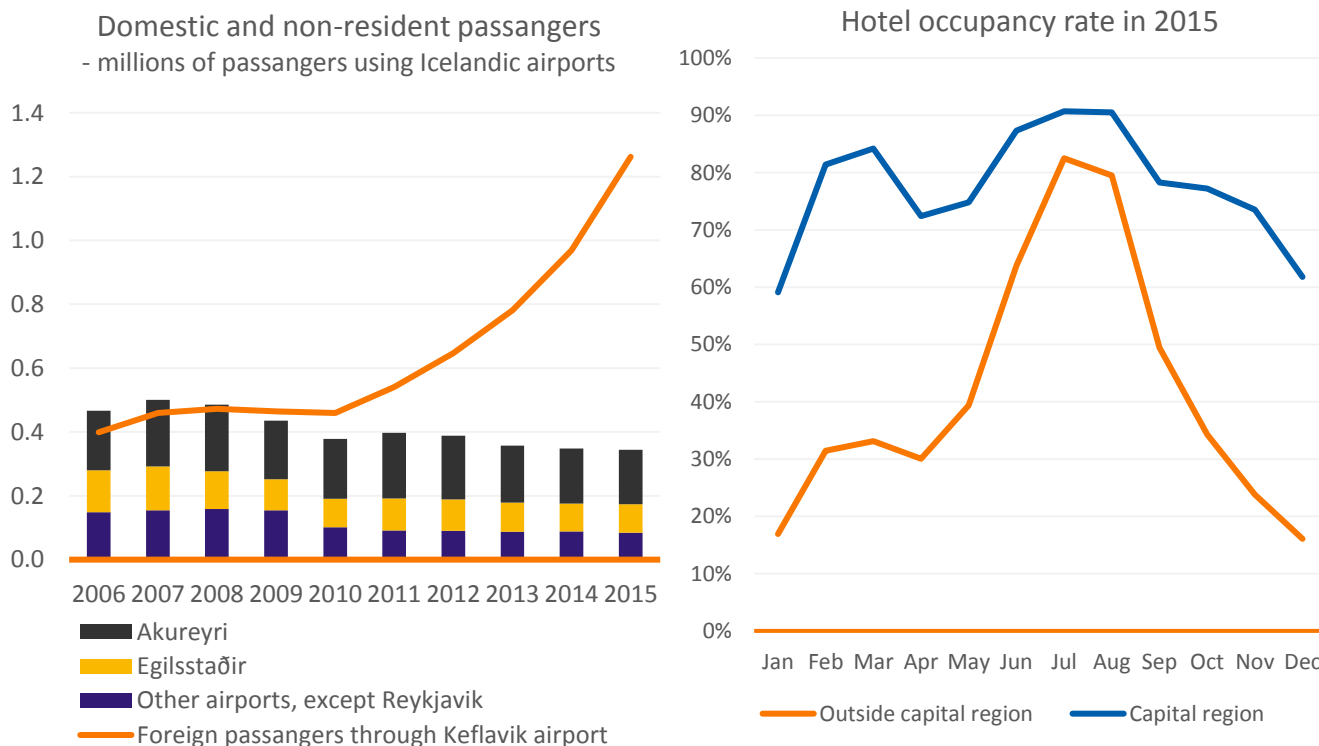
Sources: Statistics Iceland, Icelandic Tourist Board, Central Bank of Iceland, Arion Research. *Number of visitors last 12 months compared to the 12 months before.

Probably the biggest challenge facing the tourism industry today is investment in infrastructure, as rising numbers of tourists put more pressure on physical infrastructure such as airports, harbors and the road network. The influx of tourists could also put strain on social infrastructure such as healthcare and law enforcement. Investment as a percentage of GDP, which had long been below its long-term average, finally reached its long-term average in Q1 2016 and stayed above it in Q2 2016. Although investment in core sectors

of tourism has grown rapidly in recent years, public investment in physical infrastructure such as roads and bridges still lags behind and is particularly low in historical context. In that regard we estimate that pent-up need for investment in roads and bridges amounts to roughly 20 billion ISK since 2011.



In our opinion it is vital that investment is made in communications, in particular the road network, while investment in domestic flights could be stepped up to help better distribute tourists across the country. Hotel occupancy rates in the capital area were among the best in Europe in 2015, while occupancy rates outside the capital region showed considerable seasonality. Although several large scale hotel projects are underway, capacity constraints could hinder further growth of the tourism industry. One way to address that problem is to try to direct the stream of travelers outside the capital area during off season (Sep-May), where accommodation is readily available, by increasing domestic flights from Keflavík airport to e.g. Akureyri airport.



Sources: Icelandic Tourist Board, Arion Research

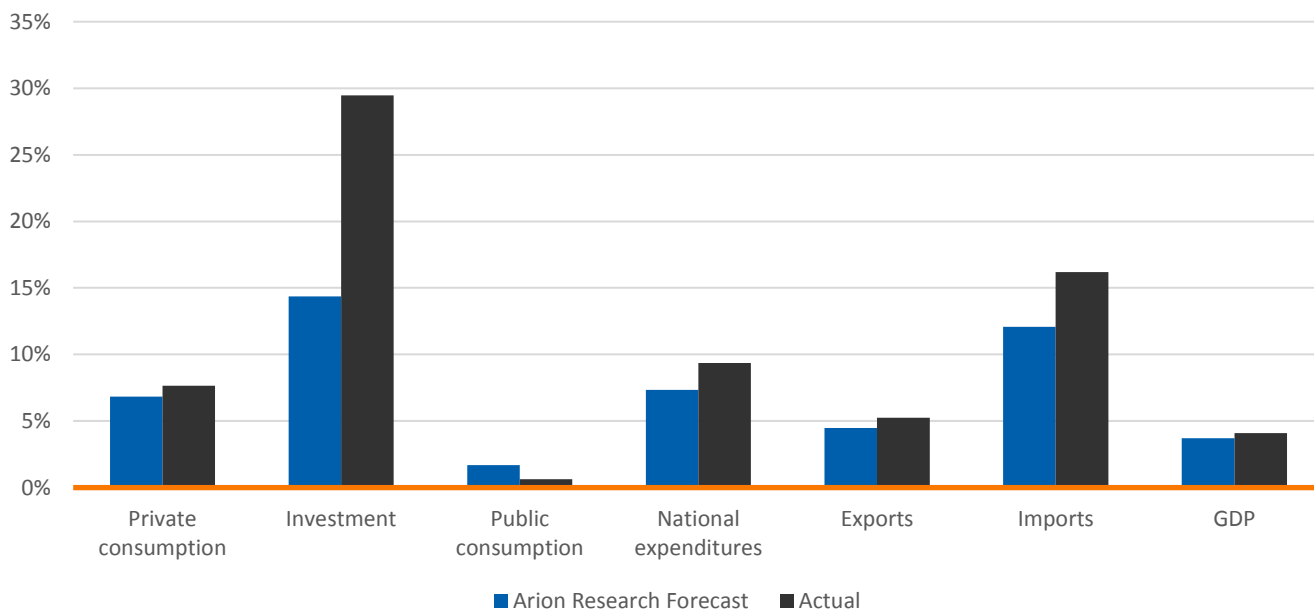
In order to fund public investment in infrastructure it is vital to reach a consensus on a fair fee system in our opinion. For example, the overnight stay tax could be increased and entry fees at certain tourist locations could be charged.

Investment picks up steam

In the beginning of September Statistics Iceland published GDP data for the second quarter of 2016 along with revised data for 2015.

It is safe to say that the Icelandic economy is advancing full speed ahead as GDP increased by 4.1% in the first half of 2016 year-on-year. The growth, like previous years, was mainly driven by private consumption growth and investment, growing 7.7% and 29.5% respectively.

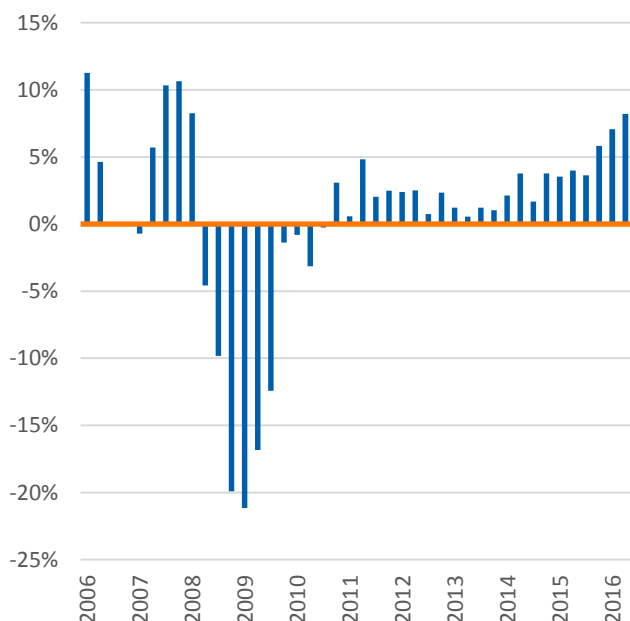
GDP growth in the first half of 2016
- comparison of forecast and actual results



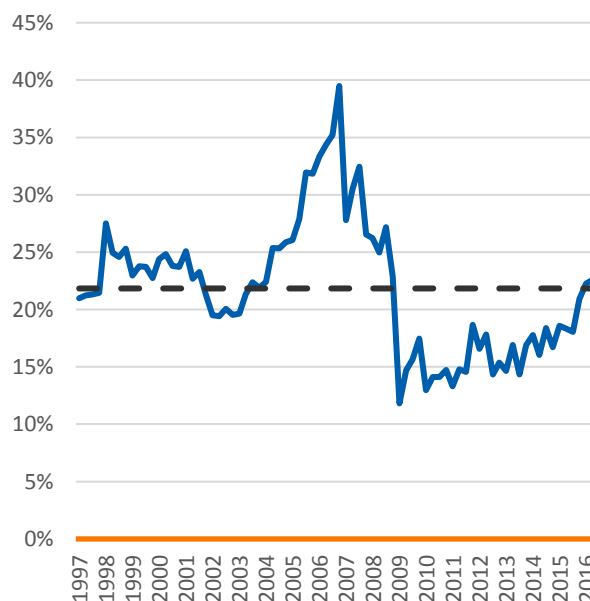
Sources: Statistics Iceland, Arion Research

Although economic growth was higher in Q1 than Q2, growth numbers for domestic demand in Q2 were the main source of attention. Private consumption increased by 8.2% in Q2, the highest growth rate since 2008, investment grew by 31.2%, also a record growth since 2008, and domestic demand grew by 9.7%, highest recorded growth since 2006.

Private consumption
- YoY change



Investment
- % of GDP

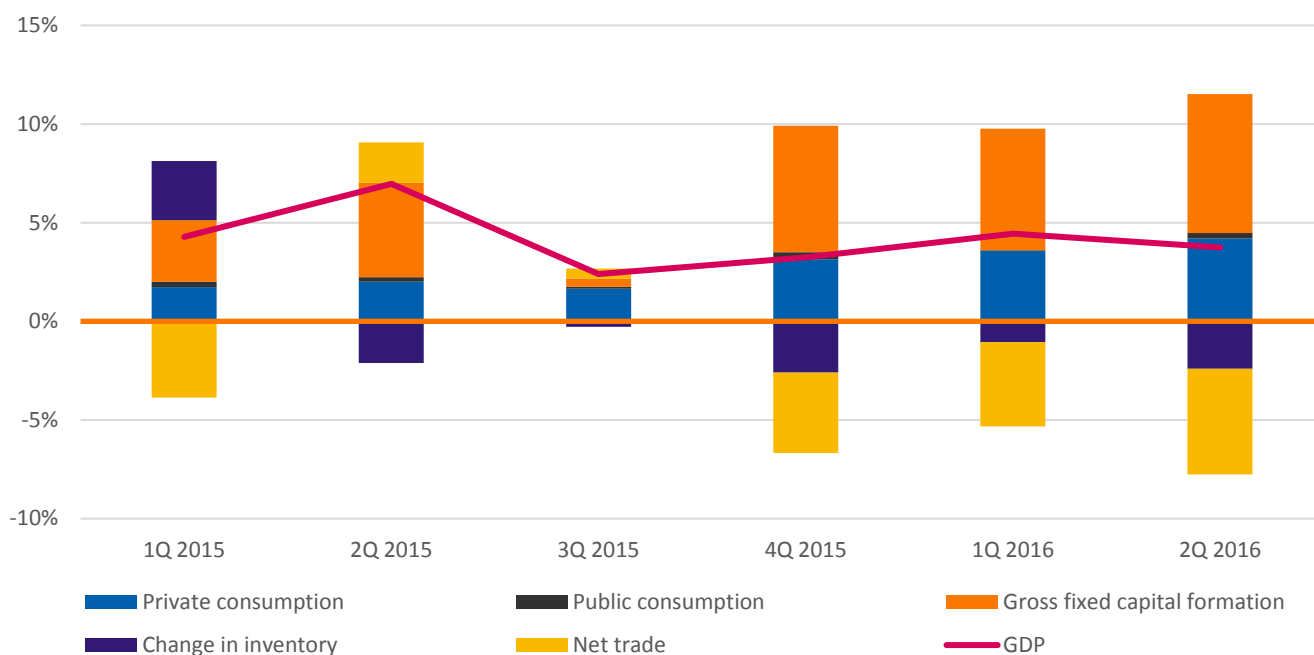


Sources: Statistics Iceland, Arion Research

Both exports and imports exceeded our expectations, as exports increased by 4.9% in Q2 YoY while imports increased by 16.7%. Therefore, the contribution of external trade to GDP was negative for the third

consecutive quarter. Moreover, changes in inventory continued for the fifth straight quarter to contribute negatively to GDP growth.

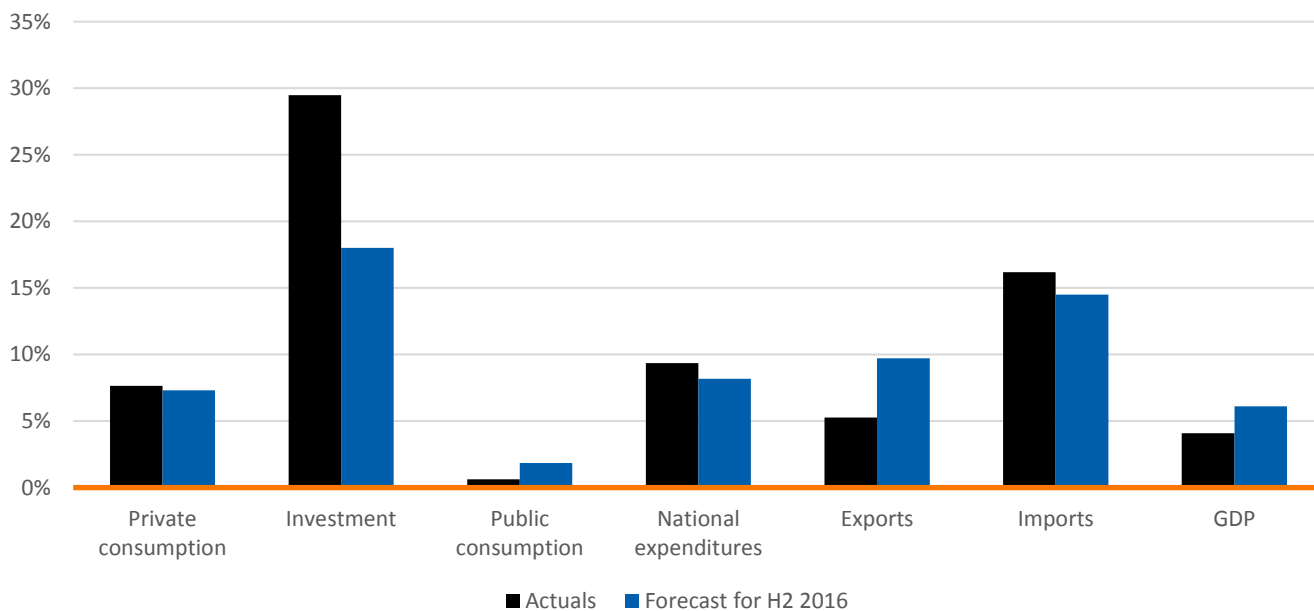
GDP growth and contribution of underlying components



Sources: Statistics Iceland, Arion Research

We have no reason to anticipate a weaker growth in the second half of 2016. Our updated economic forecast projects 4.9% growth in 2016 but for that forecast to realize, the economy has to grow by 5.7% in H2 – certainly a rapid growth but not far-fetched considering the current outlook and increasing domestic demand. We assume considerable export growth in H2, particularly in services since there will yet again be a record growth in the number of flights to Iceland this winter.

First and second half of 2016 - actuals for H1 and forecast for H2



Sources: Statistics Iceland, Arion Research