

INVESTOR CONFIDENCE INDEX FOR LITHUANIA (6), QUARTER IV, 2015

The investors' confidence index for Lithuania (ICIL) reflects the attitudes and expectations that the largest foreign capital businesses operating in Lithuania have for the country's business and investment climate. The purpose of the index is to help evaluate the country's business environment and the attractiveness of Lithuanian economy to foreign investors based on the experiences and observations of market players already operating in Lithuania.

Not only is the index used for assessing the conditions of the Lithuanian market, it also serves as a tool for identifying the most influential factors that shape these conditions. ICIL provides potential investors and other stakeholders with principal information about

Lithuanian economy, national market and short-term prospects for development.

The index consists of three indicators that provide an overview of the business environment, factors that influence business and the investment plans of companies operating in the country. When measuring ICIL, the priority is to present adequate and relevant information that reflects real market trends. With this in mind, only the heads of foreign companies and top tier management are invited to participate in the survey.

The ICIL survey is carried out by the initiative of Investors' Forum, an association of Lithuania's largest investors. A total of 84 Lithuania's foreign capital businesses participated in this quarter's survey.

| Index value | Interpretation |
|------------------------|---|
| ICIL=2 (maximum value) | All participants indicate positive expectations (absolutely positive expectations). |
| ICIL>1 | The percentage of participants with positive expectations exceeds the percentage of respondents with negative expectations. |
| ICIL=1 | Equal numbers of participants indicate positive and negative expectations. |
| ICIL<1 | The percentage of participants with negative expectations exceeds the percentage of respondents with positive expectations. |
| ICIL=0 (minimum value) | All participants indicate negative expectations (absolutely negative expectations). |

Fig. 1 Index values and descriptions, ICIL 2015Q4

Contact: Vytautas Ulozas, Investors' Forum
Vytautas@investorsforum.lt. +37066218699

SUMMARY AND CONCLUSIONS

THE 6TH ICIL SURVEY: a record-high index value in line with the upcoming reforms on labour regulations.

ICIL_{Q4, 2015} = 1,189

Positive outlook on the growth of demand and profitability as well as the growing political will to enact the new social model drive investors' expectations to a new high.

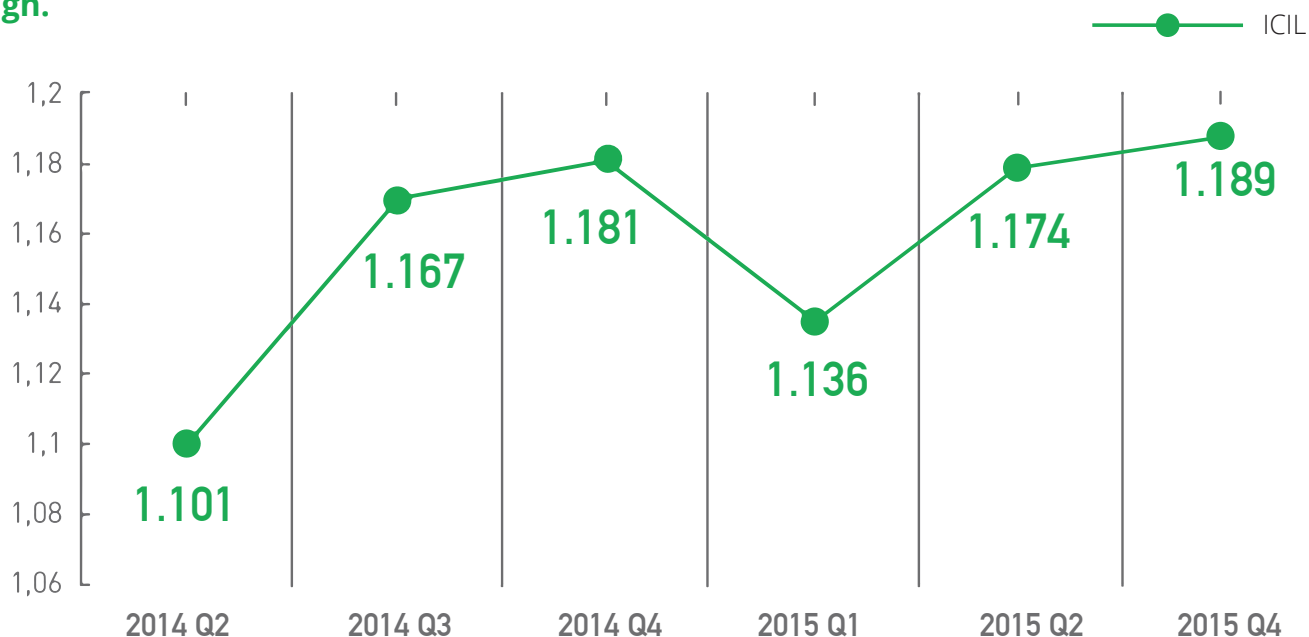


Fig. 2: ICIL dynamics Q2, 2014 - Q4, 2015

For the last quarter of 2015 the calculated value of investors' confidence Index for Lithuania is **1,189**. It marks a new record – the highest value since the creation of the index and yet another quarter when positive expectations outweigh the negative ones. This proves that investors present in the Lithuanian market continue to see economic conditions as favourable for business. Almost all of the factors included in the index push the index upwards. Macroeconomic stability is seen as high with a potential to rise further, the outlook on the company level is also affirmative, with rising demand and profitability of operations as well as plans for new investments and workplaces to be created. The single exception is political stability, which reflects the beginning of the new election cycle

in preparation for the parliament elections in Autumn 2016.

Another factor of crucial importance is the reform package of the current seriously outdated labour code. The package contains about 40 laws named as the new social model, which is finally gaining momentum. These reforms have been absolutely essential since labour regulations have been constantly identified among the main impediments to further improve Lithuania's attractiveness for foreign direct investment as well as to economic growth in general. Investors feel hopeful that the Parliament will demonstrate strong political consciousness and adopt the much-needed reforms.

KEY POSITIVE EXPECTATIONS

Macroeconomic factors: infrastructure and sustainability drives positive outlook

As already mentioned, investors' expectations for the 4th quarter are better than ever and these results are driven by a number of factors. Transport & logistics as well as telecommunications & Internet infrastructure continues to be Lithuania's trump card. It is considered as really high level and none of the respondents see any reason for it to deteriorate in the near future.

In addition, sustainability of macroeconomic environment in Lithuania has received plenty of appraisals as well. Only 5% of executives

evaluated it as low, while more than a half (64%) gave it a neutral mark and a third (31%) evaluated it as high. What is more, the majority of the surveyed managers (77%) expect the level to remain high or even rise further (13%) as we go to into the next quarter. Investors foresee a continuous improvement in the macroeconomic environment: although still not seen as high level, business transparency and taxation is gradually growing better.

Firm-specific factors: demand growth is powered equally by exports and local demand.

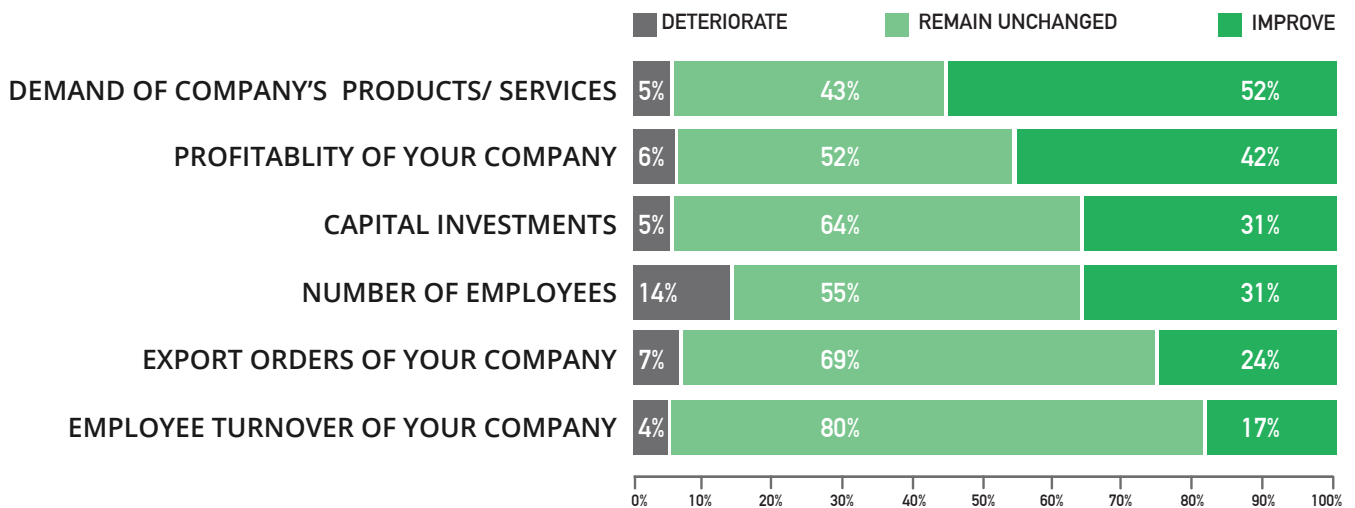


Fig. 3: "Firm-specific factors", ICIL 2015 Q4

Another pleasing fact is that firm-specific factors are also expected to climb up. It is evident that companies foresee a very promising period since every second manager (52%) claimed an expected growth of demand for their products or services. Oddly, only one in four (24%) predict higher exports, leaving the rest of the extra demand to come from the power of local

market – which again is a sign that economy is gaining momentum. 2 out of 5 surveyed companies (42%) expect their profitability to rise as well. These favourable predictions allow business to plan both new capital investments (31%) and establishment of new workplaces (31%).

KEY BARRIERS

Macroeconomic factors: beginning of the new election cycle signals reduced political stability

Although a larger proportion of respondents evaluate the current level of political stability as positive, expectations for the upcoming quarter fall to the negative side. The Parliamentary election will be held in October 2016, however, preparations for the campaign begin earlier, which brings less political predictability and possible digression from long-term strategic priorities.

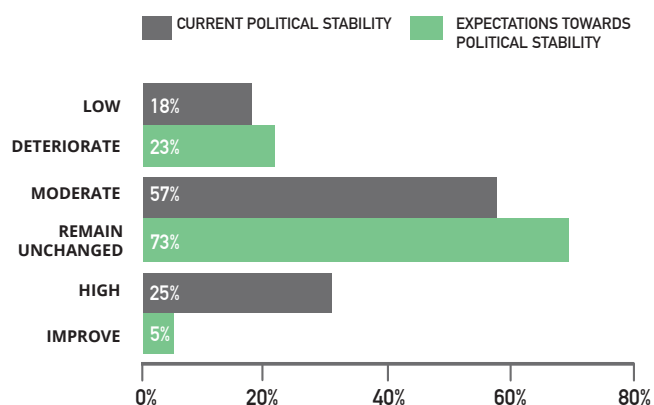


Fig. 4: Political stability - Situation and expectations, ICIL 2015Q4

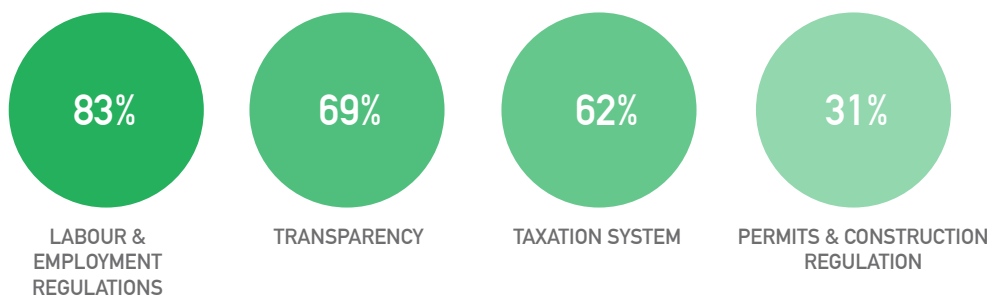


Fig. 5: Areas in need of reforms, ICIL 2015Q4

When it comes to identification of areas that require the biggest attention and improvement, tendencies remain similar since the beginning of the index surveys. Labour & Employment regulations (83%) are considered to be the most profound issue. However, there is hope for this tendency to change drastically if the

major labour code reforms will gain enough political support in the Parliament. Other areas of concern include lack of business transparency (69%) and taxation system (62%). Another problematic area is public procurement mentioned by 1 out of 3 executives (31%).

Firm-specific factors: The flip sides of labour

As discussed below, labour force is Lithuania's competitive advantage, but it has a flip side as well. Although unemployment remains at a fairly high rate of 9.4% (Statistics Lithuania, 2015), the main concern expressed by top-level managers is that it's becoming increasingly difficult to find highly qualified specialists. 93% of the respondents face these issues occasionally or often. Inflexible labour regulations coupled with

high taxation do not help as well. There is a big need for proper retraining programs as well as a thorough reform of the higher education system with labour market demand in mind, ensuring that the market gets the specialists it needs. This would hit two birds with one stone: lack of qualified labour and unemployment. Of course, if desired expertise is absent in Lithuania, the process of hiring well-educated

professionals from the third countries would create high value for the Lithuanian economy as well.

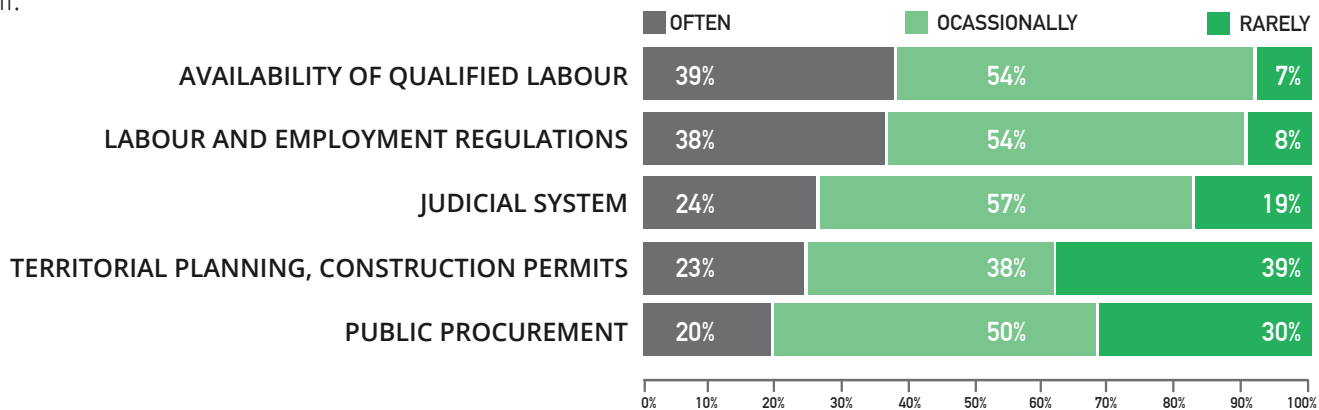


Fig. 6: Problems for everyday activities, ICIL 2015Q4

LITHUANIA'S COMPETITIVE ADVANTAGES

Investments are required to maintain the biggest asset of Lithuania - its people

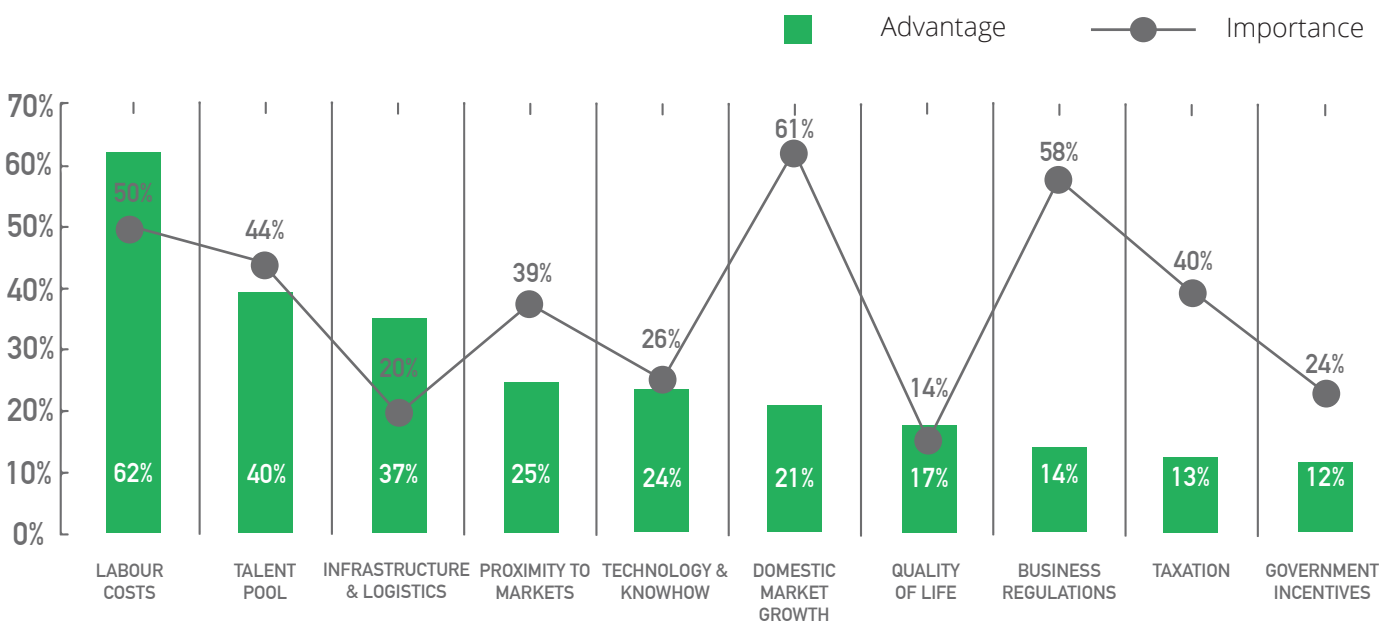


Fig.7: Lithuania's competitive advantages and Investment determinants, ICIL 2015Q4

As seen in the graph Lithuania's main competitive advantages remain the same – labour costs, talent pool and infrastructure & logistics. Interestingly enough, labour costs are losing its significance over time – the percentage of respondents who selected it as an advantage is down from 74% in 2014 Q2 to 62% for the upcoming quarter. It is an indicator that living standards are catching up with those of more mature western economies and also a reminder that this advantage is difficult to sustain in the long term. Therefore, efforts must

be paid to develop other factors maintaining our competitiveness in the global market. The graph clearly depicts areas where that effort is necessary and may have a high potential. While domestic market growth is not easy to achieve, areas in the direct control of the public sector, such as business regulations and taxation, are conspicuous to be lagging significantly behind. 58% and 40% respectively identify these factors as crucial for making investment decisions. However, only 14% and 13% consider them to be a competitive advantage of Lithuania.

ADDITIONAL INSIGHTS

THE NEW SOCIAL MODEL AND THE LABOUR CODE FOR THE 21ST CENTURY

How often does your business face problems caused by inflexible employment regulations in Lithuania?

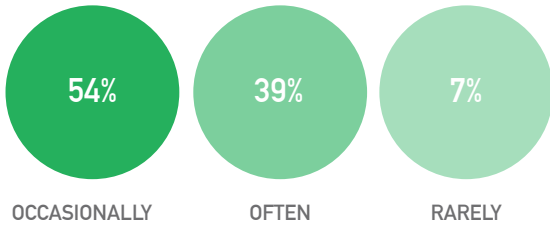


Fig.8: Frequency of problems caused by labour regulations, ICIL 2015Q4

The businesses were asked how often do they encounter problems caused by inflexible labour regulations and the results are fairly grim. As little as 7% admitted they have never faced such problems, while the rest experience difficulties either occasionally (54%) or often (39%). Moreover, Labour & Employment Regulations have been constantly identified in the previous surveys as the number one area in need of

Which areas do you consider to be in the biggest need for attention and improvement?

- Labour regulations

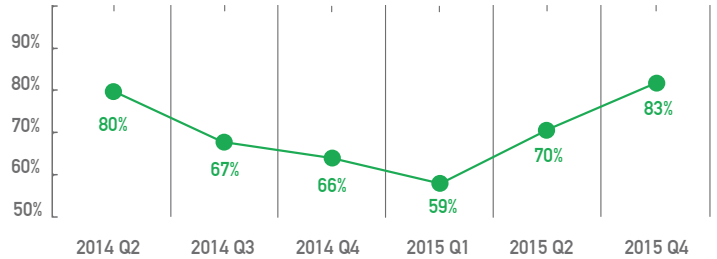


Fig.9: Labour regulations as an area in need of improvement, ICIL 2015Q4

attention and improvement. According to the newest Global competitiveness report by the World Economic Forum, there are 6 indicators where Lithuania falls outside the Top 100. Not surprisingly, 5 of those indicators belong to the pillar of labor market efficiency. It is hard to argue that something must be done if Lithuania wants to gain significance in the global market.

Which of the factors would have the greatest impact on your company's motivation to create new jobs?

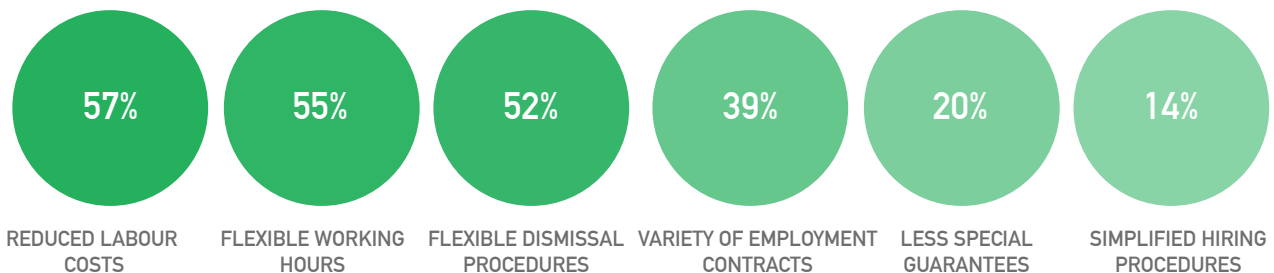


Fig.10: Motivators to create new jobs, ICIL 2015Q4

When asked about specific aspects of labour regulations that impede the creation of new jobs, the respondents agreed on three main factors that could catalyse it if tackled correctly.

57% pointed to reducing labour over-taxation, 55% opted for more flexible working hours and, finally, 52% for more flexible dismissal procedures.

Which of the factors would have the greatest impact on your company's motivation to increase salaries?

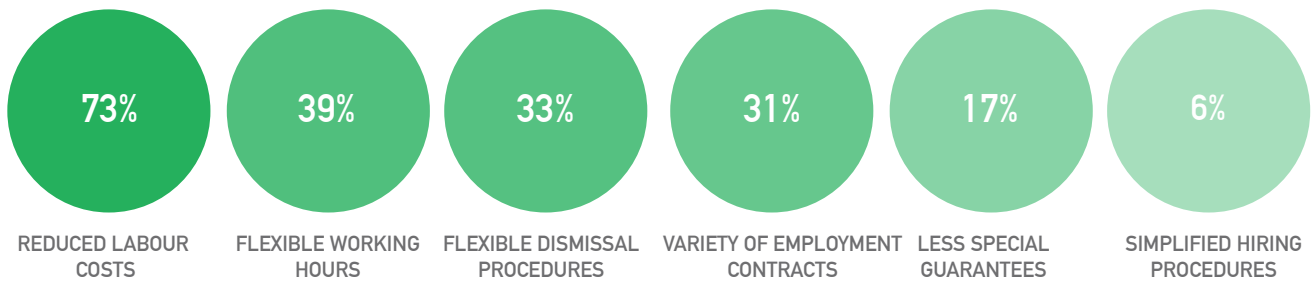


Fig.11: Motivators to raise salaries, ICIL 2015Q4

The reasons that discourage employers from raising salaries stand in the same order (just with different proportions) as the motivation to create new jobs. Clearly the biggest obstacle is the labour taxation. It could be hard to envisage how expensive a working place actually is compared to the net salary received by workers.

Despite this fact, competitive wages remain among Lithuania's top advantages. However, this will hardly perpetuate into the far future. In addition, more flexible working hours (39%), more flexible dismissal procedures (33%), and a wider variety of contract forms (31%) would all have an upward pressure on the salaries.

Proposal to enact SODRA tax ceiling

Proposal to combine social security contributions

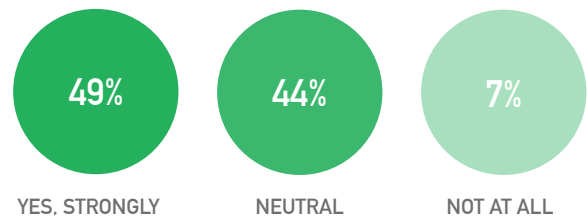
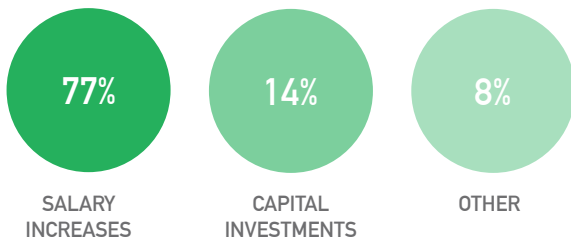


Fig.12: Support for combining employee and employer SODRA contribution, ICIL 2015Q4

Fig.13: Purpose where extra funds would be directed, ICIL 2015Q4

One of particular remedies for labour over-taxation is introduction of SODRA (social security) payment ceiling. If a maximum amount of social security contribution was set it would enable companies to reduce their operating costs as well as hire top employees for high value added positions by offering them much more attractive salaries.

The survey revealed that if case such a ceiling was introduced and additional funds were saved, three quarters (77%) of managers would use the extra money to raise salaries. 14% would devote it for further capital investments, with the rest opting to spend it on improved profitability, dividends and staff trainings.

Respondents were also asked whether they would support the proposal to combine the employer's part and the employee's part of social security contributions into a single employee contribution, with a corresponding increase of the gross salary (the net salary would remain the same). Only 7% are against it, while the rest feels either neutral (44%) or strongly in favor (49%) of the proposal. The reasoning behind this proposal is that the majority of workers do not realize the actual cost of their work place. Since the employer part of SODRA contributions is not evident on pay slips, employees tend to easily forego them in favor for the extra cash paid illegally, without realizing that they are stealing from themselves in the form of smaller pensions and other social benefits.

Employability of senior workers

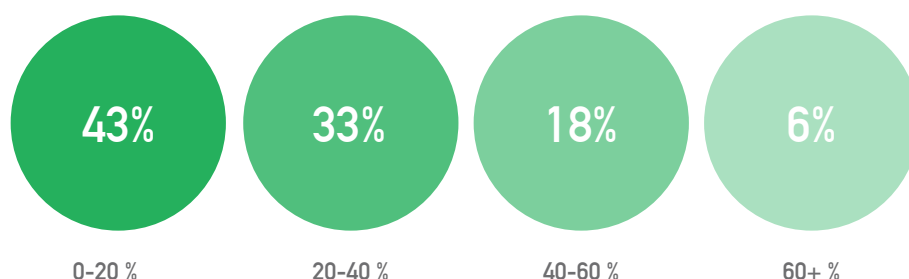


Fig.14: Percentage of company's employees older than 40 years, ICIL 2015Q4

Finally, the survey touched upon the topic of employability of those over the age of 40. It turned out that surveyed companies are fairly “young”. More than a quarter stated that less than a tenth of their staff is older than 40 years. As seen in the figure, more than 40% of respondents stated that less than a fifth of their employees are of senior age. In 91% of surveyed companies the number of staff younger than 40 outweighs the number of the ones above this age mark.

Government introduced protections in Labour and Employment regulations in order to improve employability of certain groups of labor force. However, way to often such protections work in a counter intuitive way. The intention is mostly positive, i.e. more regulations should provide more protection for workers, especially for certain groups. However, above a certain level regulations starts having an opposite result, i.e. they prevent a certain work place to be created in the first place.



Fig. 15: Motivators to hire more workers older than 40 years, ICIL 2015Q4

As seen in fig. 15, every second employer (48%) said that strict dismissal procedures increase the risk of hiring extra staff, and if the regulations were more flexible they would be willing to hire more workers who are elder than 40 years old. Otherwise, what is the purpose of being protected against dismissal if due to the protections you are not hired at all? Another 3 factors have been mentioned more

often than others. More than a third of managers shared that a wider variety of employment contracts (39%), reduced labor taxation (39%) and less special employee protection guarantees (35%) would motivate them to hire more workers older than 40 years age. It is important to mention that some respondents stated that age has no significance as a for hiring employees.