

INVESTORS' CONFIDENCE INDEX FOR LITHUANIA (8),

II QUARTER, 2016

The Investors' Confidence Index for Lithuania (ICIL) reflects 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 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.

ICIL also serves as a tool for identifying the most influential factors that shape these conditions. It provides potential investors and other stakeholders with principal information about Lithuanian economy, national market

and short-term prospects for business development. The index consists of three indicators that provide an overview of the business environment, factors that influence business and investment plans of companies operating in the country. When measuring ICIL, priority is given to 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 Investors' Forum, an association of Lithuania's largest investors. A total of 58 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

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SUMMARY AND CONCLUSIONS

THE 8TH ICIL SURVEY: so far so good, but more effort should be needed to pave a path to success in the future

ICIL_{Q2, 2016} = 1,215

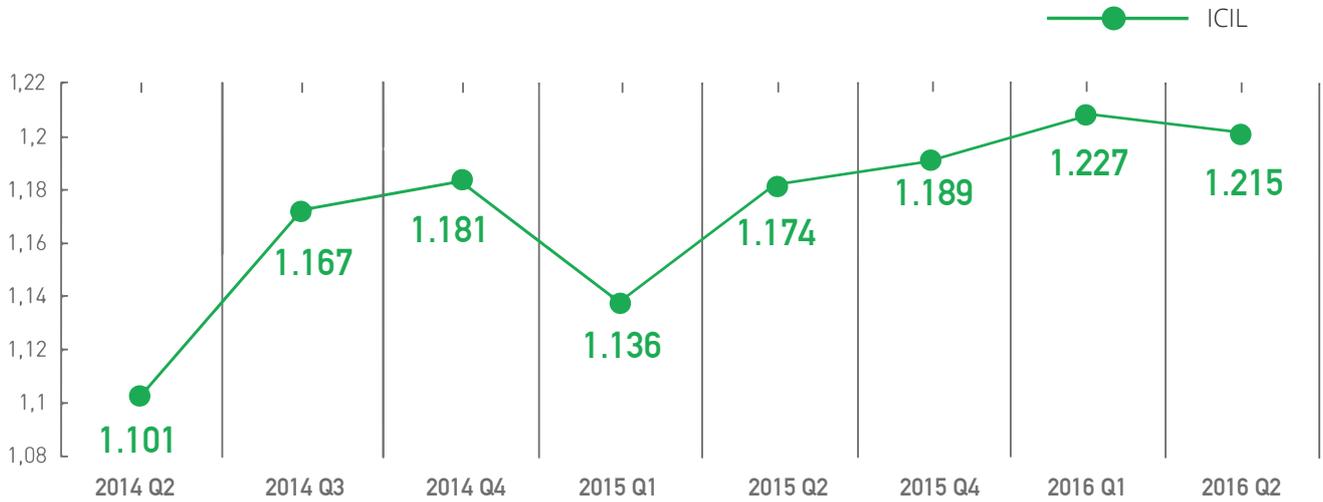


Fig. 2 : ICIL dynamics, ICIL 2016Q2

Investors maintain a positive outlook of Lithuania's economy as the Investors' confidence index remains strong at 1,215. The most optimistic trend is that company specific factors and other internal market indicators remain at a high level and investors operating in the market continue to see conditions in the country as favourable for business.

On the other hand, nobody likes elections. This quarter the expected political stability has plummeted and reached a record low. As much as 62% of respondents expect deterioration of political stability, while not a single respondent foresees an improvement of the situation. Period of political vulnerability and unpredictability of legal framework has a negative impact on the GDP producing business activities.

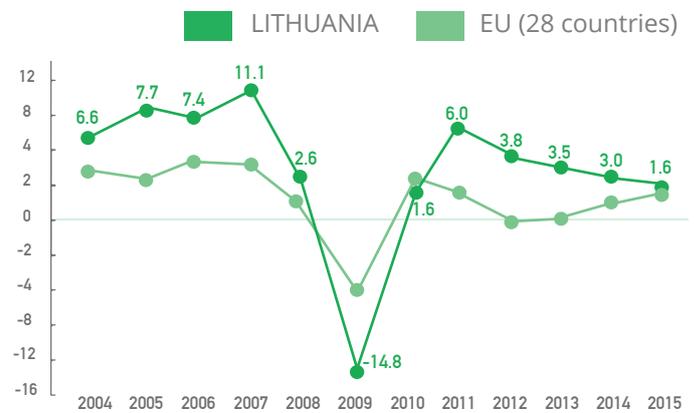


Fig. 3 – Real GDP growth, Eurostat

Economy outlook

Joining the Eurozone last year brought significant positive impact on Lithuania's economy which helped to withstand the shock from the sharp decline of exports to Russia. Lithuania clocked a 1,6 % growth of real GDP in 2015 according to Eurostat.

Recovery of the global economy recently has been limping. It was caused mainly because US and Eurozone economies have been falling short from expectations. Regardless, Lithuania has been outperforming the expectations and had a strong start at the beginning of 2016. Despite some fluctuations in the capital markets consumer and business expectations remained positive,

while retail and exports showed signs of growth. According to the forecast of the Bank of Lithuania, GDP should show a 2,6% surplus in 2016 and 3,2% growth the year after. The main drivers of this growth are expected to be strong household consumption, supported by robust real wage growth, investment and increasing exports. Nonetheless, the optimism should stay reserved as the stability of global economy remains fragile and deterioration of external conditions can severely impair national performance. Near-absence of structural reforms and deepening demographic problems remain some of the biggest internal threats.

Macro-economic factors

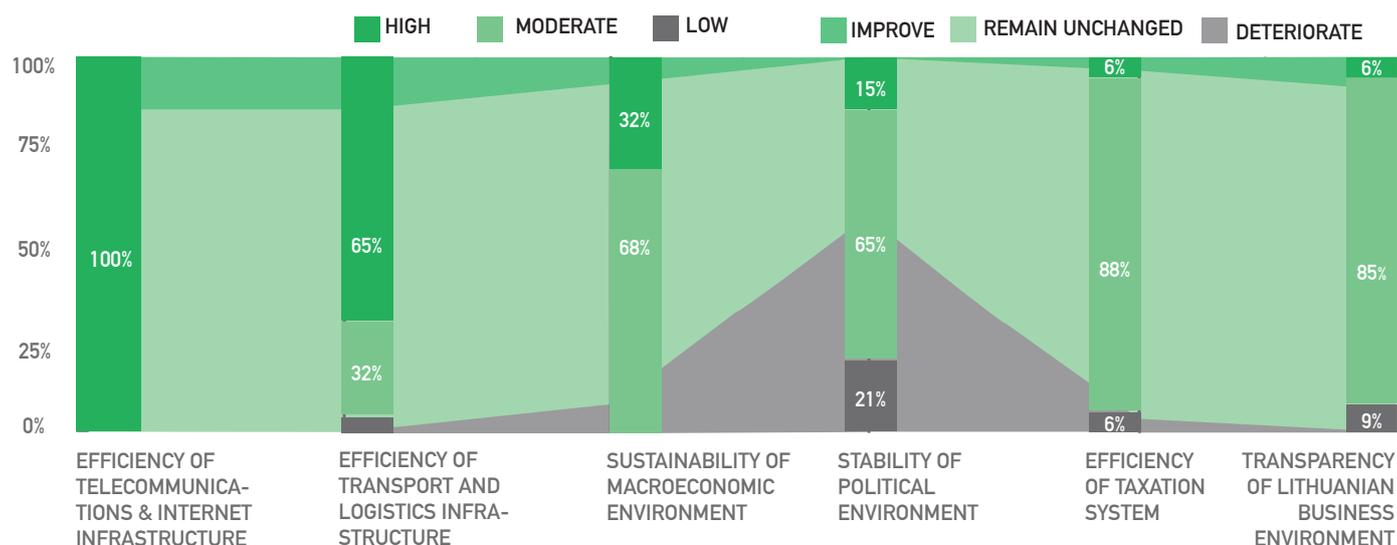


Fig. 4 – Macro-economic factors: Current situation and expectations, ICIL 2016Q2

The view of largest investors in Lithuanian market is dominated by positive opinions. Infrastructure has for a long time been an area of outstanding performance. Every single interviewed manager (100%) believes that the efficiency of telecommunications and internet infrastructure is top-notch. An open and very competitive market helps to deliver the best possible services to customers. Efficiency of transport and logistics infrastructure is lagging not far behind (65% see its level as high). When it comes to sustainability of the macroeconomic environment, there aren't too many dark clouds over it. None of the investors see it as low, which is a promising result. A third of respondents (32%) actually gave a high mark.

Efficiency of the taxation system and business transparency might be called somewhat average. Very few respondents mark it as either high or low with the majority (88% and 85% respectively) evaluating it as moderate.

Looking deeper into the expectation side (the plot in the background of the Fig. 4) of the macro economic environment some interesting insights emerge. Respondents are hoping for the transparency of business to improve in the near future. A big number of initiatives on national and company levels are all contributing to making the competition grounds for business fair and legitimate. Public sector also boasts some stars of hope. When a strong dedicated leader takes over the steering wheel of a public institution or agency good things can happen. Public procurement office is one of those examples. An area of public affairs widely known as being extremely susceptible to non-transparent practices, under new management by Diana Vilytė is taking strong steps towards making the processes of public procurement significantly more transparent, legit and open to the society.

On the other hand, inevitably approaching Parliament elections cast shadows on the business environment. The current governing coalition was never known for its consistent work and courageous decisions. With

the elections within sight, politicians are becoming less predictable. This is illustrated by the fact that as much as 62% of respondents are expecting the political environment to deteriorate. The remaining 38% believe that the level shouldn't change much, which confirms that no one (0%) dares to believe that politics in the next few months will be more predictable and consistent.

Firm-specific factors remain optimistic

When it comes to expectations for firms-specific factors in the second quarter of 2016, the overall outlook remains strongly positive, as reflected by the high value of the ICIL index. The highest proportion to date of the index, as much as half of the interviewed investors are notably optimistic and expect the demand for their products (56%) and profitability of their companies (50%) to further climb up.

Despite the fact overall economy growth took a significant impact from declining exports to Russia, a significant export market which momentarily disappeared, the businesses managed to swiftly adapt and grow stronger from the situation. At the beginning of this year exports to countries of Commonwealth of Independent States (CIS) continued to decline, however the trade relations and exports to western markets, namely USA, Sweden, Norway, UK and others have grown at substantial pace. This proves that Lithuania managed to turn a business challenge into a business opportunity and steer its exports to markets of the Western world, becoming less dependent on the CIS markets. Moreover, the countries of central and southern Americas are still to be discovered with all of its magnificent economic potential. It comes with no surprise, that foreign investors operating in the Lithuanian market are looking to grow their exports in the second quarter of 2016. Such expectations were expressed by 29% of respondents with the remaining 71% expecting to maintain exports at current levels (See Fig. 5). None of the surveyed company managers expect the number of good and services sold abroad to decline.

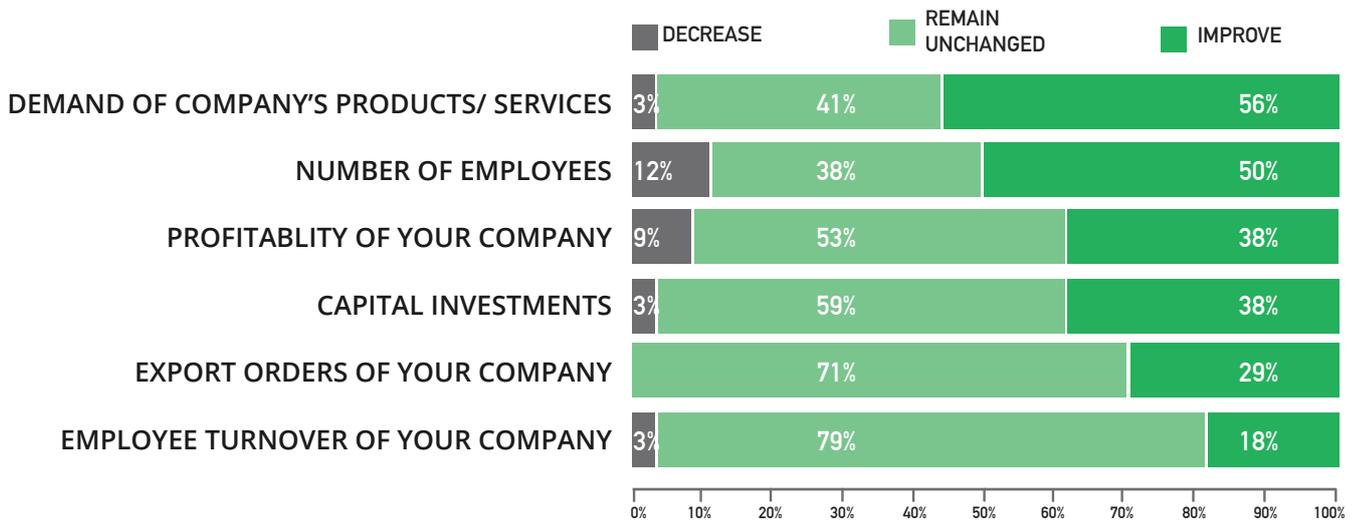


Fig. 5 - Firm-specific factors, ICIL 2016 Q2

Labour market

Labour market is a corner stone of a country's economy. For months now the debates over the labour regulations and its proposed reforms have been boiling in the committees of the Parliament, mass media and general public. However, no significant changes or decisions have been made yet, and clouds of doubt are gathering over the proposed reforms as the social model has been significantly mangled in political debates. Moreover, the time is ticking and it is becoming increasingly doubtful whether the current Government will keep its loudly

advertised promises to amend the changes before the end of their term. On the contrary, with every new day closer to the election, the Government's narration is becoming increasingly populist and indulgent towards the voters.

It is hard to argue that the reforms are crucial and foreign investors are here to testify. A whopping 85% of respondents indicated Labour regulations as an area in great need of attention. Moreover, when asked about challenges of their day to day business, as much as 41% of investors admitted to frequently face problems related

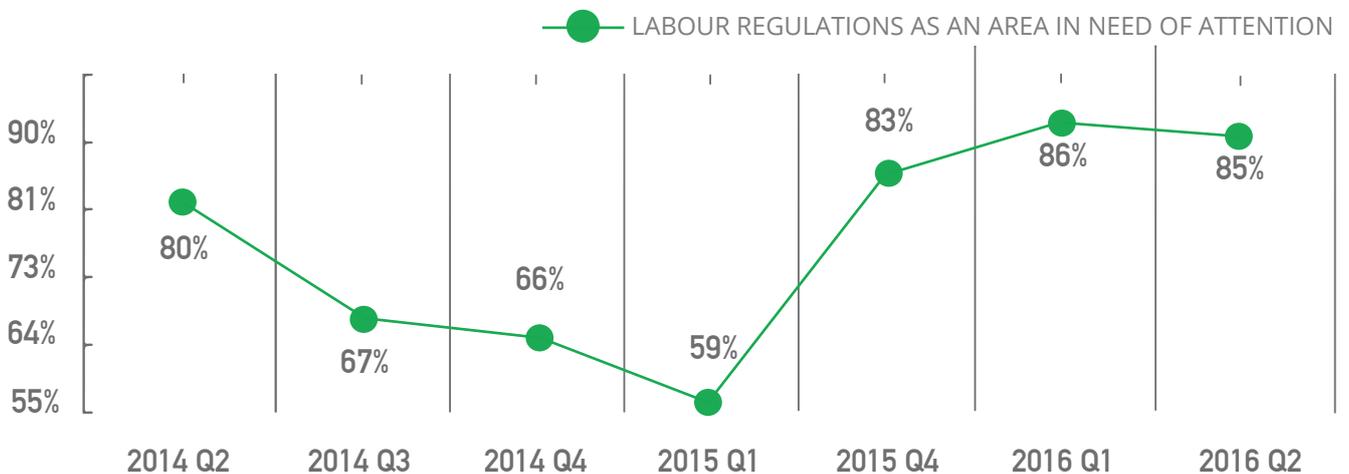


Fig. 6- Labour regulations as an area in need of attention, ICIL 2016 Q2

to Labour regulations, while 53% tackle them occasionally and only 6% rarely.

The labour market itself is fairly ambiguous. On one hand, the situation seems to be promising, since in the past few quarters employment growth remained high. According to the data of Statistics Lithuania, the average seasonally adjusted yearly unemployment rate has been continuously shrinking from 17,83 % in 2010 to 8,9 % in March, 2016, with Vilnius showing even better results. In addition, declining prices, rising wages, and increasing

employment pushed the real wage bill up by 6.8% last year. On the other hand, some serious concerns are becoming more and more evident. The proportion of very long-term and youth unemployment remains high and the skill mismatch is becoming more and more evident. Therefore, there is a need for requalification of existing unemployed workers, as well as improved steering of current and future students towards relevant professions, skills and training.

Demographics causes concerns

The falling unemployment rate gives the false impression of being a purely positive fact, while it actually covers some important details. The decline of unemployment rate is strongly influenced by the shrinking size of the labour force. The main drivers of the country's population decline are low fertility rates, overall poor health outcomes, and significant net emigration. Average net emigration in Lithuania during the last 5 years amounted to 22 000 people per year, often young and well-educated. For a country with roughly 2.9 million people, this represents a sizable proportion of its population.

Moreover, significant proportion of the emigrants are educated and talented young people of working age. Their departure causes problems for businesses, as it becomes increasingly difficult to find high-skilled workers, as well as the public sector, since the social welfare system is becoming increasingly unsustainable. The proportion of

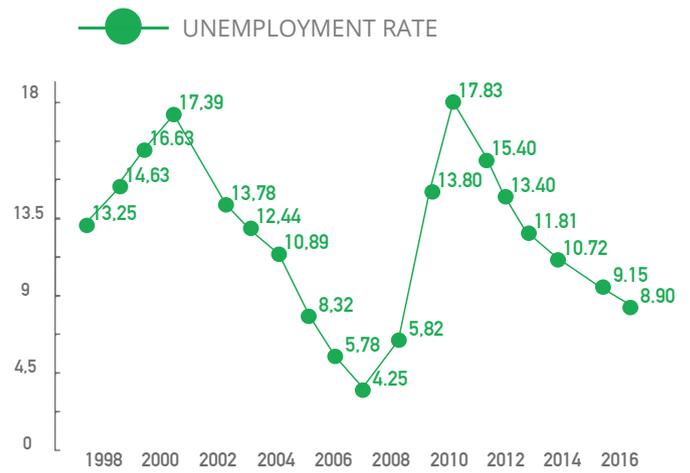


Fig. 7 - Unemployment rate (seasonally adjusted), %, Statistics Lithuania

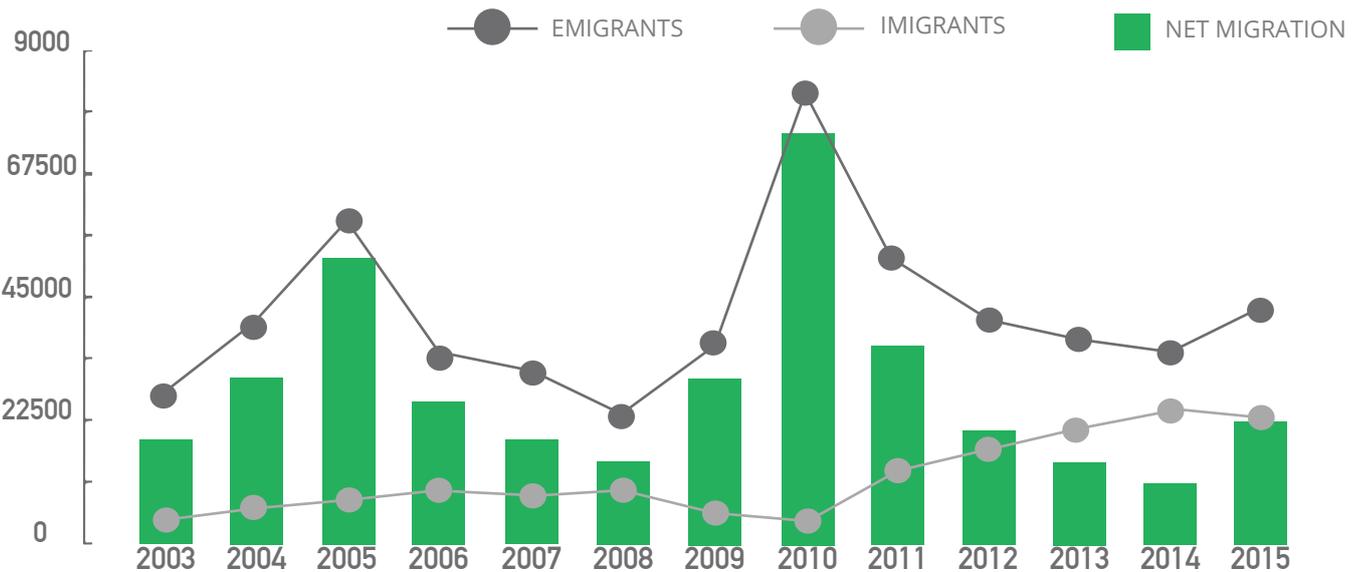


Fig. 8 - Net migration in Lithuania, Statistics Lithuania

elders, receiving pensions rising in comparison to the labour force that is paying contributions to the welfare system. If not properly addressed such a trend might trigger an array of related challenges.

Lack of qualified labour

Employment growth is also limited by lack of qualified labour. This is illustrated by the fact, that 53% of respondents marked that they expect the availability of qualified labour in this current quarter to be insufficient. One of the causes is that according to European Commission, Lithuania has one of the highest skill mismatches among the members of the EU. Policy actions in the field of education must be taken in order to bridge

the gap between the actual needs of the labour market and the outcomes of tertiary education and vocational training. The latter should also be promoted more in order to improve its image and attract more students who would attain necessary skills and qualifications that are valued in the labour market.

Productivity is in the spotlight

Another alarming trend is that wage-growth outpaces the growth of productivity, therefore the costs of nominal unit labour grew by 4,4% in 2015 and is seen to further rise through 2016. It is illustrated by the fact that from the first ICIL research the number of investors who believe that cost of labour is a competitive advantage of Lithuania

have been shrinking. It went from 74% in the first survey down to 48% last quarter and bounced back to 65% in the current. Nonetheless, cost competitiveness remains among the key attraction points of Lithuania when it comes to competing for FDI and since the country's labour productivity equals to just two-thirds of OECD average there is ample room for sustained convergence in the future. Otherwise, it can backfire if productivity growth does not catch up with the rise of nominal wages.

Investment environment: Lithuania is trusted

Although many factors remain causes for significant concern, foreign investors operating here have trust in the country. And this belief is not just declarative, since it is enshrined by plans of interviewed top-level managers to expand their businesses in Lithuania. As much as 44% of respondents foresee a rise in their new investments, while 56% of respondents plan to increase the number of working places. The latter number is the highest since the creation of Investors' confidence index for Lithuania. And such expectations are wide spread, since the Bank of Lithuania forecasts the unemployment rate to diminish by nearly a full percentage point in until 2017.

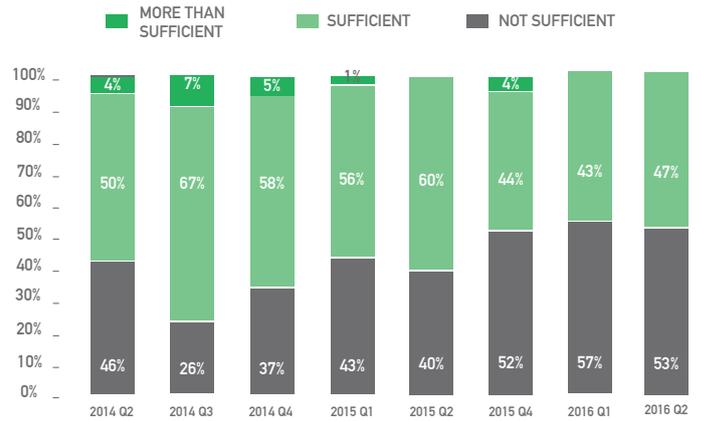


Fig. 9 - Availability of qualified labour, ICIL 2016 Q2

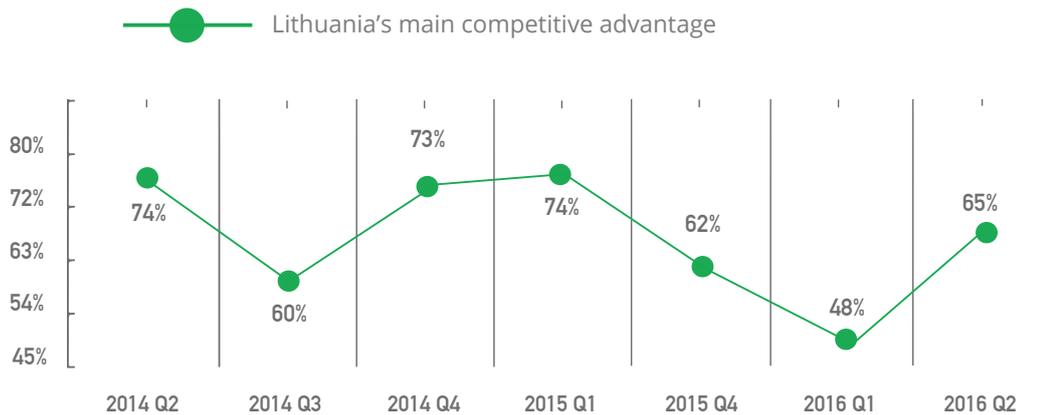
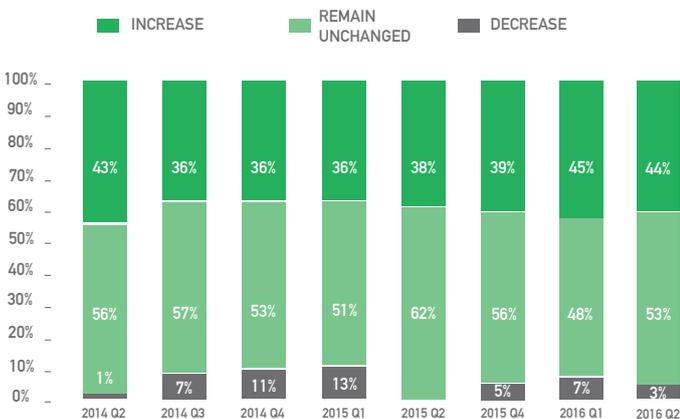


Fig. 10 - Labour costs as Lithuania's main competitive advantage, ICIL 2016 Q2

NEW CAPITAL INVESTMENTS



NEW WORKPLACES

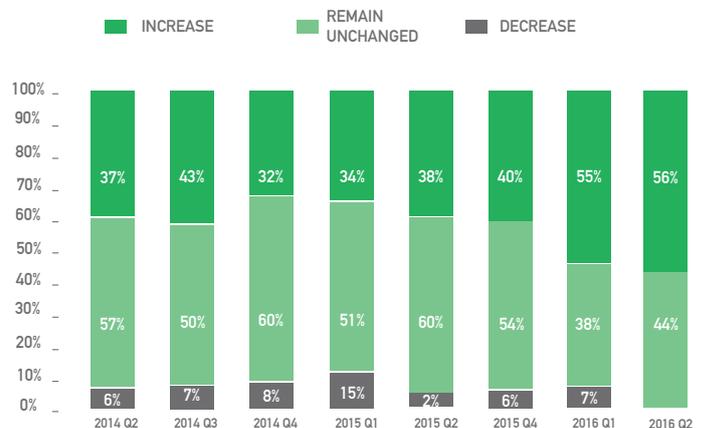


Fig.11 - Plans for new capital investments and workplaces, ICIL 2016 Q2

ADDITIONAL QUESTIONS

During every survey additional questions deviating from the standard survey form are included in the questionnaire in order to have insights on the current affairs. This quarter the theme of threats and opportunities for Lithuania was chosen.

THREAT	PROBABILITY
EU BEGINS TO FRACTURE DUE TO INTERNAL AND EXTERNAL PRESSURES (REFUGEE CRISIS, ETC)	71%
UK VOTES TO LEAVE THE EU	38%
CHINA HAS A HARD LANDING	35%
RUSSIA'S INTERVENTION IN UKRAINE AND SYRIA POTENTIALLY LEADS TOWARDS A NEW "COLD WAR"	35%
RISING THREAT OF JIHADI TERRORISM DESTABILIZES GLOBAL ECONOMY	21%
GREECE'S EXIT FROM EUROZONE CAUSES THE EUROZONE TO BREAK-UP	6%
DONALD TRUMP WINS THE US PRESIDENTIAL ELECTIONS	6%

Fig. 12 - Greatest global threats to Lithuania, ICIL 2016 Q2

In March 2016, The Guardian published list of the greatest current threats to the global economy. Our respondents were asked to choose the ones that, in their opinion, could potentially harm Lithuania and specify what impact it would have on their companies.

While economists agree that internally the economy of Lithuania is sound and steadily growing, investors have identified four biggest global threats for Lithuanian economy for the near future. As much as 7 out of 10 respondents identified that Lithuania would suffer the most if EU begins to fracture due to internal and external pressures. It would lead to political and economic instability, decreasing demand and customer confidence, decreased private and public spending which could all together cause a slowdown period in the economy. Another consequence – collapse of the internal market which would cause more business barriers to emerge, local regulation could become excessive, costs of exports would once again jump up. Moreover, free movement of goods and labour would be strangled. Finally, the continuation of EU funded projects would become uncertain.

A possible reason of EU's fracture is the second most feared event (mentioned by 38%), which is the possibility that UK will vote to leave the EU on the referendum which will be held on 23rd of June, 2016. UK is a significant member of the union and its secession would lead to decrease in free trade, cause problems with supply chains and would undermine the future of the union. Over all it would lead towards a decrease in consumer consumption across the EU countries.

35% of respondents believe that China having a hard

landing is one of the biggest external threats for Lithuania. A crisis in China, one of the largest economies of the world could influence a slowdown in global economy and in Lithuania respectively. Some investors believe that it could lead to next global financial crisis. In addition, some companies would lose the share of export and investments that comes from Asia.

The possibility that Russia's aggressive behaviour would lead to a new Cold War is seen as a major threat by 35% of investors. In case of military actions, Lithuania's geographical proximity to this dangerous and unpredictable power would drive significant amount of business out of the country as it would become "politically and economically unsafe". Even if the conflict does not break out, the possibility of such event reduces consumer confidence and deters potential foreign direct investment away from Lithuania.

Cut down of EU structural funding

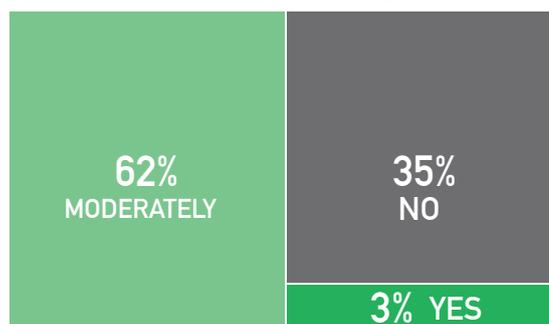


Fig. 13 - Is Lithuania ready for the decrease of EU funding, ICIL 2016 Q2

In 2020 the support from EU's structural funds will significantly shrink and only 3% of investors believe that Lithuania is prepared to maintain the economic growth independently. 62% of survey participants believe that Lithuania's preparation is moderate and 35% that it is close to none. Some crucial steps were proposed by investors to ensure that Lithuania is prepared for 2020.

Most investors believe the Labour Code must be updated in order to establish sustainable and most competitive Labour regulations in Eastern and Central Europe that would react to current Economic situations, satisfy the needs of employees and employers and enable to compete in the international arena for investments and talents. A wider variety of labour contracts, shorter notice terms, balanced severance payments and less administrative burden would allow for higher wages and creation of new workplaces.

The Government should also facilitate domestic consumption and business development, especially high-tech, increase productivity and efficiency of the economy, develop local capital markets and reduce excessive regulations.

Fight with shadow economy and promotion of transparent business is also seen as a key measure. Tax and other incentives coupled with higher funding for targeted measures for attracting Foreign direct investment is also crucial.

Policy makers must put effort in order to stop emigration, bring back skilled employees, develop the local talent pool, optimize migration processes for highly skilled specialists.

Prepare and implement effective education system reform: increase wages for higher-education lecturers as well as school teachers, promote mergers of universities and incentivize both institutions and students to focus on areas that are in greatest demand in the labour market.

Ensure efficient tax system, improve collection of taxes, remove overregulation. Improve quality of public services by raising wages for civil servants who are ready to improve their work efficiency. This should be implemented by reducing the number of employees in the public sector (with exception of areas where staff reduction in the near future is not feasible, e.g. police patrols, firefighters, etc.). State agencies and institutions that will carry out structural optimization should receive financial incentives.

These are just a few of the specific actions foreign investors operating in Lithuania propose to the Government in order to ensure a successful economic development and prosperity of Lithuania in the future.

The future Lithuania

Foreign investors were asked what opportunities are in front of Lithuania and what should it focus on as a competitive advantage in order to prosper in the future. They variety of opinions was very broad, but a few trends have emerged.

First of all, a significant amount of respondents believe that Lithuania's potential lies in its people. Emphasis on education, development of our talent pool is what the country should focus on.

Secondly, Lithuania could focus on becoming a technology centre. In order to do so, emphasis and funding should be directed towards innovation and R&D in order to create or attract high added value and high-tech companies in the country. A particular stress is put on developing IT specialists and offering investors a perfect place supplemented by great infrastructure and skilled flexible labour force for relocation of their business activities.

And finally, some see potential of Lithuania to become a producing country. Engineering, manufacturing and even food production were mentioned as possible focus points for Lithuania in the search for its competitive advantage.

Most relevant specialists and professionals

One of the greatest challenges in Lithuania is the mismatch between the professions and skills developed in educational institutions and actual needs of the labour market.

Investors were asked to identify professionals that will be in the greatest demand in the labour market in the near future. More than 88% of respondents believe that Lithuania should focus on IT sector, meaning that from the early beginning students should be inspired to become IT specialists. They must be educated about potential job positions, salaries in this field and endless opportunities of internet platform. At the same time, government should allocate EU funds towards IT business development, start-up encouragement and high-technology implementation.

Engineering (46%) was ranked as the second most relevant field for Labour market shift in the nearest future. While many product manufacturing, and customer service processes could be replaced by technology, there will be a need of sales people that could communicate in foreign languages (English, Russian, Scandinavian) and be able to manage businesses at the strategic level.

Most relevant skills

Fast pace business environment dictates the needs to global labour market. Changes, speed, information overflow, penetration of technology requires for workers who are able to constantly learn, are open to changes and adapt technology easily, regardless of the area they will be working in. The labour market is transforming from position-based to competence-based. In other words, in the modern labour market having a profession is not enough to succeed. Certain skills regardless of one's profession are of vital essence.

Leadership was ranked as the number 1 most important competence (by 38% of respondents) that combined with any specialization would lead to biggest career opportunities for workers.

In addition, significant role will be played by the ability to master "soft" skills, such as communication (32%). Also, ability to quickly learn and adapt to new environments will give professionals the edge over others (29%). And finally, technological literacy (26%) as well as mastery of foreign languages (26%) will be essential, because the minimum standards for these skill are rapidly rising. Knowing English and how to operate computer devices is no longer an advantage, but rather a must.