Baltic CFO Survey 2018

October 2018

Executive Summary

- In Estonia the opinion of CFOs about business opportunities during the next 12 months has improved while in Latvia and Lithuania it has remained at the same level as last year.
- About two thirds of entrepreneurs in all three countries have said the financial situation of their company is either good or excellent.
- Increase of labor costs and availability of qualified employees are the main challenges for large companies in Baltics. In order to deal with these challenges, companies are looking to increase productivity of their staff and investing in technologies.
- Innovations are high on the agenda for most of the large companies in Baltics. Only around 10% of CFOs consider innovations as unimportant.
- Large companies in Latvia are the most active in terms of looking for opportunities to attract labor force from abroad (69%), followed by Lithuania (58%) and Estonia (54%).
- Most of entrepreneurs in Baltics are still not using digital channels to boost their sales. 48% of Lithuanian large companies, 39% of Estonian and 25% Latvian companies are using digital channels to some extent.

Dainis Gašpuitis
Macroeconomics expert
SEB Latvia
Tel. +371 67779994
Dainis.Gaspuitis@seb.lv

Baltic CFO Outlook is based on a survey conducted by SEB:

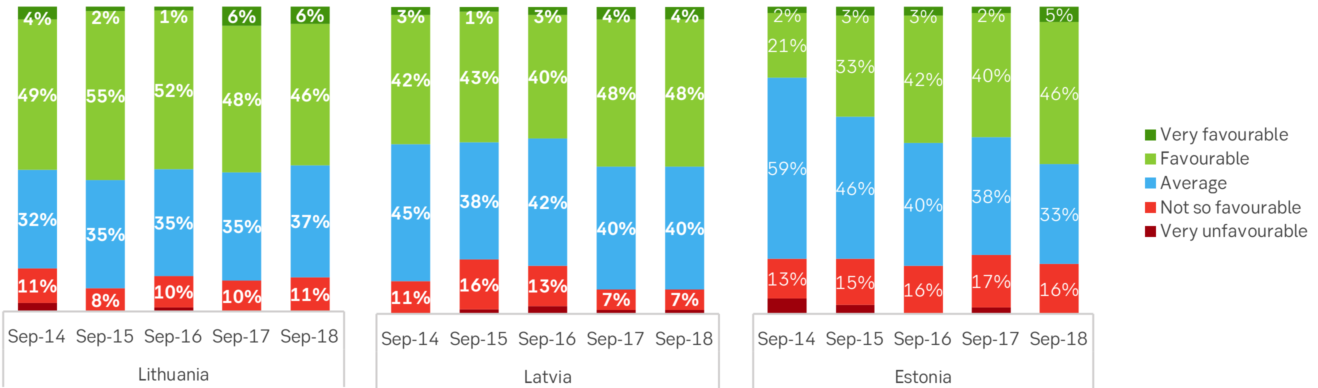
- 226 largest Baltic companies participated
- Respondents: Chief Financial Officers in Baltic companies with annual turnover exceeding 20 million EUR
- Hot topics: usage of electronic sales channels, taking up new risks, recruiting from abroad

Baltic CFO Survey 2018

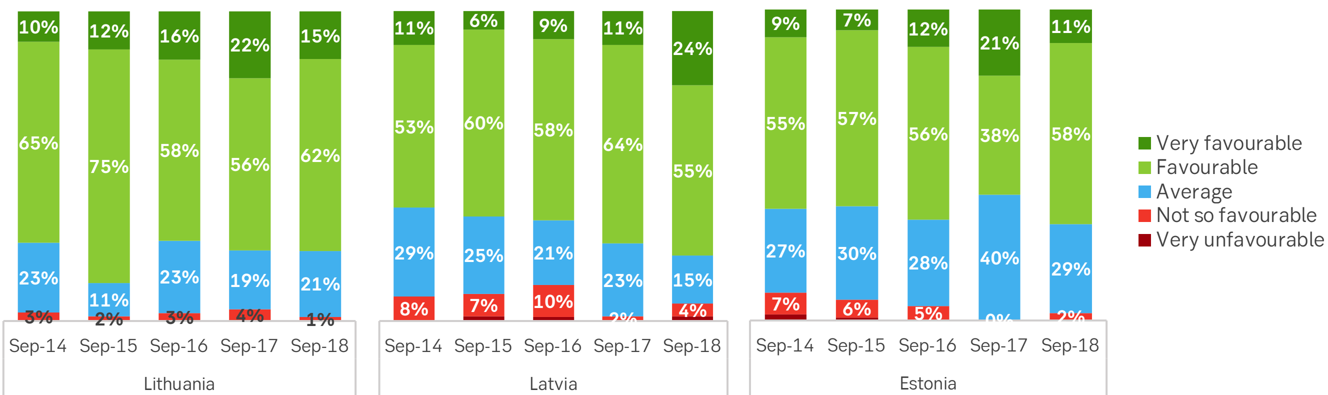
Recently, the developments of world economy have brought both encouragements and disappointments. On one hand, the unexpectedly lengthy period of slow growth in Europe and weak results in China and other emerging markets. On the other hand - during 2nd quarter in US growth picked up its pace, Japan, Great Britain and India brought pleasant surprises. SEB experts maintain an optimistic outlook on global GDP trends and expect a growth of roughly 4% in 2018 and 2019 with a slight deceleration in 2020.

Baltic economies have maintained a respectable pace of growth in 2018 as well. The positive effects of capital investments, exports and the prevailing optimism among households will continue to support growth. However, there are many signs indicating a gradual decrease of the speed in coming years.

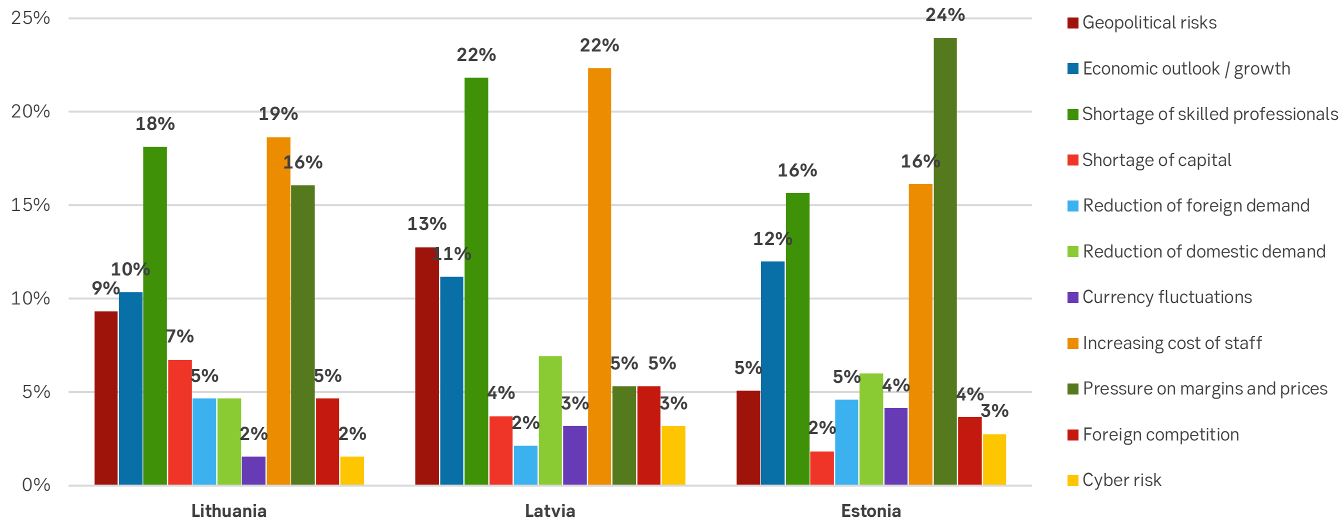
The general opinion of CFOs in large companies in Baltics concerning the business conditions for their company during the next 12 months has not changed much in Latvia and Lithuania. A convincing majority of CFOs maintain a cautious optimism about the upcoming year. In both countries nearly half of respondents have a positive outlook while 40% of Latvian and 37% of Lithuanian businesspeople have said that business conditions will be neutral. Meanwhile, the assessment of Estonian CFOs has improved over the last year and the share of optimists has grown from 40% to 46%. 5% of Estonians are convinced that the next year will be exceptionally good. Meanwhile, the share of those who think that the upcoming year will be an average one has dropped from 38% to 33%. 16% of Estonian CFOs have said that next 12 months will bring bad news for their business, which is the highest share of pessimists in Baltics.



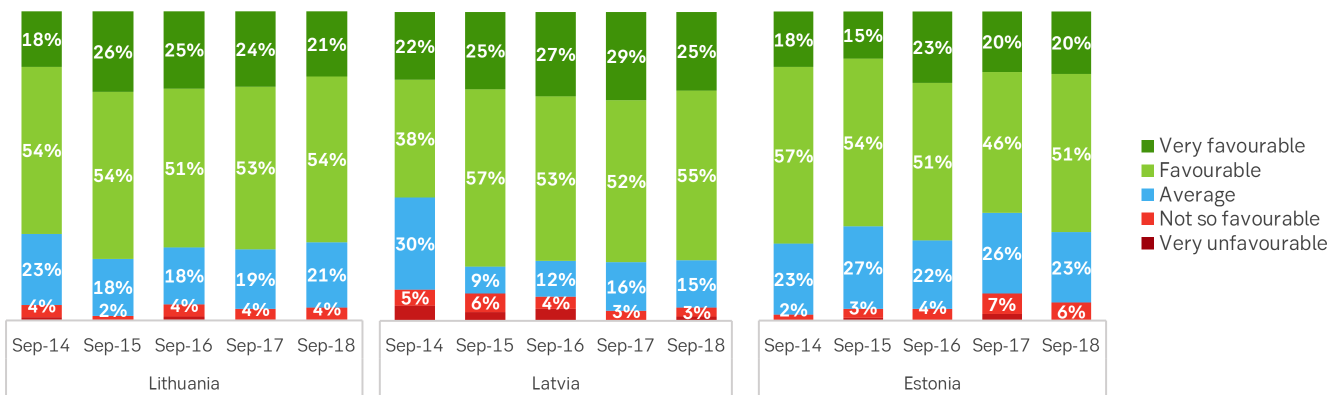
However, a certain cautiousness can be sensed in answers of CFOs about the business conditions during next 12 months, if we compare these answers with their assessment of their company's current financial situation, which is way more positive. 77% of Latvian, 79% of Lithuanian and 69% of Estonian CFOs have said that their company's financial position is either good or excellent. 29% of Estonian, 21% of Lithuanian and 15% of Latvian respondents have ranked their company's financials as average.



Labour costs and availability of qualified workforce are mentioned as the greatest concerns in Latvia (22% and 22%) and Lithuania (19% and 18%). These issues are #2 and #3 in Estonia as well (16% and 16%), while 24% of Estonian CFOs have said that pressure of costs on profit margins is the main challenge. Latvians have pointed out geopolitical risks as the third most urgent issue while Lithuanians are concerned whether they will be able to maintain the current level of profitability. Large companies in Baltics are also worried about possible downturns in economic growth, availability of capital and negative changes in domestic demand.

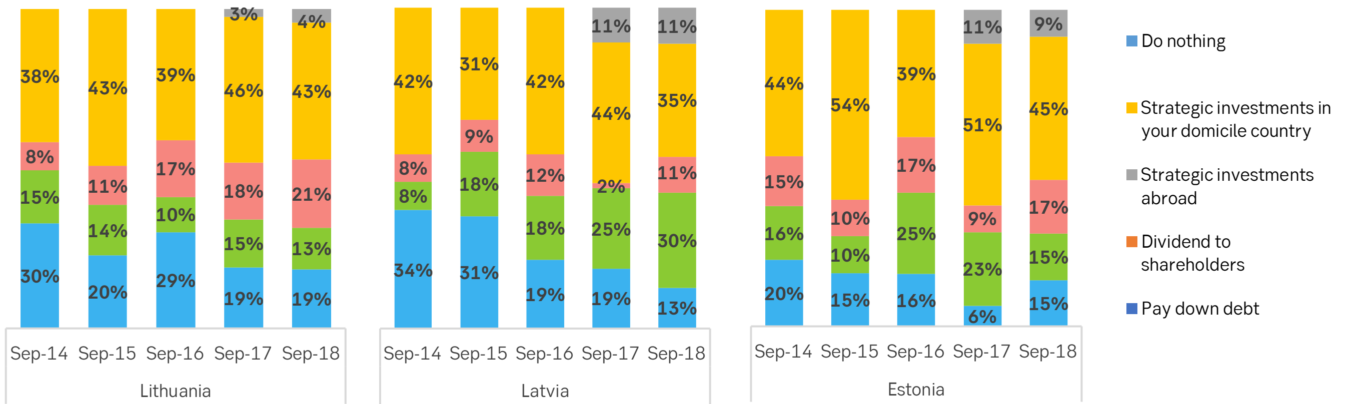


Although banks are often criticised as being too conservative in terms of lending, large companies in all three countries are convinced that the lending attitude of financial institutions toward their companies is either good or very favourable (75% in Lithuania, 80% in Latvia and 71% in Estonia). Only 4.2-6% of large companies in Baltics are dissatisfied with their cooperation with banks.

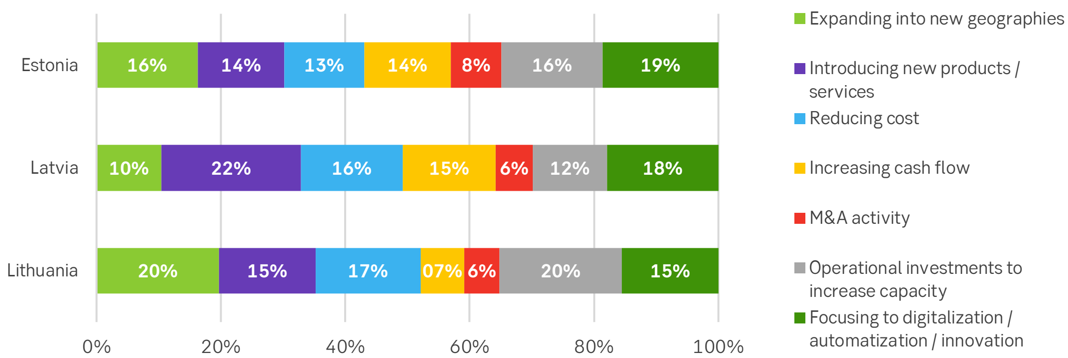


A consistent and growing determination to use their surplus cash for investments abroad can be observed among Lithuanian entrepreneurs. The share of companies with such plans has grown from 8% in 2014 to 21.4% this year. 43% of Lithuanian CFOs are planning invest in the domestic market, 13% will pay out dividends while 18.6% would use the cash to decrease their debt. Estonian businesspeople are also quite active in planning investments: 17% have said they are considering investments in other countries and 45% are thinking about investments in their domestic market. 15% would choose repaying their debts and an equal share would pay out dividends to shareholders.

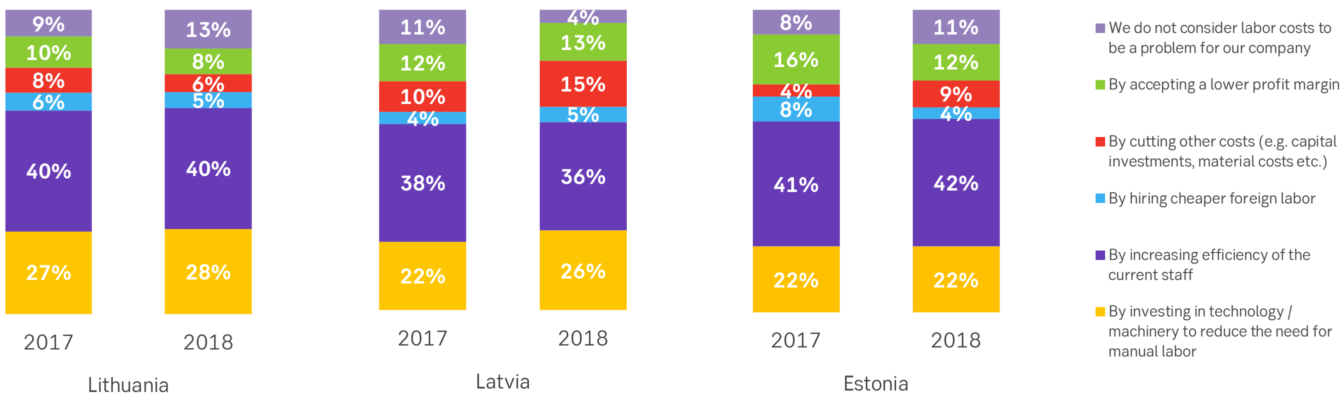
Meanwhile in Latvia there are not as many companies which are considering new investment projects. Only 11% are considering investments abroad and 35% are thinking about domestic investments. 30% would use the surplus cash to pay dividends to shareholders, 13% would repay debts and 11% would choose to leave the surplus cash untouched and do nothing.

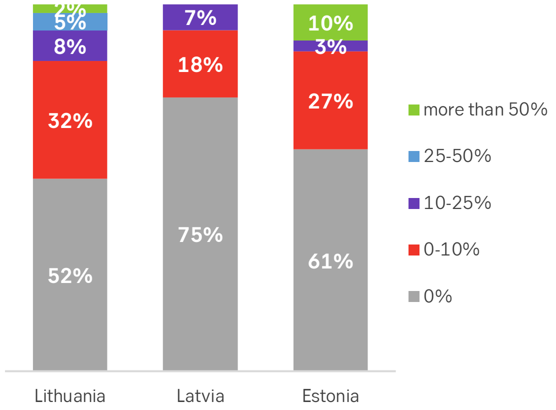


If we look closer at company priorities for the next year, the plans are quite ambitious. Every fifth Lithuanian company intends to expand into new geographies, and 16% Estonian and 10% of Latvian companies have similar plans. 20% Lithuanian, 16% Estonian and 12% Latvian large companies will invest to increase their capacities. Latvian companies are putting the emphasis on developing new products and services (22%), while 15% of Lithuanian and 14% of Estonian companies have similar ideas. Companies in Baltics are also focusing on initiatives related to digitization, automation and innovations - as confirmed by 19% of Estonian, 18% Latvian and 16% of Lithuanian CFOs.

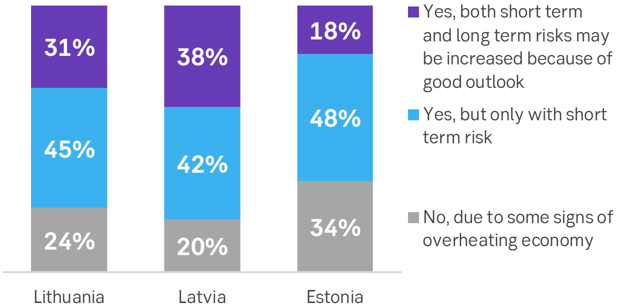


Dealing with increased costs is an important, probably even the most important challenge for the next few years. Responses from CFOs suggest that they are answering this challenge mainly by looking for opportunities to increase the productivity of their employees. There are also efforts aimed at introducing automation solutions which enable to increase the output. Latvian companies are more active in looking for ways to decrease other costs than their neighbours in Lithuania and Estonia. Latvian and Estonian entrepreneurs are also ready to accept smaller profit margins (13% and 12% have said so), while only 8% of Lithuanians find it acceptable. Only 4% of CFOs in Latvia have said that labour costs is not a problem for their company, while in Estonia 11% and in Lithuania 13% have chosen this answer.

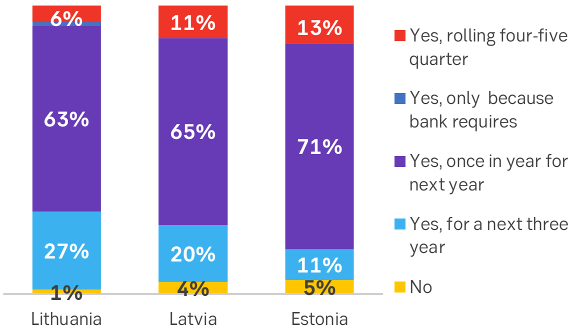




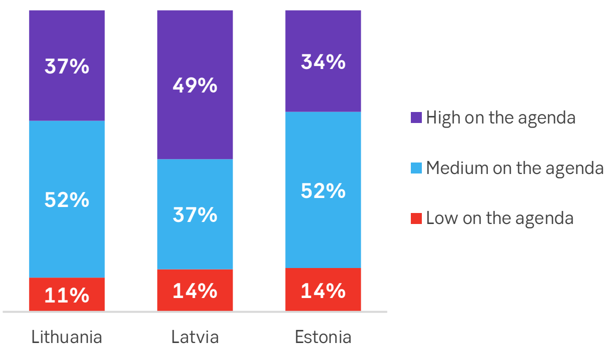
The largest share of sales of products and services in Baltics still takes place outside digital channels such as webpages, mobile applications, etc. 75% of large companies in Latvia, 61% in Estonia and 52% in Lithuania are not using digital opportunities at all to boost their sales. Meanwhile Estonia has the largest share of those companies who sell more than half of their stuff via digital channels: 10%. 32% of Lithuanian companies, 27% of Estonian and 18% of Latvian large companies in Latvia generate up to 10% of their total turnover through digital channels.



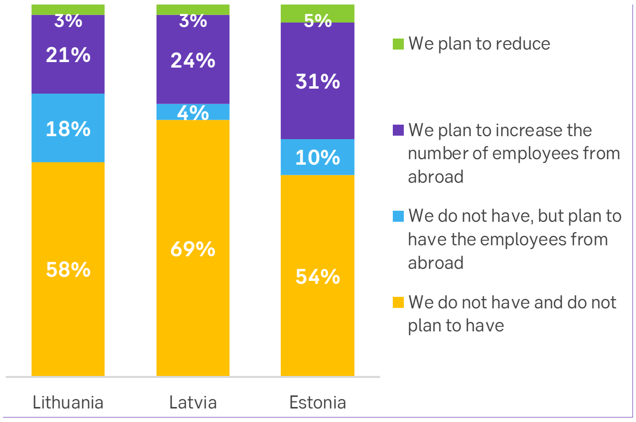
In terms of short-term risks, CFOs in all three Baltic States have similar views. Almost half of them are ready to take more short-term risks in the balance sheet of their company. 38% of Latvian and 31% of Lithuanian financial experts feel confident about the economic outlook and are ready to accept more short-term and long-term liabilities. Only 18% of Estonian entrepreneurs agree to this opinion. This means that Estonia has the largest share of companies who feel that it is not the right time to increase their risks: 34%. This view is shared by 24% of Lithuanian and 20% of Latvian respondents.



Most of the large companies in Baltics are planning their budgets for the upcoming year. Lithuania has the largest share of companies who are preparing a three-year budget: 27%, followed by Latvia (20%) and Estonia (11%). 13% Estonian, 11% Latvian and 6% Lithuanian companies operate with a rolling four-five quarter budgets. A certain number of large companies in each of the countries are not doing any budget planning activities at all.



In the light of this survey's results in the previous years, it is somewhat unusual to see that 49% of Latvian companies have said innovations are one of their main priorities, ahead of Lithuanian (37%) and Estonian (34%) entrepreneurs. 52% of Lithuanian and Estonian CFOs have answered that their company is thinking about innovations, however, it is not a top priority, while in Latvia 37% of respondents have chosen this answer. For 11-14% of large companies in Baltics innovations currently are not an important topic.



Despite the fact that the situation in the labour market is becoming increasingly tense, more than half of large companies in Baltics do not have a set strategy for attracting employees from abroad. At this point 69% of Latvian companies have no such plans and are not even thinking about this alternative. The share of such companies in Latvia is considerably larger than in other Baltic countries – 58% of Lithuanian and 54% of Estonian companies are not considering attracting workers from other countries.

18% of Lithuanian, 10% of Estonian and 4% of Latvian CFOs have said that they do not have a precise strategyfor attracting foreign employees, however they are not ruling out this option. On the other hand, 31% of Estonian, 24% of Latvian and 21% of Lithuanian businesspeople have made precise plans to find employees beyond the borders of their country. This means that altogether 41% of Estonian, 39% of Lithuanian and 28% of Latvian large companies will look for foreign workers in one way or another. Meanwhile a small share of companies are thinking about reducing the number of their employees from abroad: 5% of Estonian and 3% of Latvian and Lithuanian respondents.

Macroeconomic outlook for Latvia: next 12 months

Latvia's year-on-year GDP growth accelerated from 4% in the first quarter of 2018 to more than 5% in Q2. Construction contributed about 35% of this growth, thereby offsetting negative effects connected to the problems surrounding shutdown of ABLV Bank. The key role of the construction sector in GDP growth, Latvia's increasingly strained labour market and expected reductions in capital inflows from EU structural funds raise questions about future growth. We still believe that activity will be sustained with the help of private consumption, capital spending and exports. GDP growth will be 4.2% this year. We expect GDP to grow by 3.7% in 2019 and 3.2% in 2020.

During 2017, capital spending rose by 16%. This expansion looks set to persist. In the near future and until 2020, EU money will foster both private and public sector investments. Profitability remains solid in the export-oriented sector.

The overall outlook is positive for Latvia's economy and financial situation, but there are downside risks. Excessively pro-cyclical fiscal policy, along with cost problems in industry, may lead to an overheated economy with growing imbalances and lower growth. On the other hand, structural reforms may boost mobility and supply in the labour and housing markets. Higher productivity growth would awaken greater interest in capital spending and help lower the risks posed by mounting cost problems.

Unemployment is 7.7%, the lowest level in 10 years. It will fall in the next couple of years, reaching 6.5% in 2020. The participation rate for people aged 15-74 is record-high: 64.4%, forcing employers to search intensively for employees. The labour market is thus becoming tighter and tighter. This situation risks becoming a serious obstacle to future growth and is made worse by such factors as growing skills shortages and low mobility. The number of people available to the labour market is falling, while any labour reserves are already essentially exhausted.

Pay increases are high. Over the next three years, wages and salaries are expected to climb by 6.5-8% annually. Because productivity growth is weak – as in many other economies – cost pressure is rising. We predict that inflation will be 2.5% this year, rising to 2.8% in 2019. A strong labour market and solid increases in real wages will provide good conditions for both higher consumption and increased saving.

Macroeconomic outlook for Lithuania: next 12 months

Historically high consumer confidence, increasing investments and better than expected net trade balance support the economy this year. We believe that the economy will improve by 3.4% in 2018, or at a slightly slower pace compared to the last year's growth of 3.9%. However, the expectation of gradual slowdown in the growth in major global economies is the main factor leading us to forecast GDP growth in Lithuania of 3.0% in 2019 and 2.6% in 2020.

Investments, both private and public, will remain in the positive growth trend in the few upcoming quarters. Firstly, since capital spending is pro-cyclical, recent positive years for manufacturers encouraged them to finally start expanding their production capacity more aggressively. Secondly, sharply rising labour costs are pushing companies to invest in more equipment. Thirdly, there is a positive impetus from the accelerating distribution of EU structural funds.

Unemployment is expected to fall down from 7.1% in 2017 to 6.5% in 2018 and 6.2% in 2019. The lack of labour forces businesses to search intensively for employees from other countries. In the first half of 2018 the number of national visas issued to the citizens of non-EU countries jumped by even 93% year-on-year. A tighter labour market is clearly positive for employees. Average gross salary will climb by more than 9% in 2018 as the result of a shortage of both skilled and unskilled staff, higher minimum wage and hike in salaries to employees in health care sector. In 2019 we expect still rather significant increase of 7% in gross wage. There will also be a boost to household income from the tax reform that will take into effect from 1st January, 2019.

To sum it up briefly, a hot labor market is the largest headache for businesses. Nevertheless, the development in economy remains rather balanced with the major unknowns stemming from external factors.

Macroeconomic outlook for Estonia: next 12 months

After a 5% surge last year, the economic growth has returned to its normal path with GDP expanding by 3.5% in the first half of 2018. While the growth has benefited most of the sectors, the main driver of current expansion has clearly been construction. High demand especially from households and the public sector has boosted construction volumes by 25%. However due to unfavourable trend in demography and expected slowdown in public investments after 2020, it may soon reach its peak.

Despite the fact that industrial production has expanded by almost 5% this year, industry's business sentiment has trended downwards. The economic growth in Estonia's main export markets remains healthy, the growth of their import demand is forecasted to be slower than previously. In addition, the high wage growth of recent years has decreased the profitability of businesses relying on cheap labour.

While the average gross salary has increased by 22% in last three years and will most probably reach EUR 1,300 in 2018, the share of profits in GDP has continually decreased and remains now below the average of the EU28.

Another cause for concern is the fact that according to the quarterly structural business statistics, the investments of nonfinancial enterprises as a share of turnover has dropped to its lowest level in more than 20 years. This could leave a lasting dent to the economy's future growth potential.

Estonia's labour market remains strong with unemployment as low as 5% in Q2. Hand-in-hand with high wage growth this is benefiting household consumption, but also savings. In conclusion, Estonia's economic outlook remains good, but in longer years low investment and demography will start to weigh down on the growth.