KPMG

Pulse of Economy 2015

Survey by KPMG in Central & Eastern Europe

Bosnia and Herzegovina, Croatia, Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia

Contents:

Foreword

Dear Reader,

When plotting out future scenarios for the economy and entrepreneurship, including the views of business leaders is vital.

For the second consecutive year, KPMG's Pulse of Economy survey reached out to 731 heads of business across a number of countries in Central & Eastern Europe (CEE). Including Bosnia and Herzegovina and Croatia in this year's edition, we have expanded the number of countries surveyed to nine, enabling us to elaborate on current trends in these markets.

In several areas, this year's survey results overlap with those from 2014. At a time when Europe is facing many economic challenges, the most important and encouraging conclusion is that respondents largely see a healthy economic environment for 2016. About half of the survey participants believe that the economy will improve next year, while only 15% think the situation will deteriorate. Inflation, they say, will be mostly contained, not exceeding the 2% threshold, and about two-thirds plan to resume investments in the next 3 years.

Moreover, 79% of the entrepreneurs and managers who participated in our survey also expect simplified tax payment and administration procedures from their governments, and strong sentiment was expressed in favour of a flat personal income tax system: by half of respondents. Education, science and innovation should receive priority in governments' fiscal planning, they say.

Business leaders have also expressed clearly that without good, skilled people success is unthinkable, while about three-quarters believe retaining staff is a key aspect companies should focus on. Finally, about half of respondents intend to keep staff numbers mostly unchanged, and for employees, the salary outlook for 2016 appears rather promising with 58% of the CEE respondents planning increases in remuneration.

We are confident that these observations and the additional insights included in the survey are likely to be relevant to your business and encourage you to contact us about anything you may wish to discuss.

Yours faithfully,

Stephen Spill

COO, KPMG in Central & Eastern Europe

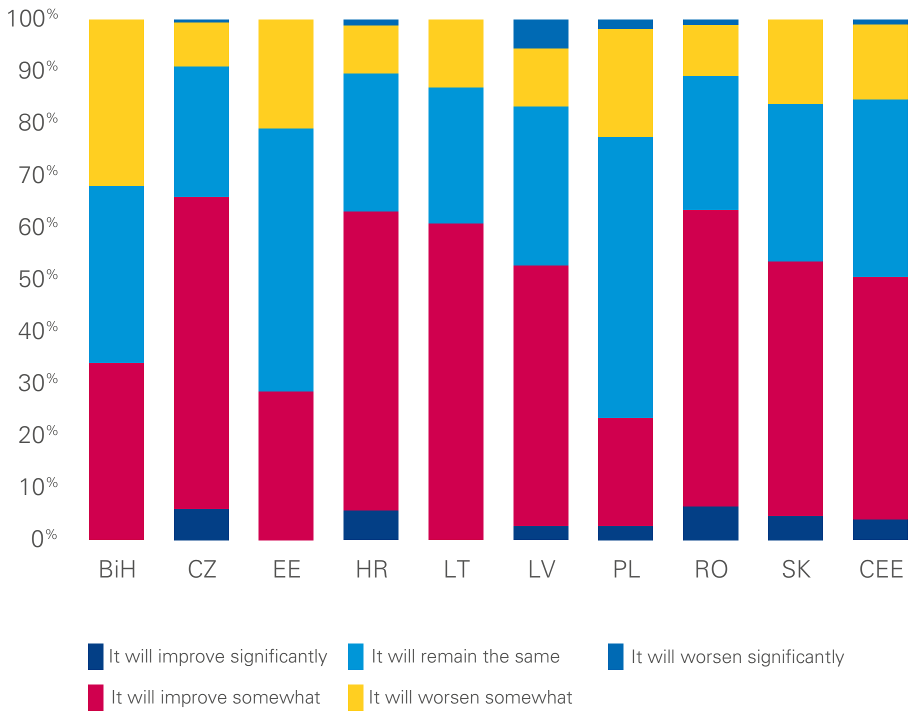
Outlook for the economy

About half of respondents see the economy improving

The macroeconomic conditions in the nine countries included here are considered satisfactory, as on average 51% of the respondents in the region believe that the economic situation will improve somewhat or even significantly, while 34% do not see any particular changes and only 15% expect worse times ahead.

Business leaders in the Czech Republic are in the most upbeat mood (66% say the economic situation will improve), followed by Croatia and Romania (both 63%). About half of respondents in Poland (54%) and Estonia (51%) expect that the economic situation will remain the same and the share of respondents who believe that the situation will worsen is the highest in Bosnia and Herzegovina (32%).

How do you expect the economic situation in your country to change in 2016?



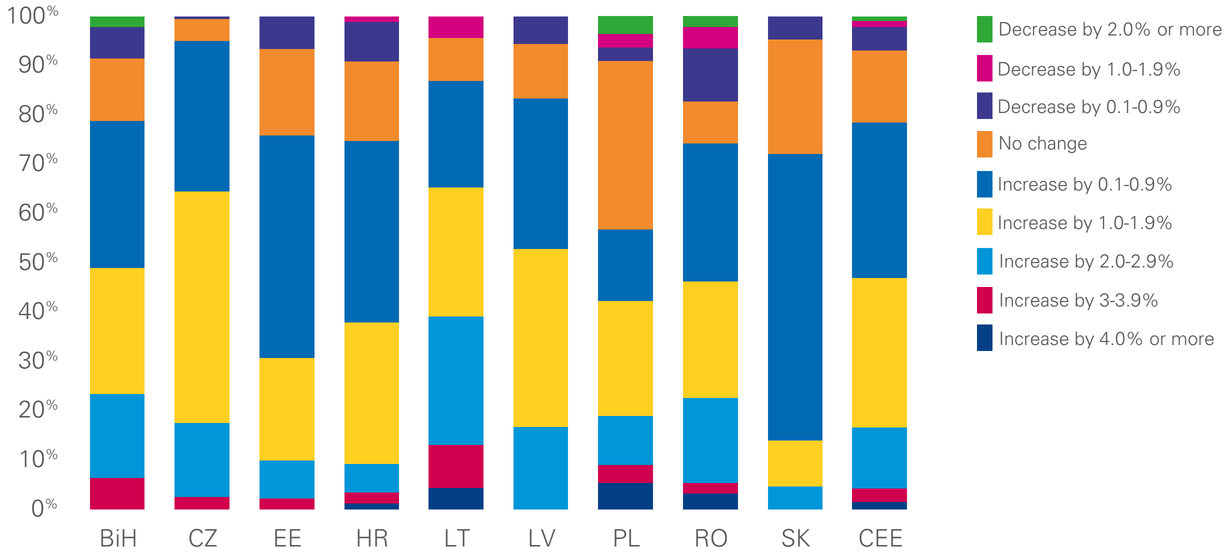
Inflation expected to remain under 2%

Of those surveyed in the nine countries, 62% believe that inflation will be contained in 2016, remaining between 0.1% and 1.9% – a result similar to that seen in last year's survey, where about 52% of the respondents gave this response. Inflation going over 2% was selected by 17% of the respondents.

Survey participants in the Czech Republic (78%), Slovakia and Latvia (both 67%) think inflation will remain between 0.1 and 1.9% and 66% are of the same opinion in Croatia and Estonia.

Although clearly down from the last year's 69%, the highest price pressures are expected in the newest member of the euro area, Lithuania, where 39% of respondents see inflation exceeding 2%, followed by Bosnia and Herzegovina at 23%. According to 17% of respondents in Romania, deflation looks to be in the forecast.

What do you expect the consumer price index change to be in in your country in 2016?



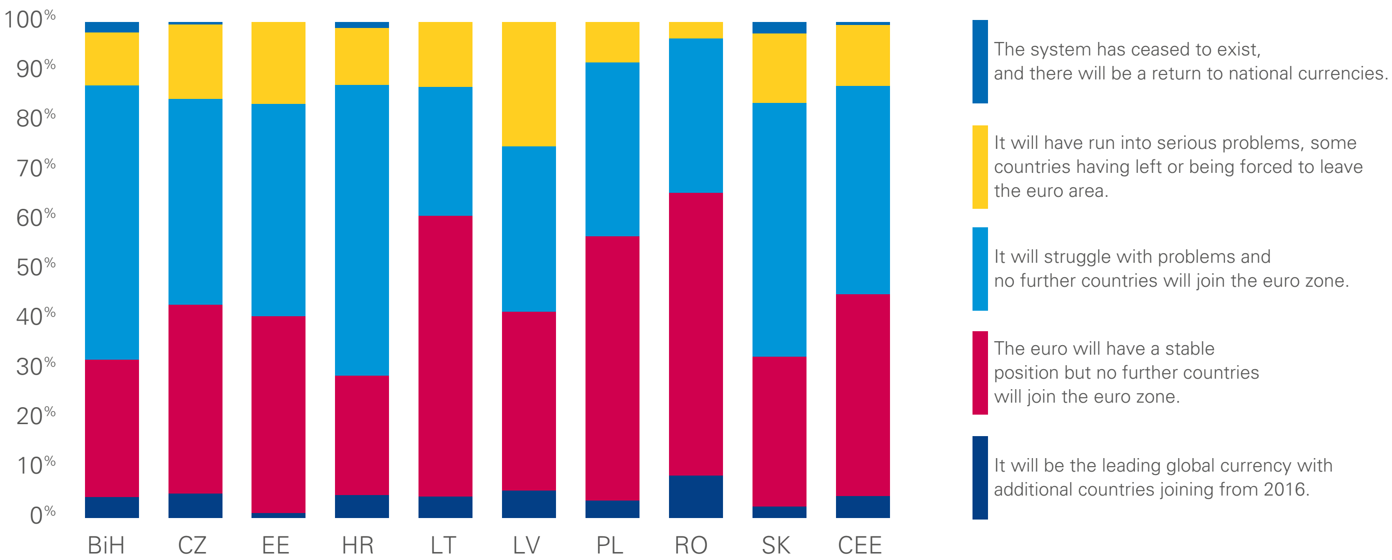
Mixed views on the outlook for the euro

After Latvia joined the euro area in 2014, and Lithuania following suit this year, it is unclear when the next countries will switch to the common currency.

Possibly due to the ongoing challenges in the common monetary policy, the biggest share of respondents in the region – 42% compared to the last year's 31% – indicate that by 2020 the euro will see many struggles and no further countries will have joined the euro area. Almost the same percentage of respondents indicate that the euro will have a stable position (41% vs. 43% in 2014), with that sentiment the strongest in Lithuania and Romania (both 57%).

Some responded that by 2020, the euro area will have run into serious problems and lost some of its members: 25% in Latvia, 12% of the region, while just a few respondents envision the currency collapsing by 2020.

What future do you see for the euro by 2020?



Simplified tax administration expected from governments

Simplified tax payment and administration procedures are seen as the most vital tax policy issues that should be tackled by the government, as in the 2014 edition of our survey, as mentioned by 79% of respondents in the CEE sample* – Lithuanian (57%) and Estonian (58%) respondents indicated the least concern about the subject. Strong sentiment was expressed regarding the implementation and retention of the flat personal income tax system by 50% of the respondents, most strongly in Slovakia (65%) and Romania (63%).

Introducing or increasing tax incentives for R&D activities is endorsed by 47% who participated in the survey, and having a ceiling for the annual amount of social security tax on the workforce by 42%. The least support (from only 13% of respondents) was given to the implementation or maintenance of a progressive personal income tax system, an idea that is the least popular in Romania (5%) and Estonia (7%).

Please select five tax policy issues that should be tackled by the government**

Other options that did not belong to the top five in any country:

- Changing the proportion of the employer's and employee's share of social security contributions.
- Lowering excise tax rates.
- Introducing or increasing taxes on private property.
- Implementing/keeping progressive personal income tax system.

In 7 CEE countries (excluding Croatia and Bosnia & Herzegovina)
*** Top 5 options for each country displayed*

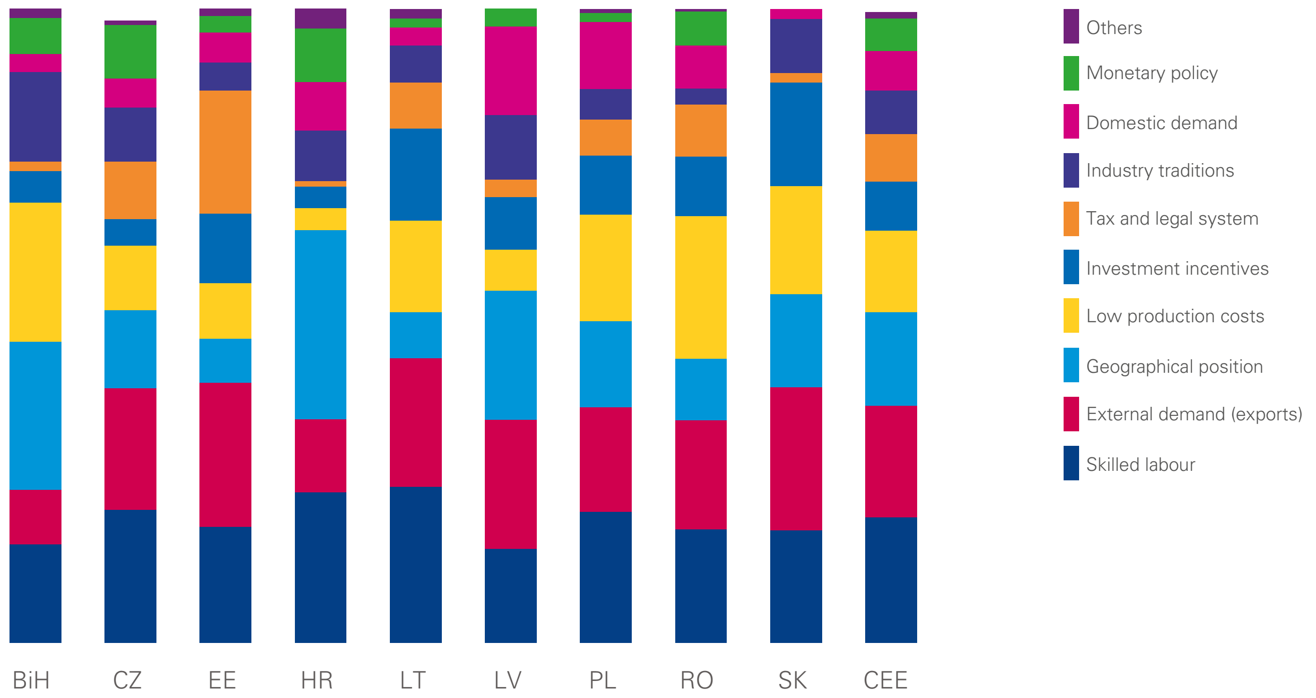
Skilled labour and exports vital for competitiveness

Across the region, skilled labour has maintained its position in the race for competitiveness, according to 60% of respondents overall (whose figure was 62% in 2014), receiving the most support in Lithuania (74%) and Croatia (71%).

The external demand category has retained the second slot at 53% (59% in 2014) and geographical position is seen by 44% (39% in 2014) as a key driver of economic competitiveness. As in 2014, industrial traditions (21%), domestic demand (19%) and monetary policy (15%) play a minor role on average, according to those surveyed.

Low production costs are an important factor in Romania (68%) and Bosnia and Herzegovina (66%), but not relevant for Croatia, where this factor was selected by only 10% of respondents. Investment incentives are helpful according to survey participants in Slovakia (49%) and Lithuania (43%), while the tax and legal system offers competitive advantages for Estonia (as indicated by 58%).

In your opinion, what are the three key drivers of your country´s economic competitiveness?



Renewables' potential competes with nuclear energy

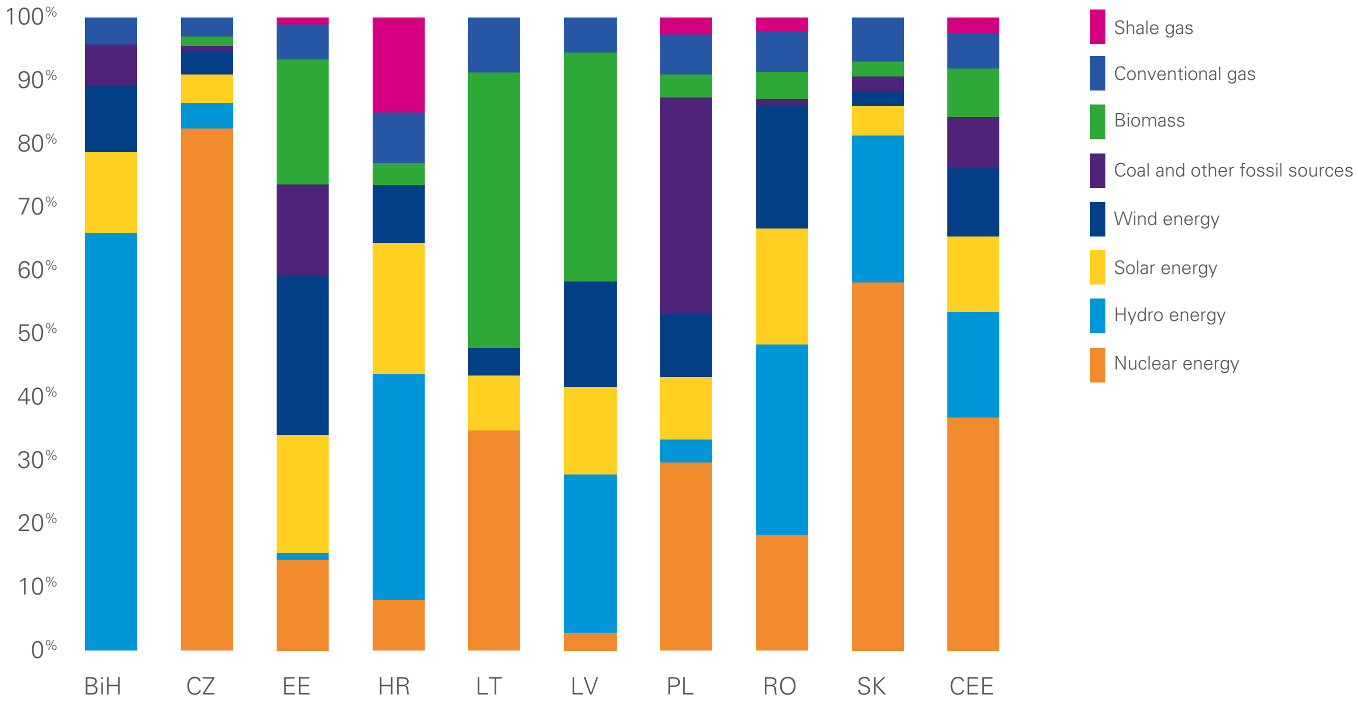
Nuclear maintains the first position among energy carriers, according to a survey query of energy sector priorities in the CEE countries. However, aggregate support for renewable sources amounts to 48%.

The support for nuclear energy stands at 37% in the region, slightly down from last year's 40%. It enjoys the broadest support in the Czech Republic (83%) and Slovakia (58%), but clearly it is not an option for Latvia (3%) or Bosnia and Herzegovina (0%).

A clear winner in Bosnia and Herzegovina (66%), hydro energy is preferred by 17% of all respondents in the CEE, followed by solar (12%) and wind (11%) energy. The Baltics pledge their trust in biomass, for which support in Lithuania amounts to 43%, in Latvia 36% and in Estonia 20%, while in the other countries it stays under the 5% threshold.

In terms of support for coal and other fossil fuel sources, they received the strongest support in Poland (34%) and by 14% of respondents in Estonia, renowned for its oil shale reserves.

Which source of energy should have the priority in your country's energy sector portfolio?



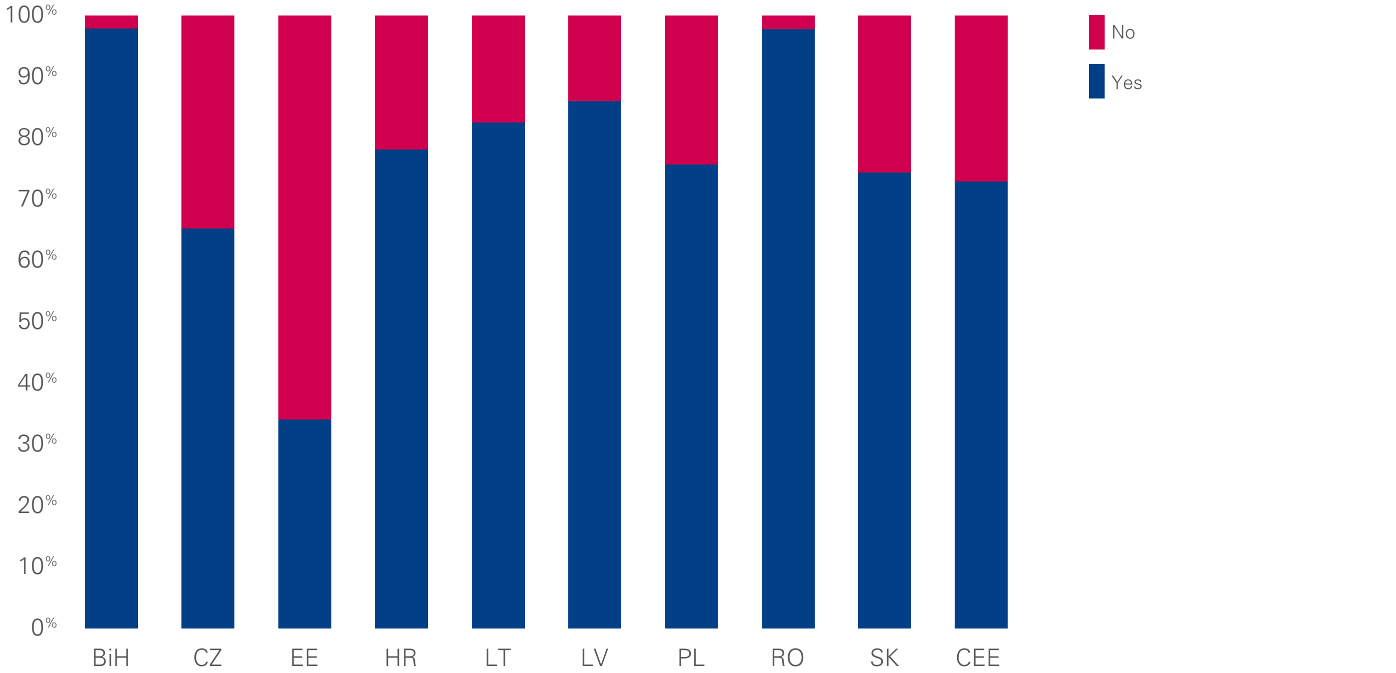
Shadow economy remains a problem

Still, 73% of respondents in the CEE indicated that the shadow economy (75% in 2014) is a problem in their respective countries. The grey side of the economy is the most challenging issue in Bosnia and Herzegovina and Romania (both at 98%), while in Estonia the indicator stands at 34%, the lowest in the region like the last year's 55%.

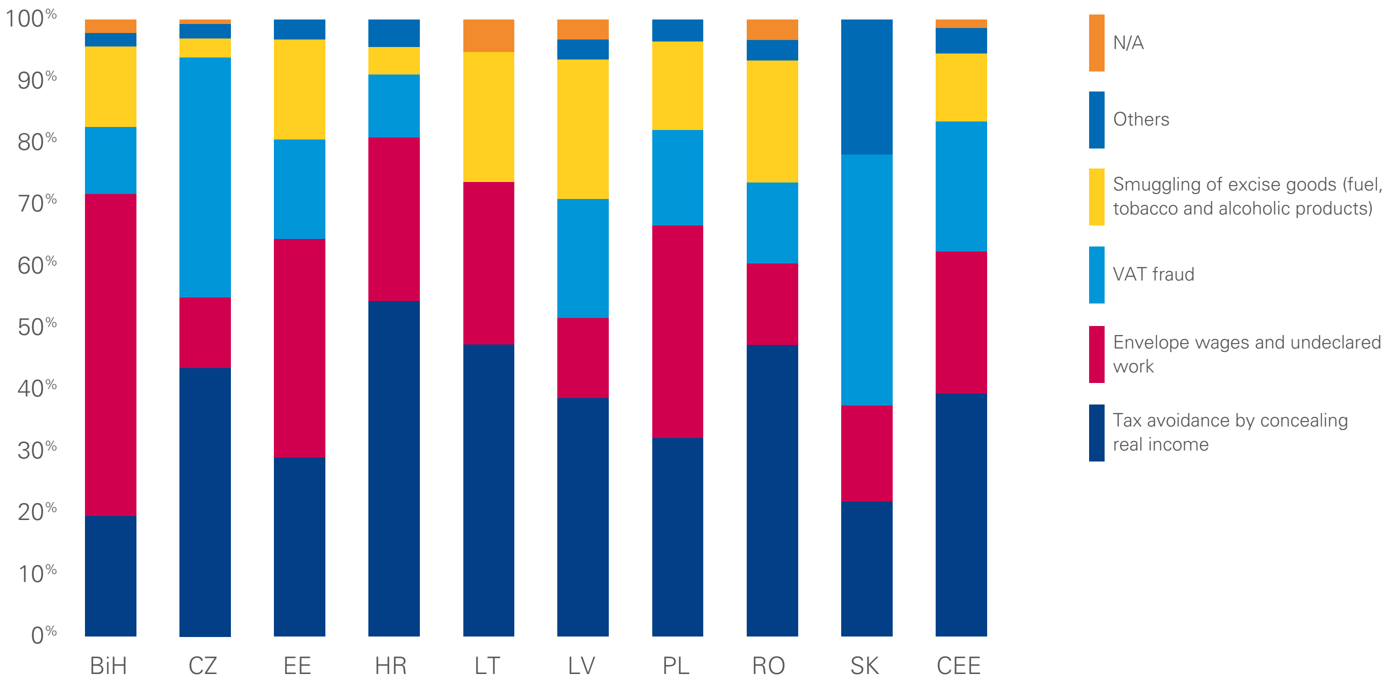
Thirty-nine per cent of the respondents say tax avoidance by concealing real income is the main source of concern, followed by envelope wages (23%) and VAT fraud (21%).

The smuggling of excise goods received the most responses in two Baltic countries, when 23% of Latvian and 21% of Lithuanian respondents see it as the main driver of the shadow economy, the CEE average being at 11%.

Do you think that the shadow economy is a serious issue in your country?



In your opinion, what makes the largest part of the shadow economy in your country?

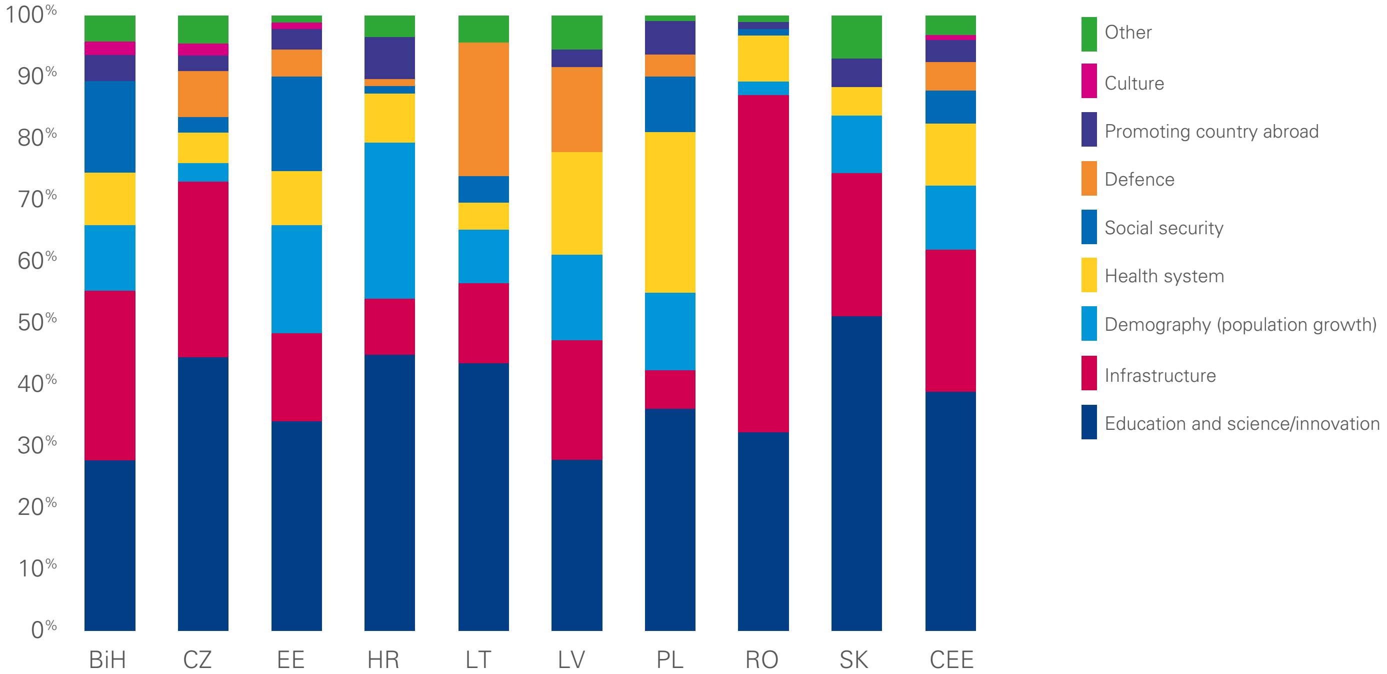


Fiscal priorities: Education, science and innovation

Education, science and innovation should receive priority in governments' fiscal planning, according to 39% of respondents (43% in 2014) who replied to the question regarding which areas they would like to see governments increase fiscal expenditure between 2016 and 2018. This sentiment was highest in Slovakia (51%), in the Czech Republic and Croatia (both 45%).

Funding infrastructure is supported by 23% of survey participants in the CEE, most strongly in Romania (55%), followed by demography and health system (both receiving 10%). In Bosnia and Herzegovina, and Estonia, 15% prefer spending on social security, while the CEE average response stands at a mere 5%.

In which area would you entitle the government to increase your country's fiscal expenditure between 2016 and 2018?



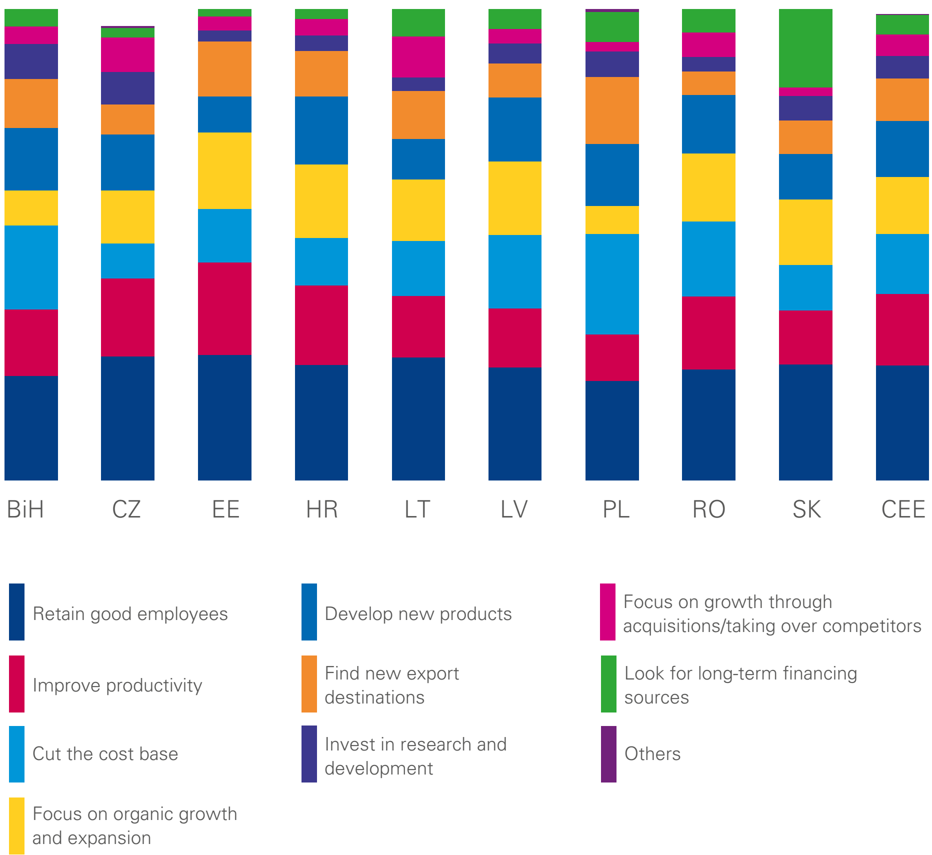
Outlook for enterprise

Good staff even more valuable

Good employees are even more valuable than before, as on average 73% of CEE respondents maintain that retaining staff is a key aspect a company should focus on; in the 2014 survey the corresponding rate was 69%. As in 2014, improving productivity comes second, but the gap to the preferred option has increased – now 45% of respondents chose it compared to 61% last year. In Estonia, raising the productivity is selected by 59% in the national survey sample.

Cutting the cost base (38%), focus on organic growth and expansion and development of new products (both 36%) come next. While the CEE average for finding export destinations is 27%, companies in Poland deem it more important (42%). Investments in R&D (15%), growth through acquisitions (14%) and search for long-term financing sources (12%) play only a minor role according to business leaders participating in the survey.

In the current economic situation, what are the three key aspects your company should focus on?



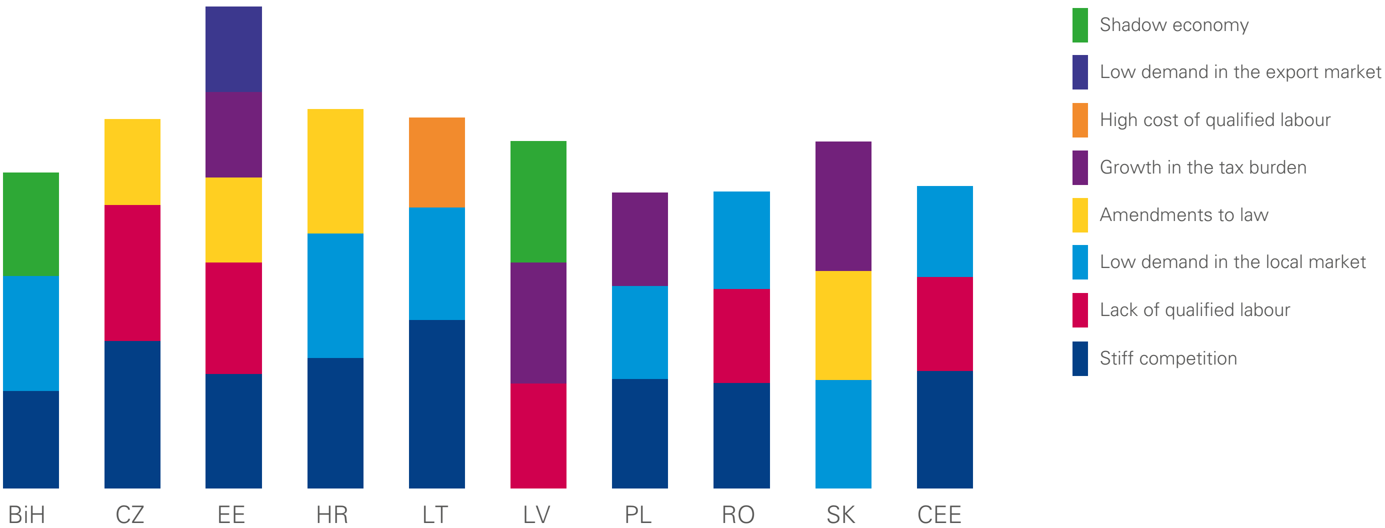
Stiff competition and labour issues restrict turnover growth

Of those surveyed, 45% contend that stiff competition is a key issue that restricts their turnover growth through to the end of 2016, followed by lack of qualified labour (36%), low demand in the local market (35%), legal amendments (33%) and growth in tax burden (29%), meaning that the composition of the top five has not changed since last year.

Stiff competition is a strong case for concern in Lithuania (as indicated by 65% of respondents) and in the Czech Republic (57%).

The lack of qualified labour may be a concern for entrepreneurs in the Czech Republic (53%), while low domestic demand ranked high in Croatia (48%), Bosnia and Herzegovina (44%), Lithuania (43%) and Slovakia (42%). Of less problematic issues, lack of both local and foreign strategic investors is singled out in Bosnia and Herzegovina (27%).

What are the three key issues that you expect will restrict the growth of your company's turnover until the end of 2016?*



** Top 3 options for each country displayed*

Other options that did not belong to the top three in any country:

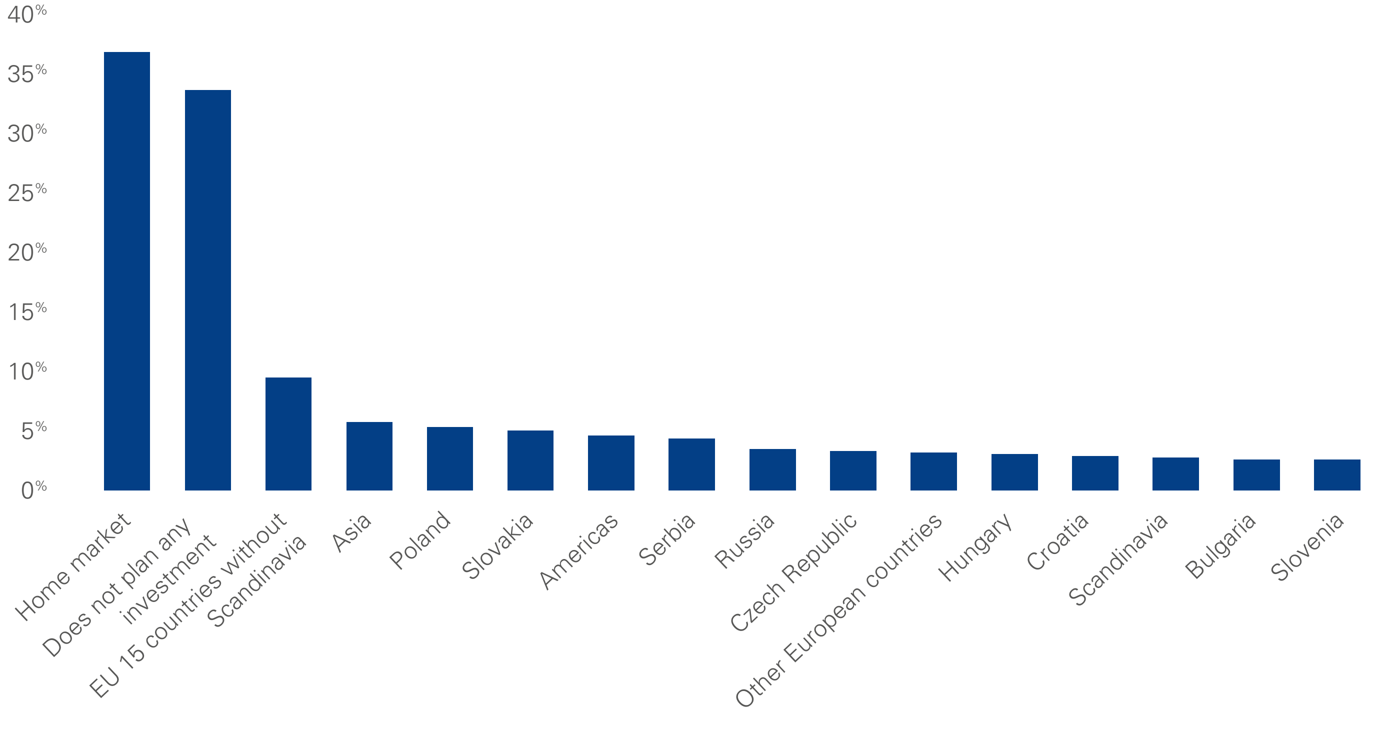
- Prices of raw materials (including energy costs).
- Lack of local strategic investors.
- Lack of foreign strategic investors.
- Lack of research and development.
- Limited access to bank loans.
- Lack of unskilled labour.
- High cost of unskilled labour.

About two-thirds aiming for investments in the coming years

Investments are a vital part of remaining competitive, according to 66% of survey respondents who indicate their companies are planning investments in the period from 2016 to 2018. For 37% the home market is the primary target, which received the most responses in Bosnia and Herzegovina (53%), Poland (50%) and Slovakia (45%).

The EU15 countries are also high on the list for investment (9%); meanwhile Asia was indicated by 6% of respondents, while Poland, Slovakia and the Americas all received 5%. Respondents in Latvia are most cautious, as 53% say they do not plan any investments, followed by Lithuania and Romania, both at 48%.

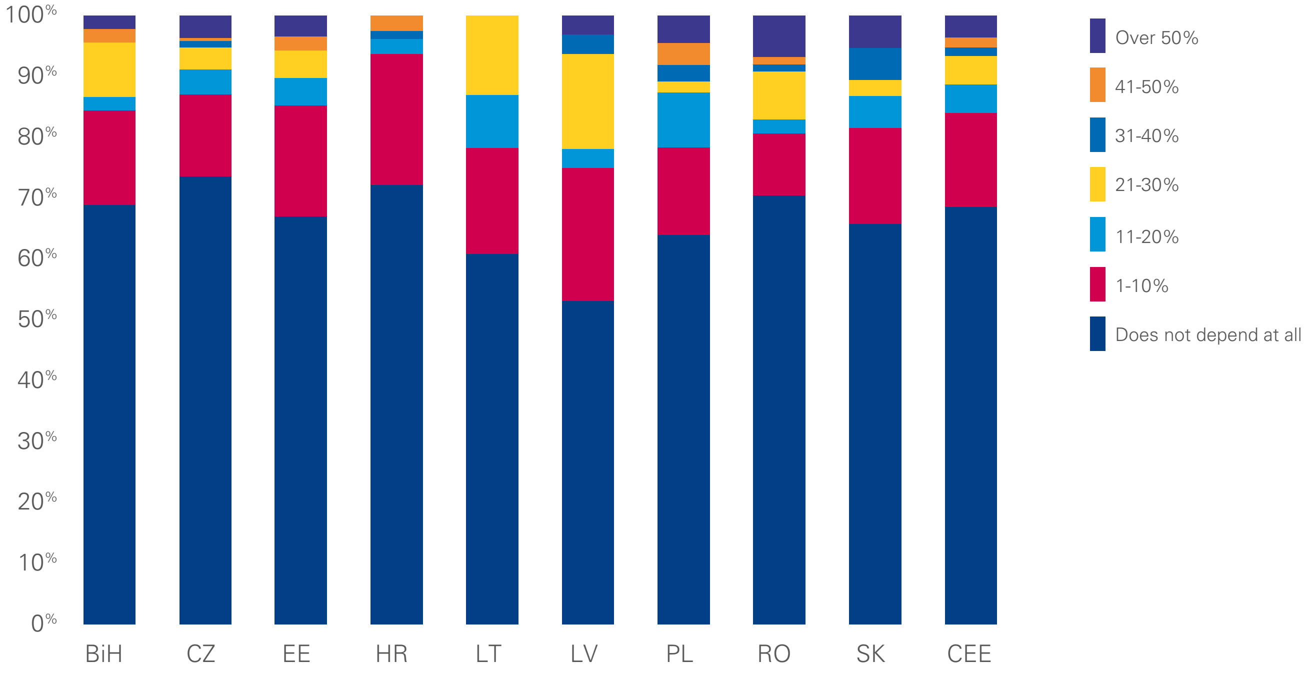
Including your home market, in which country or region does your company plan to invest in 2016-2018?

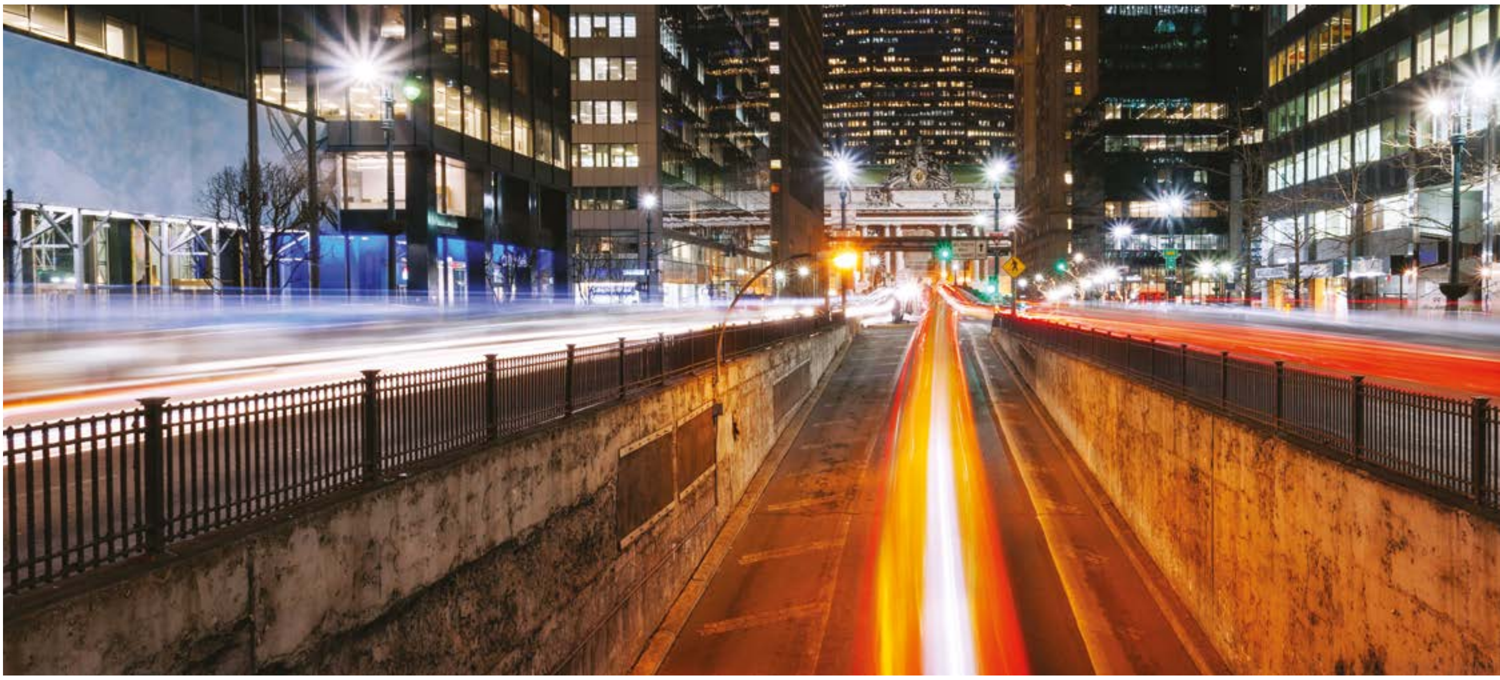


Companies can live without EU funding

Thirty-one per cent of respondents say their company turnover depends on EU funding or public procurements for EU-funded projects, most notably in Latvia (47%) and Lithuania (39%). For about one quarter of the respondents, the EU-related funding does not exceed 30% of turnover, according to those surveyed. A marginal amount – 4% of companies – admit that their dependence on EU funding is above 50% of turnover, the highest share of such responses being in Romania (7%).

To what extent does the turnover of your company depend on EU funding or public procurements for EU funded projects?



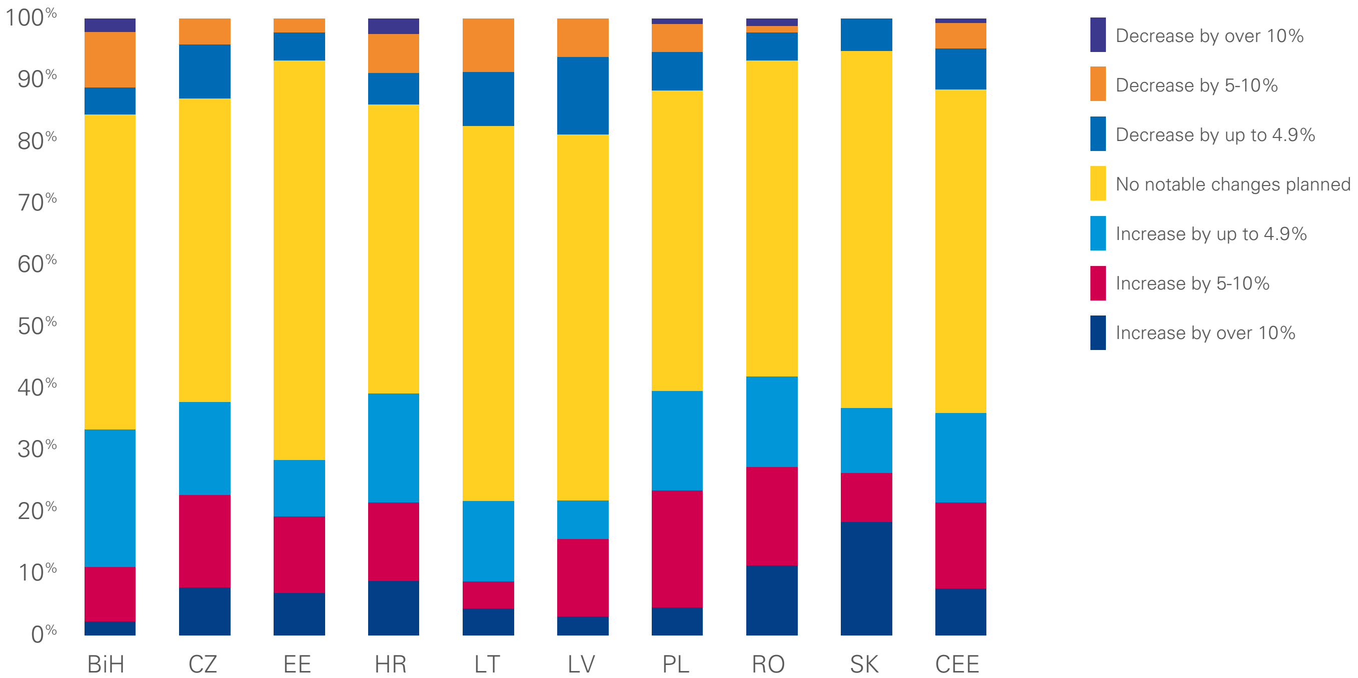


Staff changes remain limited

Well in line with the last year's outcome, 53% of respondents in the CEE countries do not plan any notable changes in employee numbers. In the Baltics, the share of such responses was between 65% and 59% and in Slovakia 58%.

The CEE average of those companies planning to hire stands at 36%, and for individual countries Romania (42% of the respondents), Poland (40%) and Croatia (39%) plan to more actively get new people on board. Only 12% of respondents in the region plan to decrease staff numbers, with no notable difference in comparison to last year, but above average percentages are seen in Latvia (19%), Lithuania (18%) and Bosnia and Herzegovina (15%).

In 2016 what do you plan to do with employee numbers in your company?

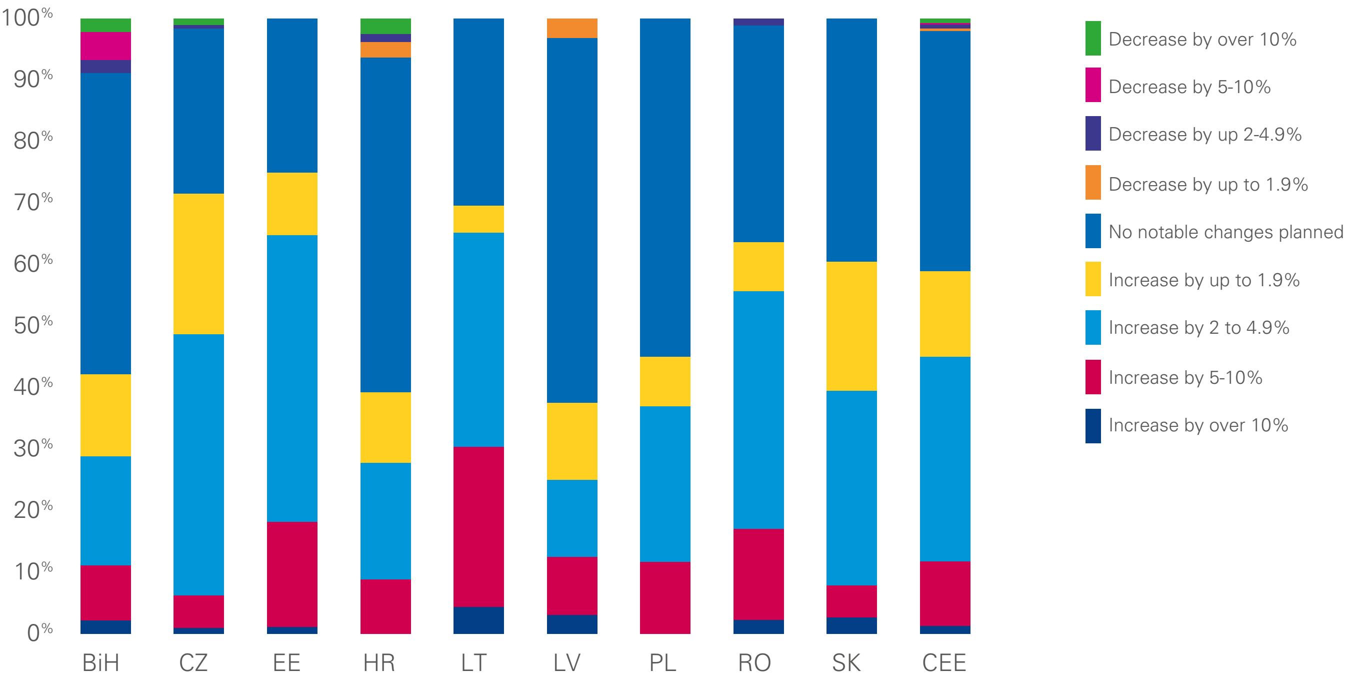


Salaries continue to rise slightly

For employees, the salary outlook for 2016 appears rather promising, with 58% of CEE respondents planning increases in staff remuneration. However, that is a lower response than the 69% indicted in the previous survey.

In Estonia, 75% of respondents intend to adjust salaries upwards, followed by sentiment in the Czech Republic (71%) and Lithuania (69%), while in Latvia and Croatia the share remains slightly below 40%. An increase of up to 5%, indicated on average by 47% of respondents, is expected to outpace projected inflation. Most generous are the respondents in Lithuania, where 30% are planning to increase salaries by over 5%. Salary decreases in the region are expected to remain quite rare, on average mentioned by 2% of respondents.

What are your plans regarding employees' salaries at your company in 2016?

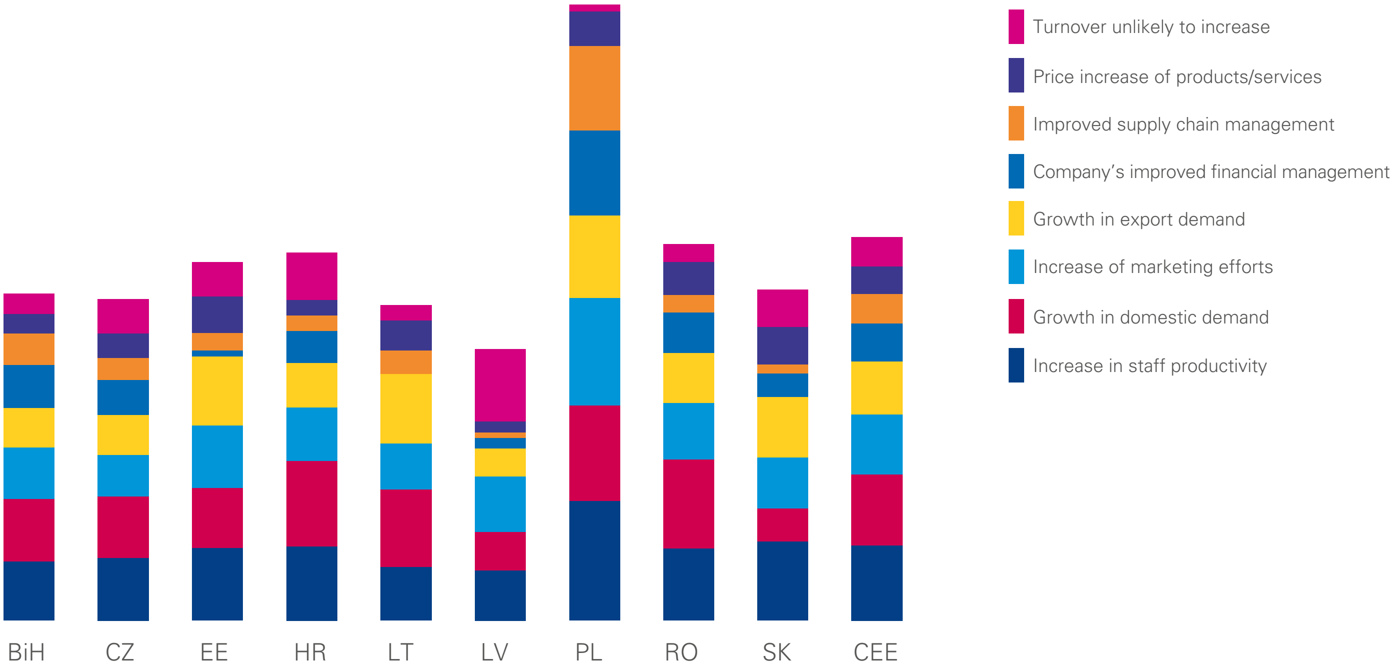


Higher productivity and better domestic demand drives turnover

Similarly to 2015, business leaders in the region expect that turnover growth of their companies in 2016 will be mainly driven by higher staff productivity (according to 42% of respondents), growth in domestic demand (40%) and increase in marketing efforts (34%). Price increase of products or services is regarded as not helpful for higher turnover, as only 16% on average have chosen this option.

Increases in staff productivity and higher domestic demand are held in high esteem, especially in Poland, receiving 68% and 54% responses respectively. On average, in CEE 17% of respondents do not see turnover growth for 2016, with a dimmer view in Latvia, at 41%.

What are the main drivers of the turnover growth of your company in 2016?*



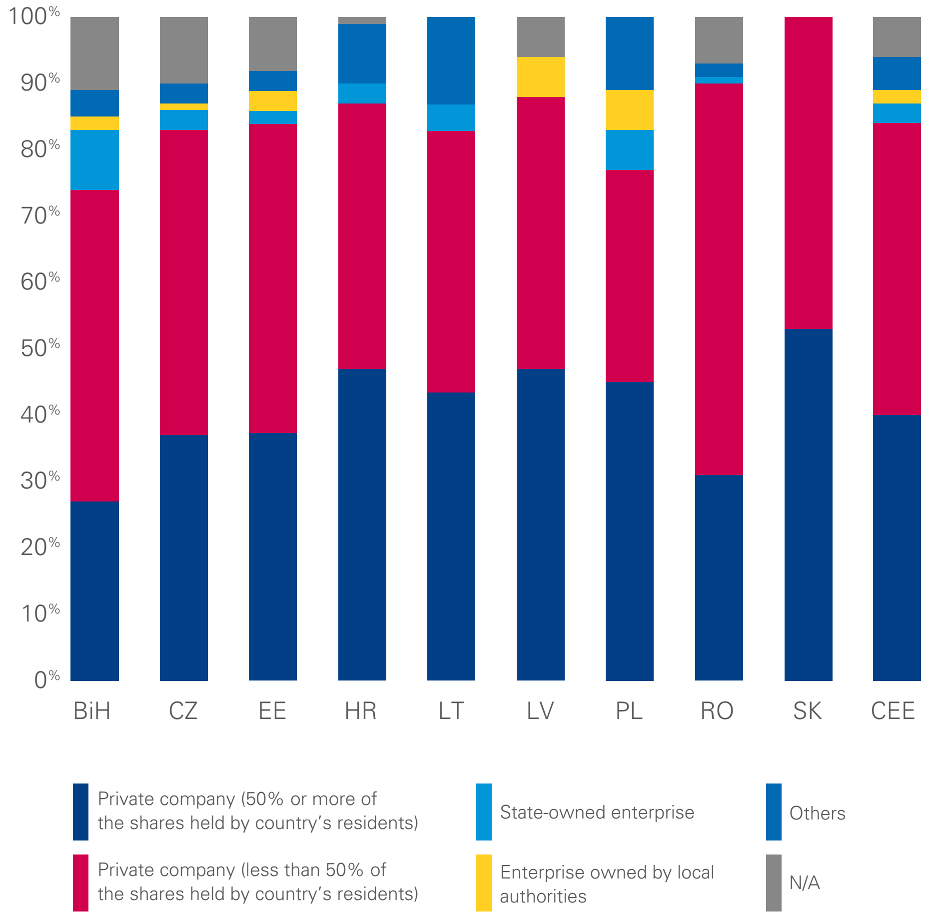
* *The dataset for Poland stands out on the chart, as Polish respondents chose almost 3.5 drivers on average; in the other countries the average fell between 1.5 and 2.1.*

Profile of respondents

A total of 731 responses, about 60% more than in 2014, was collected in the survey, which involved various business sectors.

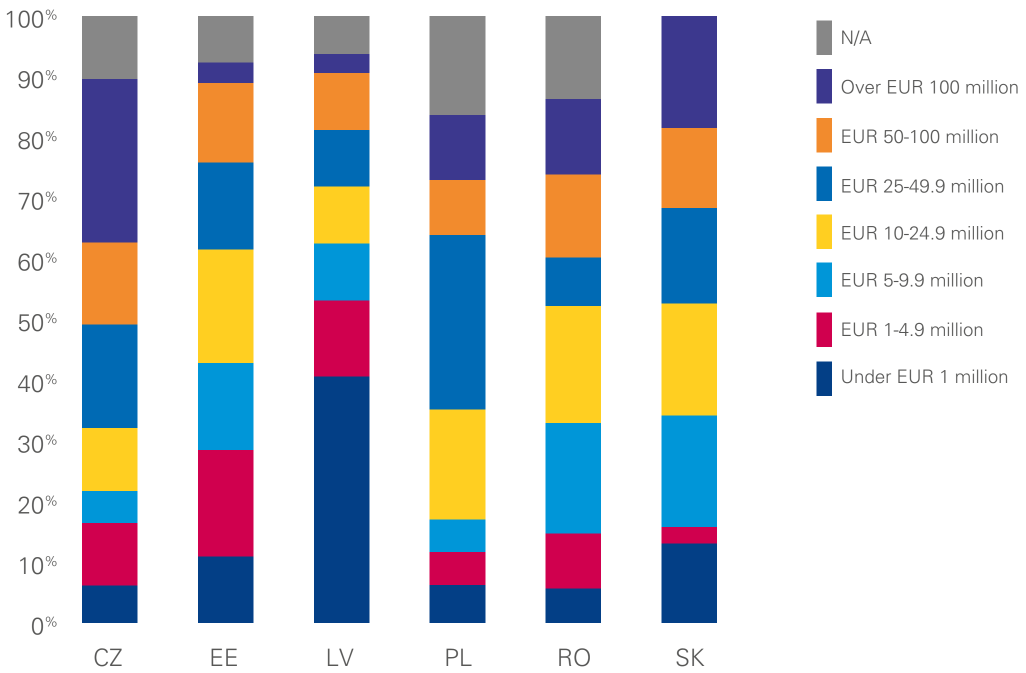
Forty-four per cent of the respondents came from companies where less than 50% of the shares are held by residents, this share being the highest in Romania (59%). The share of local private companies was the highest in Slovakia (53%).

Type of organisation

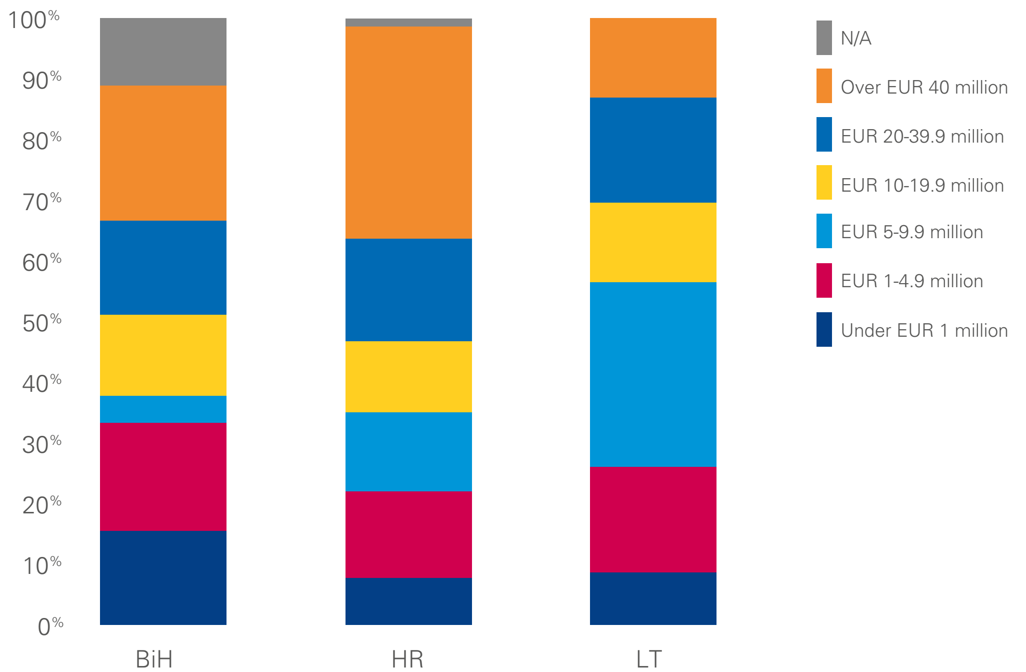


By turnover, the sample across the nine countries in the region represented mostly larger enterprises. The share of companies with an annual turnover of under one million euros remained below 20%.

Company's turnover (2014)

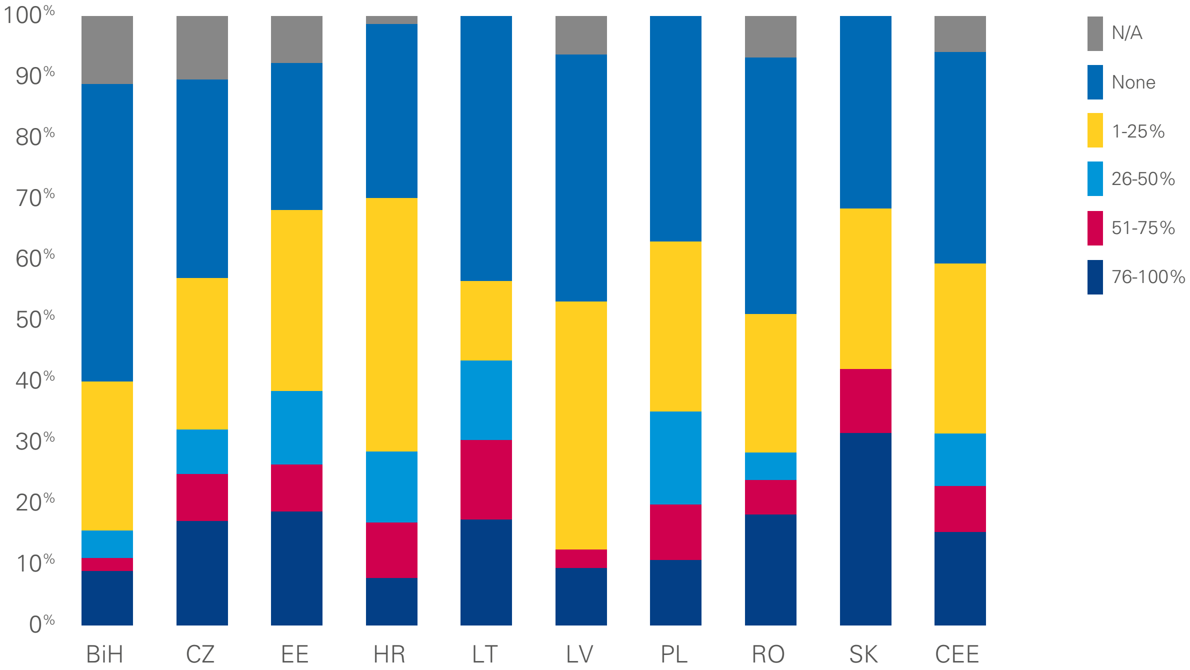


Company's turnover (2014)



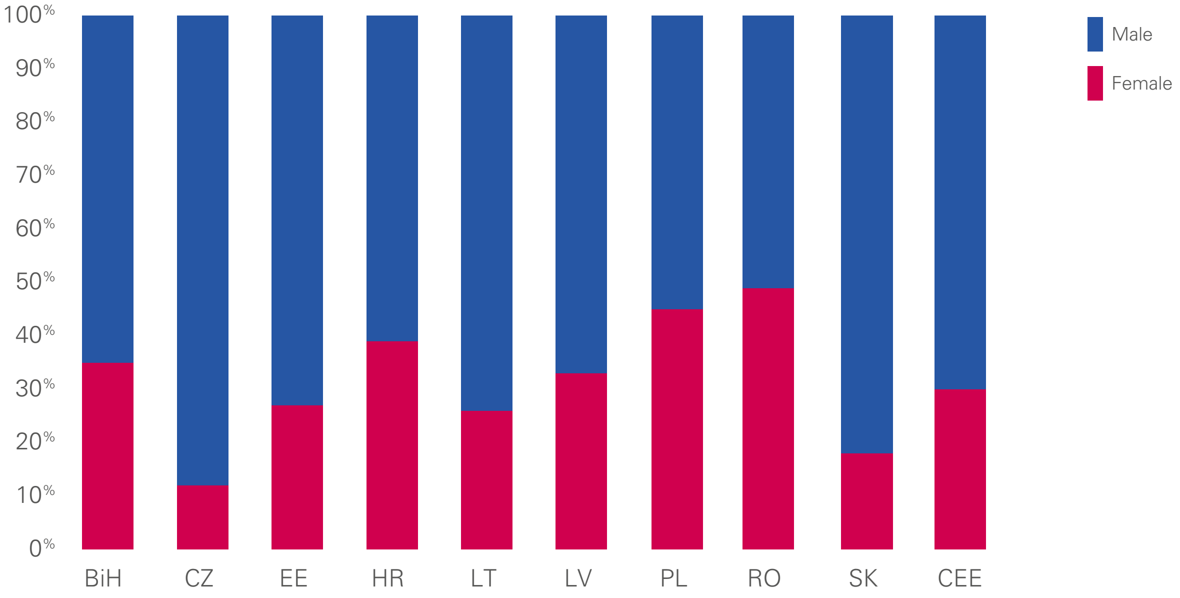
About 60% of respondents represent companies with export markets, the highest share being in Croatia (71%), Slovakia and Estonia (both 69%). At 43%, Slovakia leads the ranking of companies receiving half or more of their turnover from exports. The share of non-exporting companies is the highest in Bosnia and Herzegovina (49%).

Share of exports in the company's sales



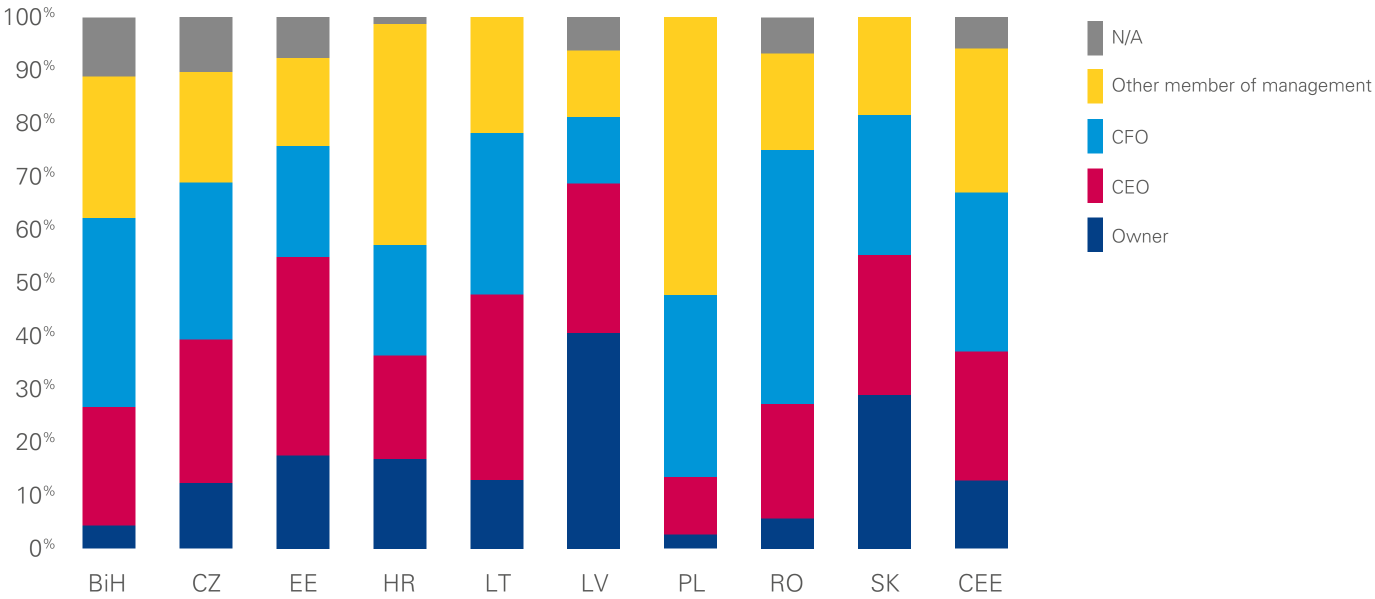
By gender, male respondents account for 70% of the survey's respondents, while the highest share of female participants is seen in Romania (49%) and Poland (45%), and the lowest in the Czech Republic (12%) and Slovakia (18%).

Gender



By function, 30% of respondents are CFOs (in Romania 48%), 24% CEOs, 13% company owners – their share being the highest in Latvia (41%) – and 27% other members of management.

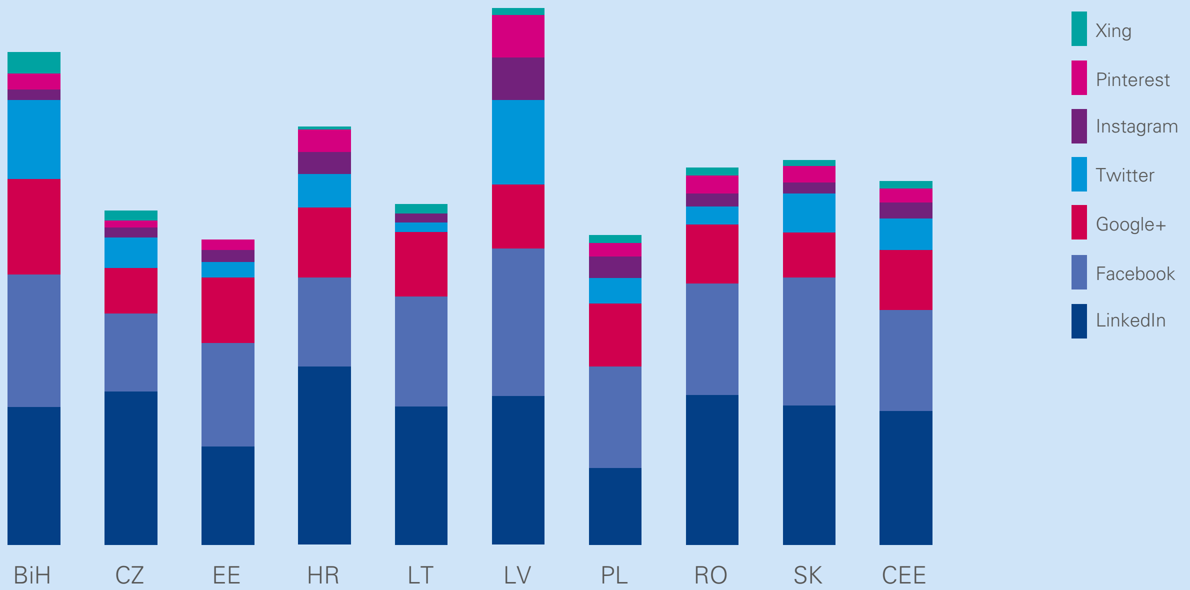
Position



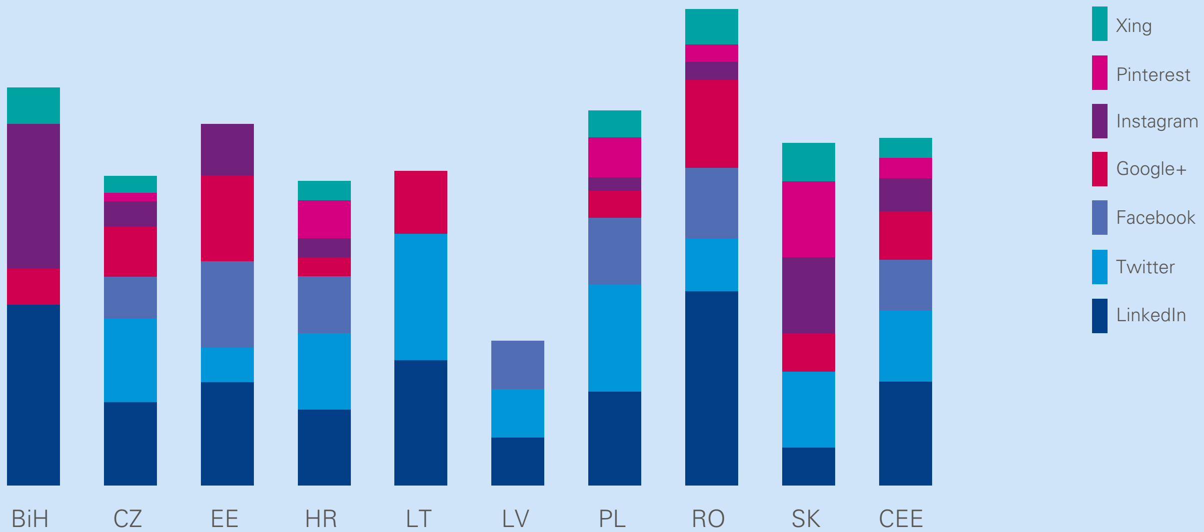
In social media, business leaders prefer LinkedIn

When asked about their social media habits, business leaders in the CEE prefer LinkedIn (63% saying they use it), followed by Facebook (48%) and Google Plus (28%). Twitter is less popular (15%), and the popularity of Instagram, Pinterest and Xing is well below 10%. Among respondents who are planning to use social media channels, LinkedIn and Twitter are seen with the strongest potential.

Social media users among the respondents



Respondents planning to use social media



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