Lithuania's FDI promotion strategy
Executive Summary
March 2009

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1. Foreword

This executive summary is an extract from a report which was produced by Ernst & Young Advisory for the Lithuanian Development Agency concerning the design of a strategy for Lithuanian FDI. It covers the outcomes that were presented in the executive summary that was delivered to the Ministry of Economy and the Ministry of Foreign Affairs in early January 2009.

The full FDI report itself is part of a two-fold study concerning the design of a strategy for Lithuanian exports and FDI. This study was carried out by Ernst & Young International Location Advisory Services (based in France), in cooperation with Ernst & Young Advisory Lithuania.

The two studies include a diagnosis of the FDI and exports market trends and situation, strategic recommendations to improve Lithuania's FDI and exports, as well as an action plan for the implementation of the strategy.

Ernst & Young's analysis is based on a deep desktop research, Ernst & Young's specific databases, interviews with international businesses and key players and interviews with Ernst & Young international experts.

This executive summary focuses on FDI promotion only. It presents the diagnosis outcomes, the strategic orientations and the associated action plan.

2. Lithuania's FDI situation is at a critical turning point, challenged by the current economic crisis and by various competitors, old and new

Lithuania has performed fairly well over the past 5 years. FDI projects were multiplied by four between 2003 & 2007, reaching a total of 99 projects and a 2% market share in CEE over the five year-period, representing an estimated 3,255 direct jobs in Lithuania.

However, the value of this FDI is not sufficient. Although concentrated in technological and knowledge-based sectors (the top sectors of inward investment to Lithuania are electronics, business services, logistics and finance) the value of FDI to Lithuania is not sufficient: It is made of manufacturing (44%) and sales and marketing projects (47%)[1], whereas high added value business functions (Regional HQ, R&D centers or even Shared Services Centers) are underperforming.

In terms of **perception by foreign investors, Lithuania does not appear on the radar:** the country ranks 12 among Central Eastern Countries according to Ernst & Young's 2008 European attractiveness survey. Lithuania is deemed the most attractive CEE country by 0.8% of international investors, behind Poland (32.5%), Hungary (9%), Slovakia (2.3%) or Serbia (1.4%)[2]. However the country ranks ahead Latvia (0.6 %) and Estonia (0.3%) in the top of mind of international investors.

Competition comes from **more aggressive FDI destinations:**

- More established competitors in the Baltic sea region, already knowledge-based economies (Denmark, Sweden, Finland)
- Central and Eastern European countries which have started earlier: Poland, Hungary and the Czech Republic (attracted 41% of FDI projects to CEE between 2003 & 2007[1])
- Direct competitors in the Baltics, particularly Estonia, getting more than 50% of FDI jobs created in the Baltics between 2003 & 2007[1]
- Lower-cost competition from offshore destinations in South East Europe, with larger markets: Romania, Bulgaria and Turkey attracted 24% of FDI projects to CEE in 2007

Finally, the current economic crisis will add tension to the market and put pressure on investors. FDI may slow down in 2009 as investors put projects on hold because of an uncertain future. FDI inflows into Central and Eastern Europe may reach a record US$158bn for 2008 (slightly above the previous record of US$156bn in 2007), but a 20-30 % reduction is forecast in 2009.

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[1] Ernst & Young European Investment Monitor, 2008
[2] Ernst & Young's 2008 European Attractiveness Survey

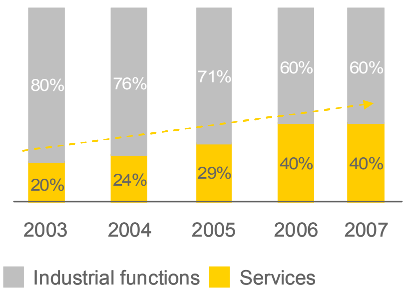
3. The FDI market is itself in transition, providing fewer and more value-added FDI opportunities

FDI in traditional sectors is declining across Europe. Central and Eastern Europe remains industry-based, but the number of FDI projects dropped by 40% in the automotive sector, 32% in the food industry, and 24% in the electronics sector between 2003 and 2007. In Western Europe, this trend is even more marked: 30,527 industrial job creations were 'missing' in 2007[1] compared to 2006. The four leading industrial sectors (logistics, automotive, pharmaceuticals and industrial equipment) provided 31% of total FDI job creation in Western Europe in 2006. Their share dropped to 23% in 2007[2].

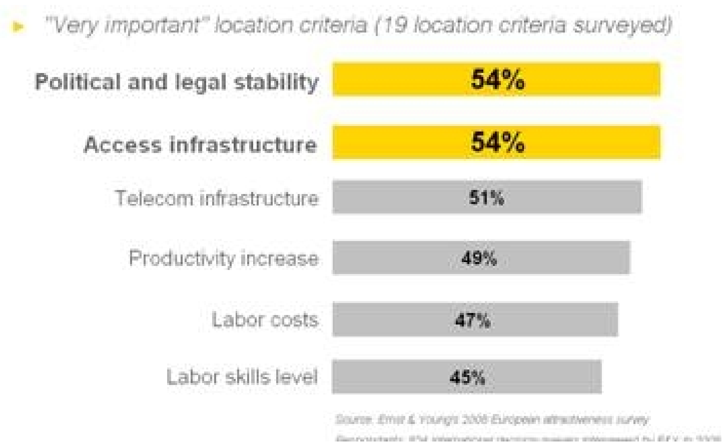
The FDI market is shifting towards services. In 2007, investment in services was responsible for 60% of FDI job creation in Western Europe vs. 43% in 2006. In Central and Eastern Europe, the trend is similar: the number of FDI projects in services has increased from 29% market share in 2003 to reach 40% in 2007[1].

In terms of decisions, the search for high quality and low risk has become as important as costs. Location decisions depend heavily **(50%)** on the stability, transparency and predictability of the business environment, the proximity to markets, efficient access infrastructure and telecommunications and labor skills level[2]. Clusters and sector-specific policies are becoming key to meet these high-quality requirements from the business community. In many cases - particularly for investors in high-growth economies - M&A and partnerships just are the first steps toward further greenfield investments[3].

FDI distribution of services and industrial projects in Central and Eastern Europe (number of projects 2003 – 2007)



Source: Ernst & Young European Investment Monitor, 2008



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2 Ernst & Young European Investment Monitor, 2008

2 Ernst & Young's 2008 European Attractiveness Survey

3 50 interviews of investors from Brazil, Russia, India and China

4. Lithuania's "SWOT" analysis indicates a series of strategic challenges concerning clusters, infrastructure, investment policies and marketing

The following critical assessment was established on the basis of 40+ interviews with foreign investors, key industry experts, public stake holders, the LDA teams and Ernst & Young's network of international business and location professionals.

Strengths

Market

- The largest of the 3 Baltic countries: 3.4 million Lithuanian people, half of total Baltic countries' GDP.

People

- Skilled workforce: 40% of the labor force with higher education, 20% of tertiary graduates in engineering. The percentage of the Lithuanian population with higher education is two times higher than the EU-15 average (Lithuanian department of statistics) with a strong "international" profile

Infrastructure

- Lithuania is located at the crossroads between Eastern and Western markets (250 and 340 million inhabitants respectively)
- Major infrastructure network, widely recognized as one of the best-functioning in the region, with a "hub" positioning (Vilnius international airport, Kaunas cargo airport and Klaipeda ice-free seaport)

Knowledge-based economy

- Services already account for over half of FDI projects in Lithuania (57% of total FDI projects received in 2007)

Business environment

- Compact economy and government, easy top-level access

International clients

- Established international service providers (IBM, CSC, SEB, Transcom, CITCO…)
- Some FDI brand names (GE, IBM, Philips Morris…)

International awareness

- A western capital city (Vilnius) by all standards and other medium-sized cities

Weaknesses

Market

- No real sector or cluster strategy
- Limited domestic market potential: Lithuania receives as many FDI projects as Zurich (Switzerland) region, Dusseldorf (Germany) region or Lorraine (France)

Infrastructure

- Vilnius airport landing fees puts it at a disadvantage vs. Riga or other CEE hubs (until recent changes in Vilnius airport management changes)
- Railroad transportation network
- Low business park capacity with 9 industrial parks under development

Business environment

- A history of bureaucracy, a complex land situation and a perception of corruption (whether true or not)
- High social security employer tax rates (~31% until 2009, ~27,98% from 2009)
- Influential domestic players sometimes reluctant to welcome new FDI

People

- Education is considered a major issue, with a critical lack of applied or applicable skills
- Labor shortages, due to the small size of the country and combined with a low 4.3%-6.6% (in 2008) unemployment rate (estimated unemployment rate for the end of 2009 – 10.8%)

International awareness

- Lack of international marketing and promotion of Lithuania to build the country's image

Opportunities

- Gateway to Russia and CIS countries (Belarus, Ukraine, Middle Asian countries) - although undervalued by most local stakeholders
- Opportunities for FDI in key sectors such as accounting and finance services, IT services and outsourcing, laser and biotech if applied to industries, renewable energies and logistics (current top sectors of investment into Lithuania are logistics, electronics, business services and finance)
- Increasing competition for talents among foreign investors
- Rising labor costs in Western neighboring countries (Nordics and Germany)
- European Capital of Culture 2009: how can this opportunity be turned into longer-term business opportunities?
- EU funds 2007-2013 to provide significant support for key projects

Risks

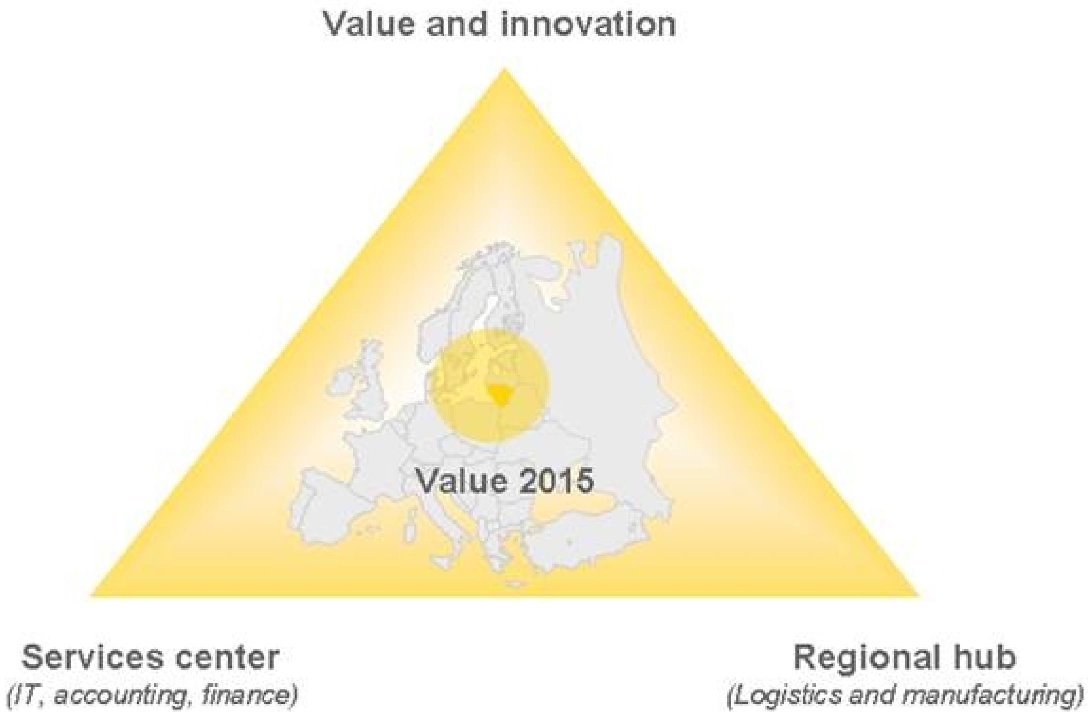
- The global crisis will have a strong impact in FDI (expect over 50% drop in FDI numbers over 2008)
- Rising costs vs. immediate CEE and Baltics competition
- Reluctance and lack of speed to create a FDI strategy at a time when competitors are setting aggressive strategies
- Perception of "lack of execution"
- A fragmented industrial policy
- Over-generic message to FDI, with little or no difference made against competition: lack of sector, activity and market targeting
- Loss of competitiveness in certain traditional sectors (chemical, paper, textile)
- Energy shortage/ high energy prices

5. Strategic vision for Lithuania's attractiveness and competitiveness: 'Value 2015'

The three dimensions of Lithuania's FDI proposition

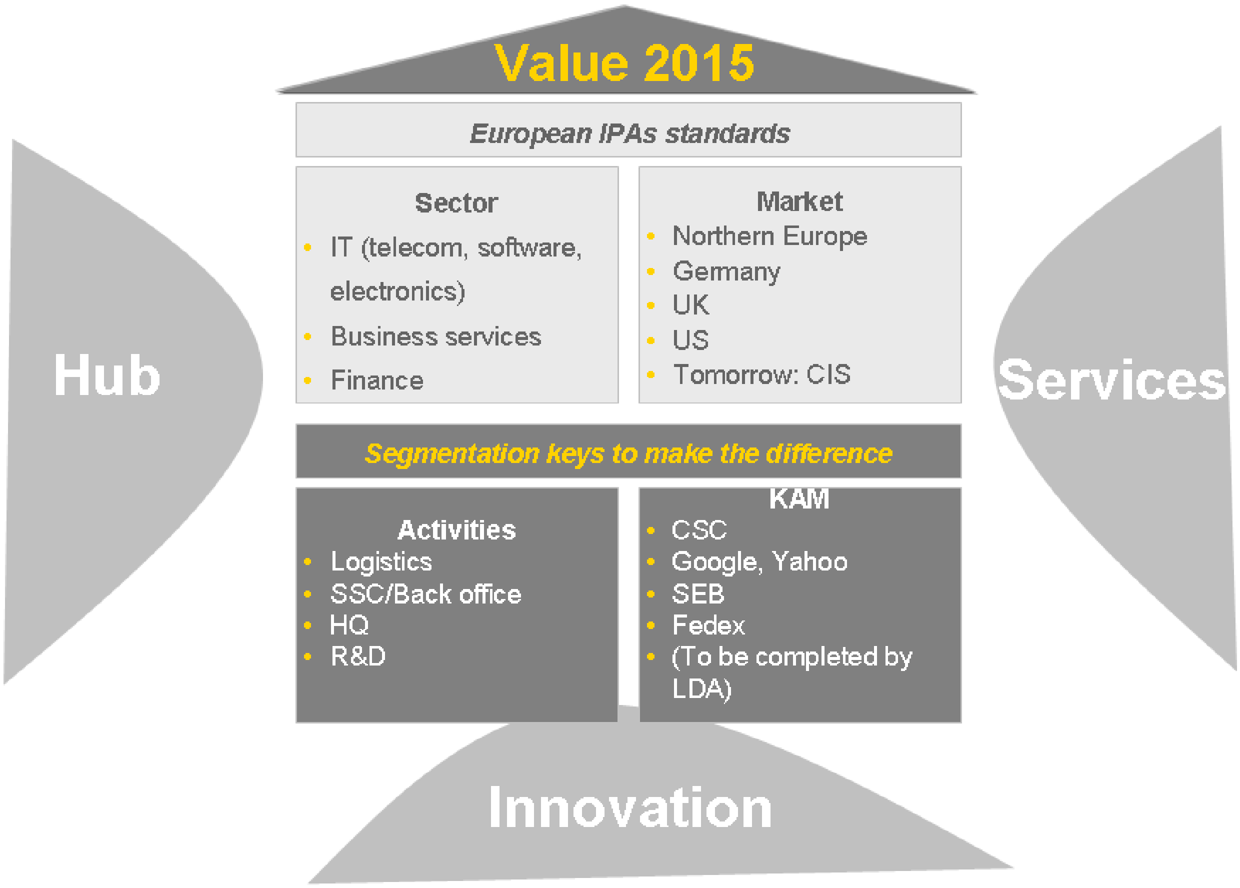
In summary, Lithuania's FDI situation is not recognized at its real value. There is an urgency to react and, at the same time, get ready to take advantage of Europe's rebound from the economic crisis. The strategic assessment has indicated that the FDI market's demand and Lithuania's unique selling points can be resumed under three main categories:

- **Value and innovation** through cluster excellence across all activities and sectors
- **Services** as a key support to Lithuania's economic development (logistics, nearshoring, regional HQs, design and R&D by manufacturers)
- **The "Hub" position** based on Lithuania's regional and metropolitan characteristics



To climb up the attractiveness and competitiveness ladders, Lithuania must undergo a **quadruple challenge**:

- **Shift 1:** focus on high value **activities/ functions** (Regional HQ, R&D centers,…). In addition the sector focus,, transversal business functions should be addressed and will attract further investments in the mid term (co-location effect)
- **Shift 2:** add services to manufacturing and think **high-value sectors**. In addition to empowering the traditional sectors (both for FDI and Exports), Lithuania will have also to focus on services, encompassing services to industries and pure services (Business support services in Accounting, finance and IT)
- **Shift 3:** shift from a Baltic country to a **Northern European / regional hub position.** Lithuania can capitalize on its immediate and strong international assets (logistic capacity, inclusion of the business community in the Vilnius culture capital of Europe opportunity). This can also be achieved not just through competition, but through cooperation in the Baltic region
- **Shift 4: investors are clients and must be treated as such.** LDA's top FDI clients must be treated through a **key account management** approach, which comes on top of the sector and market standard approach practiced by all European investment promotion agencies. Lithuania's top FDI clients are key to the future development of its attractiveness and international positioning. It is essential to start having a tailor-made approach of these accounts with special services and extra-care of Lithuania's top clients.



It will allow Lithuania to be considered as a **creative hub in the Baltic Sea Region**. The Northern European (Scandinavia, Germany, Poland, Denmark) market will secure the value, innovation and solvency of investments and exports in the short term, whereas Russia, but also Ukraine and Belarus will drive the growth in the mid term. The 2009-2010 crisis requires immediate key account management and after care of the key investors and exporters to be ready for a future rebound.

Discussion on our recommended scenario

Our recommendation is to aim at the "value" proposition. Only value can create long term prospects for a country such as Lithuania. Europe's most successful FDI models have been built on aggressive marketing programs (Ireland's 10-year corporate income tax exemption) and/or focused cluster strategies (Denmark's Medicon, or the UK's financial services). CEE countries which had based their entry into the European FDI field on cost competitiveness are gradually transitioning to promise and deliver "value" via innovation, high-quality skills, top-class infrastructure and disciplined cluster strategies. For Lithuania, cost is no longer an answer. The domestic market and cluster critical size cannot be established (except for niche and segmented activities – see below). The value option is the only realistic and most beneficial scenario.

Key levers

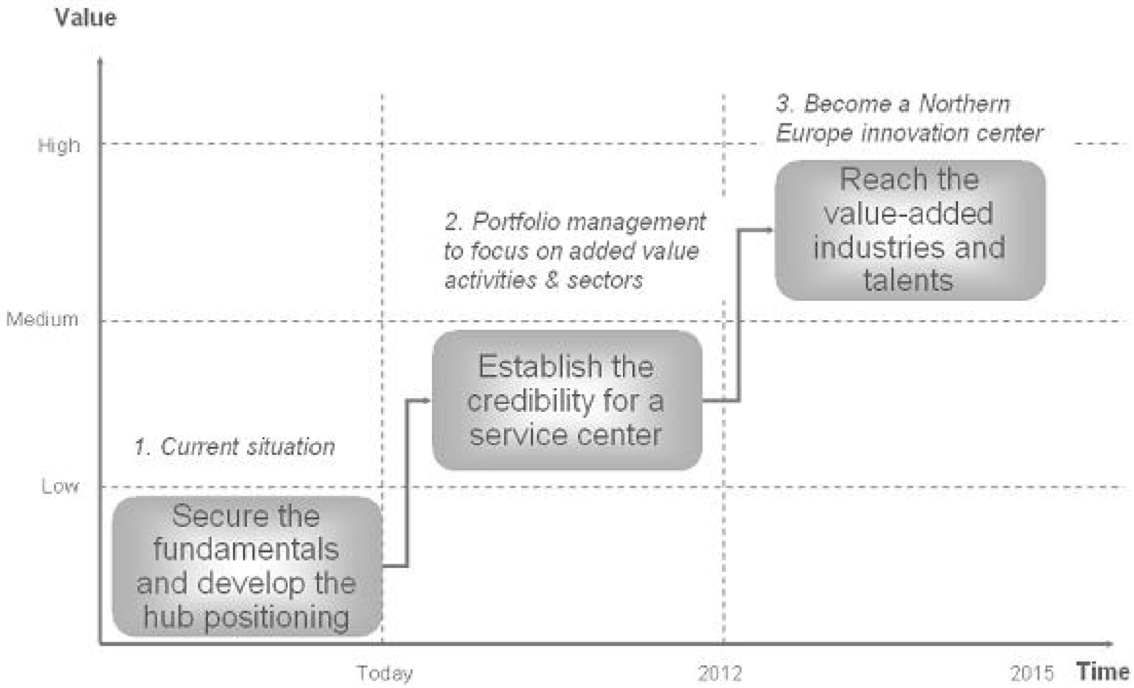
The FDI strategy must be connected to a wider economic development plan. From the FDI perspective, this plan should have 4 elements

- **A cluster strategy…** across all sectors and activities, gathering businesses, professional organizations, universities and research centers into structured networks
- **A strategic infrastructure strategy…** to ensure the country's integration at regional level. Optimizing the existing infrastructures (Vilnius airport, Klaipeda seaport, telecom infrastructure) and improving the current strategic weaknesses (railroad transportation network)
- **A revised investment platform…** to shape a clear package to foreign investors, including tax & costs, education and training, recruitment, real estate offering, legal conditions issues

- **An internal and external marketing plan…** to 'tell the (success) story' and to let Lithuania's clients and prospects know that the country is on the move

In addition to working on these 4 dimensions, Lithuania must also ensure the transformation of its more traditional, domestic economy. The FDI "Value 2015 Strategy" is not only about FDI. It requires local businesses to be involved, prepared, and ready to move up the value chain, universities to provide the right skills to businesses' needs, structured networks with a capacity for effective clustering and adapted infrastructures for the most efficient international integration.

Strategic steps
However, we believe there are critical steps. Lithuania needs to build piece by piece (some components to the **Value 2015 strategy** have long-term implications) and time-to-market is critical.



6. Benchmarking LDA against Europe's best-in-class[1] shows a vast program to bring the organization to the right level

Our benchmarking study of the selected 'best-in-class' investment promotion agencies highlighted the following key messages concerning LDA:

Strategic markets
- A limited number of strategic markets, sectors and activities should be targeted (3 to 5)
- Emerging FDI sources (Russia, China, India, Cleantechs, etc) should be included in LDA's strategy
- M&A opportunities need to be included in the scope of LDA
- Cooperation between trade and FDI departments to be developed
- A key account management approach needs to be adopted
- Not only FDI, but also international talents and research teams need to be attracted

Services to foreign investors

[1] UK Trade & Investment, Invest in Sweden Agency, Czech Invest

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- FDI professionals need to be involved in product development. They are the closest to the most demanding market and may provide invaluable feedback on real estate, sector policy, investment regimes
- Business culture is the right model: speed, quality and pragmatism is what LDA's client need

International promotion

- Promotional brochures need updating, although a new range of sector-oriented leaflets has been recently published
- The link with tourism, events and culture needs to be created
- A PR and media strategy need to be set-up

Organization and network

- Small FDI staff (8 FTE) compared to competition
- LDA is a young organization, with little aftercare and a weak foreign market presence
- A more aggressive attitude is needed together with more presence in local markets
- A structured network of multipliers and service providers who are involved in FDI (audit & advisory firms, real estate agents, recruitment firms, tax & legal firms, etc…) should be established

7. Actions to be taken by LDA

Ernst & Young has carried out a three-day working session with LDA teams to build an action plan for the implementation of the strategy. LDA teams have identified twenty specific actions. These actions are detailed in the final phase 3 report.

Value 2015

Promotion Communication

1. Press relation strategy
2. Ambassador tool kit
3. International economic events based in Vilnius
4. Entrepreneurs / student contest
5. Value 2015 logo and tagline
6. New name: Invest in Lithuania
7. Newsletters for social partners
8. R&D and HQ brochures

Local offering

9. Structured network of social partners
10. Training package for new employees at LDA
11. Directory of FDI in Lithuania
12. Expansion of Vilnius airport direct international connections *(critical but not LDA's competence)*
13. Business Center and Cluster within FEZ (Kaunas and Klaipeda)

Coordination and services

14. Key account management
15. Diaspora management
16. Involve foreign skills in the management of Klapedia university *(University management competence)*
17. New incentive package and full-care services *(Government competence)*
18. Relaunch of risk fund for industrial real estate *(Government competence)*
19. Labeling of parks *, **, ***

Besides, we recommend implementing some immediate actions, while announcing the "Value 2015" strategy. These actions go beyond LDA's competence and imply a strong commitment of the Lithuanian government.

- The launch of a national Cluster Strategy and a national Strategic Infrastructure program are urgent
- The review and packaging of the current Investment platform
- A re-organisation of LEPA: the success of a strategy is in its execution with the appropriate staffing, market alignment and the right governance under the appropriate Ministries and business leaders
- The design of the right international marketing strategy to write and tell the Lithuanian success story to the world and make sure its international image is correctly managed
- Leverage on Vilnius European Capital of Culture 2009

8. Specific, immediate anti-crisis measures to be taken by the government

On top of the FDI promotion strategy - which looks at 2015 horizon - Lithuania must take immediate, specific anti-crisis measures to address the current downturn. These actions are:

Key account management

- A crisis strategy to retain existing investors (Top 100) in Lithuania and treat them as key accounts
- Rate key accounts: from most to less critical, in order to prioritize public support and services
- Take a look at next market opportunities, where growth is still expected to remain positive in 2009 (BRIC + others)
- Business reshaping and restructuring (outsourcing, liquidity management, portfolio optimization, etc…)

Public investment policy

- Encourage, support and accelerate public investment projects covering:
  - Construction / real estate
  - Housing program including state housing
  - Strategic infrastructure and key projects (Vilnius airport, business and industrial parks, etc…)
- Financing: public investment fund, loan or debt
- Ensure short and effective terms of payment to private contractors

Anti-crisis task-force

- Anti-crisis task force to lead immediate networking with economic stakeholders for quick detection of needs and moves (professional organizations, foreign investors, chambers of commerce, public stakeholders)

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