EY25: Should value creation be the Baltic business mantra?

October 2017
We at EY Baltics take the welfare of Estonia, Latvia and Lithuania seriously. Therefore, we have endeavored to explore what long-term issues need to be addressed in order to achieve it.

We have conducted a value added (VA) study for the Top 1000 companies in each of the Baltic countries, and developed a tailored methodology.

The methodology calculates a VA index that incorporates VA creation, its sharing with company employees and also takes into consideration the structural differences among industries.

We found that Baltic companies need to do better in terms of VA creation and its sharing with employees as these are lagging more than twice behind the EU28 average.

Among the Baltic countries, Estonia stands out positively. This is likely due to higher levels of capital investments as well as investments into research and development.

Technology, Finance and Energy sectors create and share the most VA.

Companies create more VA if they receive FDIs and are located in capital cities.

Companies engaged in M&A activity also create more VA.

To create more VA in the future companies will need to focus on growth ambition, investments into modern technology, people competencies, R&D, become more client-centric, use analytics, and review business models in order to respond to the current trend of digital disruption.
Why value added matters?
VA is directly related to the level of welfare in the European countries.

The Welfare Index is calculated based on income, economic stability, the quality of healthcare, education, infrastructure, environment, and other variables.

Source: BCG SEDA, EY analysis
Methodology
Methodology for the VA study

To respond to the welfare creation challenge a tailored methodology has been created incorporating both VA creation as well as its sharing with employees.

### Value added (VA):
An additional value that is generated by the business with the acquired materials and services.

**Calculation:**
Alternative 1: Income - Value of used materials and services.

Alternative 2: Net profit + Salary and related costs + Depreciation and amortization + Taxes + Net interest paid.

### VA generation is determined by:
- Chosen markets (with a deep focus on export)
- Product/service quality, innovation, value generated for the client
- Operating efficiency: automation level, cost competitiveness (relations with suppliers, etc.)
- Selected business model: position in the value chain, proximity to ultimate clients, production vs subcontracting decisions, innovation and trademark management

### VA Index

#### I. Effective and sustainable generation of VA

#### II. Sharing VA with employees

This aspect is important to assess, as it shows:
- Benefits that the community receives as part of the Company's operations (apart from the paid taxes) and the creation of well-paying jobs
- Sustainability of the Company's operations - the ability to attract and maintain qualified labor force
### Baltic VA performance assessment criteria

- **The sources used for the study:** “Verslo Žinios” (LT), “Diena Business” and „Lursoft“ (LV), „Äripäev infobank“ (EE), „MergerMarkets“, „Amadeus“.
- **The initial sample consisted of TOP 3,030 Baltic registered companies, sorted by sales revenue.**
- **Holding companies, state enterprises and non-profitable companies were not assessed (-673).**
- **The list did not include companies that lacked data for the calculation of at least one of the evaluation criteria (-139).**
- **The number of employees in the companies on the list in 2016 must have been at least 30, leaving 1,841 companies for the final evaluation.**

Each company is evaluated based on the following criteria:

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Absolute value</th>
<th>Relative value in the context of the Baltic industry</th>
<th>Relative value in the context of the EU industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Productivity</td>
<td>VA / Number of employees</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>2. VA margin</td>
<td>VA / Income X 100%</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>3. Employee compensation</td>
<td>Personnel expenses / Number of employees</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>4. Salary share in value added</td>
<td>Personnel expenses / Value added x 100 %</td>
<td>10</td>
<td>11</td>
</tr>
</tbody>
</table>

#### Results

- **Rating of all assessed companies by the derivative index**
- **Additional criteria evaluation**
- **Industry analysis summary and results**

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**Data on FDI, M&A and other variables**

**November 2017**

**Should value creation be the Baltic business mantra?**
Estonian companies lead the VA drive

- Estonian companies lead in 2016 Baltic VA study with the higher VA per Employee, higher VA margin and also higher employee compensation all demonstrating higher productivity.
- Lithuanian companies pay higher share of VA to their employees indicating the labor market challenges.

Sources: EY analysis, „Verslo Žinios“, Lursoft, Äripäev infobank
Leading sectors

- Trade and Manufacturing are the largest sectors in the Baltics in terms of gross VA. However, they are the least efficient and companies in these sectors have the lowest VA indexes.
- The Technology sector has the highest share of companies in the 1st VA index quartile, indicating higher rates of productivity and VA sharing.

Sources: EY analysis, „Verslo Žinios“, Lursoft, Äripäev infobank
Companies in the key Baltic cities are the most efficient in VA creation

- Companies that are located in Tallinn, Riga or Vilnius receive the most foreign direct investments (FDIs).
- Most of the companies in the Top 100 list also come from either of the three Baltic capitals.

Leading companies’ geographic distribution

FDI and Top 100 distribution by region (%)

Sources: EY Investment Monitor, Google Maps geolocation data
Technology, Finance and Energy are the leading sectors

The highest VA that is also shared with employees is observed in the Energy, Finance and Technology sectors.

Productivity vs. Personnel Expenses

Sources: EY analysis, "Verslo Žinios", Lursoft, Äripäev infobank

October 2017

Should value creation be the Baltic business mantra?
However, all sectors trail the EU-28 average

- Leading Manufacturing companies occupy attractive niches.
- Transport companies are employing natural geographic advantages and exploiting niches as well.
- Leading Services companies are engaged in the business of people-sourcing.
- Technology companies must pay attractive salaries to retain top-tier talent, but cannot rival other EU companies in creating VA.
- Finance sector, whilst leading locally, falls behind the competition from the EU-28.
Should value creation be the Baltic business mantra?

Low margins (at least 30% lower than the EU-28 average) in the Transport, Agrobusiness and Trade sectors indicate that the Baltic countries remain transit economies, geared at re-export and the outflow of raw materials.

There is high growth potential for the Transport sector as it relates to brand name development and the strategic position of being closer to clients. New product developments are also expected in the Agrobusiness industry.

Margins in Estonia are lower in leading sectors, but higher overall. This indicates a more consistent spread of VA generation among companies.
What drives value added creation?
Estonian recipe for VA creation

- Estonia showcases better productivity due to investments into modern equipment and better compensation of employees, which increases satisfaction and develops the skills that boost productivity.
- Estonia is the Baltic leader in R&D investments and the rapid adoption of new technologies.

Sources: EY analysis, Eurostat, „Verslo Žinios“, Lursoft, Äripäev infobank
Estonia is leading in terms of investments...
...and R&D

R&D expenditure as a percentage of GDP

Source: Eurostat
Foreign direct investments (FDIs) increase VA creation

- Since 1997, the Baltic states have attracted more than 1,168 FDI projects.
- The regions that receive the most FDIs are also the same regions that are the most efficient in VA creation.
- Most of the FDIs are directed towards the Manufacturing sector.
- Estonia stands out in terms of FDI per person, which feeds positively to its companies’ capability to generate a higher VA.

Sources: EY Investment Monitor, Google Maps geolocation data
M&A transactions were analysed as a part of the VA study

As part of the M&A transaction analysis, the following sample of transactions were analyzed:

1. All Baltic M&A deals (announced and completed) were gathered from the Mergermarket database between the years 2012 and 2016.
2. The list of VA companies was matched with the M&A deals’ list to identify which VA companies had any transactions in the last 5 years.
3. Some companies had more than one transaction, hence the list was refined to get the final amount of companies that had at least one transaction in the last 5 years.
4. The analysis was based on the refined sample of VA companies with at least one transaction. The samples represented a range of 11% to 26% as a percentage of the total amount of the available transactions.

Sources: EY analysis, Mergermarket
Companies engaged in M&A activity generate more VA

VA over employee for Transacting and Non-transacting Companies (Baltics VA companies together)

VA over employee for Transacting and Non-transacting Companies (Baltics VA companies country split)

Companies that have transacted in the last 5 years

Companies that have NOT transacted in the last 5 years

Sources: EY analysis, Mergermarket
Positive feedback loop of active M&A engagement

- Helps to maintain optimal capital and asset structure
- Leads to higher VA
- Allows to engage promptly in Investments and M&A (in reaction to market opportunities)
- Allows for higher liquidity and cash buffer

Active portfolio and Capital management through M&A
Future directions for a higher value added economy
Future directions for creation of higher VA

- **Defining growth ambition**
  - Aim high in terms of growth ambition, target markets definition, differentiation.
  - Adopt new business models to respond to new digital technologies trends.
  - Invest into modern technology and machinery, innovation, R&D, and employee retention.

- **Widening of horizons**
  - Put client experience at the forefront of attention, aligning the whole operating model to this priority.
  - Use data analytics.

- **Reorientation towards value creation**
  - Develop skills that are essential for future competitiveness outside of the organization.
  - Develop and integrate an ecosystem around the enterprise.
  - Transform product sales into integrated solution offerings for the global market.
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