KPMG

Why Poland?

Strengths and weaknesses of running a business in Poland, from the perspective of foreign investors

Report

ADVISORY

AUDIT • TAX • ADVISORY

Contents

Introduction **1**

Methodology and results **2**

Foreign Direct Investments in Poland and international markets **4**

Global Direct Investments (2000-2004) 4

Value of FDI inflow 5

Russia and Poland as FDI leaders in the region 6

FDI per capita 6

FDI inflow to Poland in 1990-2004 7

FDI in Poland in 2000-2004 8

Forms of FDI in Poland 8

Foreign investors' opinions about Poland **9**

Perception of investments made to date 9

Key selection criteria 10

Labour force qualifications 11

Alternative locations 12

Truths and myths 13

Competition 14

Summary **15**

Introduction

Foreign direct investments (FDI) contribute to long-term economic growth and may play a particularly important role in technology transfer, creation of new jobs as well as improving productivity and increasing export. Is Poland an attractive destination for investors? What opinions about Poland prevail among companies which have already invested here? Would they decide to enter Poland again?

This report attempts to answer the above questions which are important not only from an economic but also from social and political perspectives. We aimed to present foreign direct investments not only from the perspective of statistics, collected by United Nations Conference on Trade and Development (UNCTAD) globally and by the Polish Information and Foreign Investment Agency (PAIiIZ) locally, but, above all, to look at investments in Poland through the eyes of investors themselves. This is an attempt to collect and structure investors' experiences to date and, on this basis, to establish Poland's appeal on the global investment map. We sincerely hope that this report and the results contained in it will cast new light on how Poland is perceived by foreign players.

We wish to extend our thanks to the companies which agreed to participate in our study and shared their comments on costs and benefits of running a business in Poland. Our thanks also go to SMG/KRC Millward Brown Company, the research partner in this study.

Mirosław Proppé, Director
Advisory

Mariusz Strojny, Ph.D., Project Manager
Advisory

Methodology and results

Methodology

The study was conducted in two stages. The first stage took place in October-November 2005 and consisted of a questionnaire-based survey with top management from 32 foreign investors who made investments in Poland in 2000-2005. The study was commissioned by KPMG in Poland and conducted by SMG/KRC Millward Brown Company using the CATI (computer-assisted telephone interview) technique, based on KPMG's research methodology.

The second stage involved analysis of FDI statistics for Poland, Central and Eastern Europe[1] and the world based on data from UNCTAD, PAIiIZ and other organisations (e.g. EUROSTAT, OECD, Economist Intelligence Unit). This stage commenced in December 2005 and was completed in January 2006.

Foreign direct investments in Central and Eastern Europe growing faster than in China

While the value of foreign investments in Central and Eastern Europe in 2004 represented approximately three-fourth of investments that flowed to China in that time, the growth rate in the studied period (2000-2004) was higher in China and reached 54%. Growth in the European Union was negative during the same period.

Poland leading and lagging behind

Alongside Russia, Poland is the region's leader with respect to the value of FDI inflow. In 2004 it attracted 13% of all investments in Central and Eastern Europe. However, Poland performs very poorly with regard to FDI per capita and FDI growth dynamics since 2000. In the former category Poland only outperforms its eastern neighbours (Russia, Ukraine and Belarus). Compared with other countries from the region covered in this study Poland had the weakest FDI growth in the studied period.

Foreign investors content with their investments in Poland

Over 80% of foreign investors see the results of their investments to date as positive or very positive and none of the studied companies reported a negative opinion. Moreover, three-forth of foreign investors already operating in Poland intend to strengthen their presence by making further investments in the near- or long-term. An overwhelming majority of the survey participants believe that the decision to enter Poland was right and they do not intend to leave.

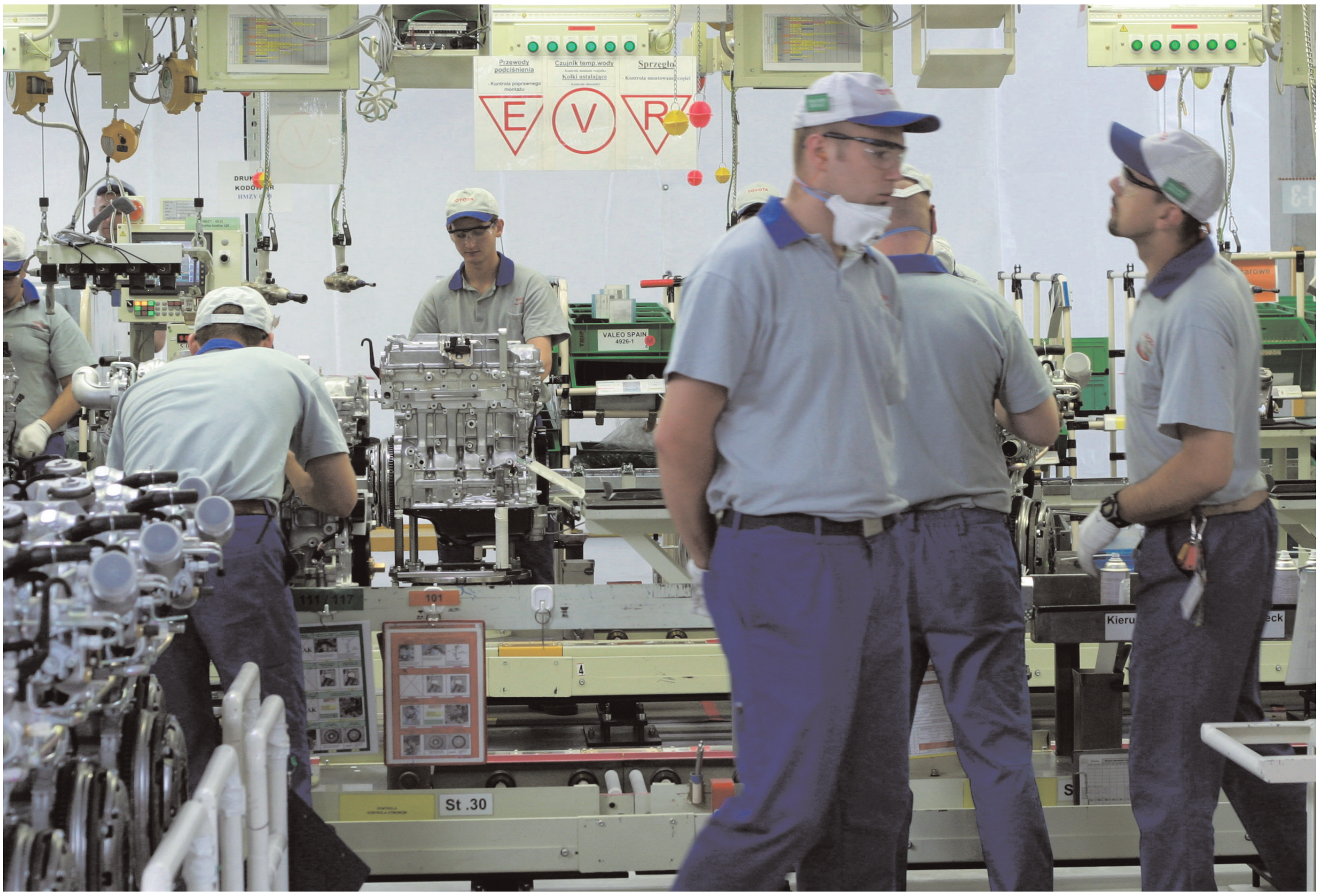
[1] Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia, Ukraine.

Poland's three key strengths

Poland attracts foreign investors with three main assets: relatively low cost of labour, favourable geographic location on transit routes, and a large internal market (compared to other Central and Eastern Europe countries). Notably, these elements are not dependent on current events or political decisions (except, perhaps, labour costs). What surprised most investors was unrelated to taxes, regulations or infrastructure but related to the high qualifications and work skills of Polish labour force. Foreign investors seem to view Poland as a country with low labour costs whereas, in fact, we are a country of 'low labour costs and highly skilled people.'

Truths and myths about Poland

The study put some common opinions about Poland to a test. Foreign investors do not agree that 'Polish labour force is inefficient', that 'it is hard to get anything done without a kickback', that 'Poles don't speak foreign languages' and 'taxes are too high'. However, the respondents confirmed opinions about ubiquitous bureaucracy, inefficient judiciary, poor infrastructure and the complicated taxation system.



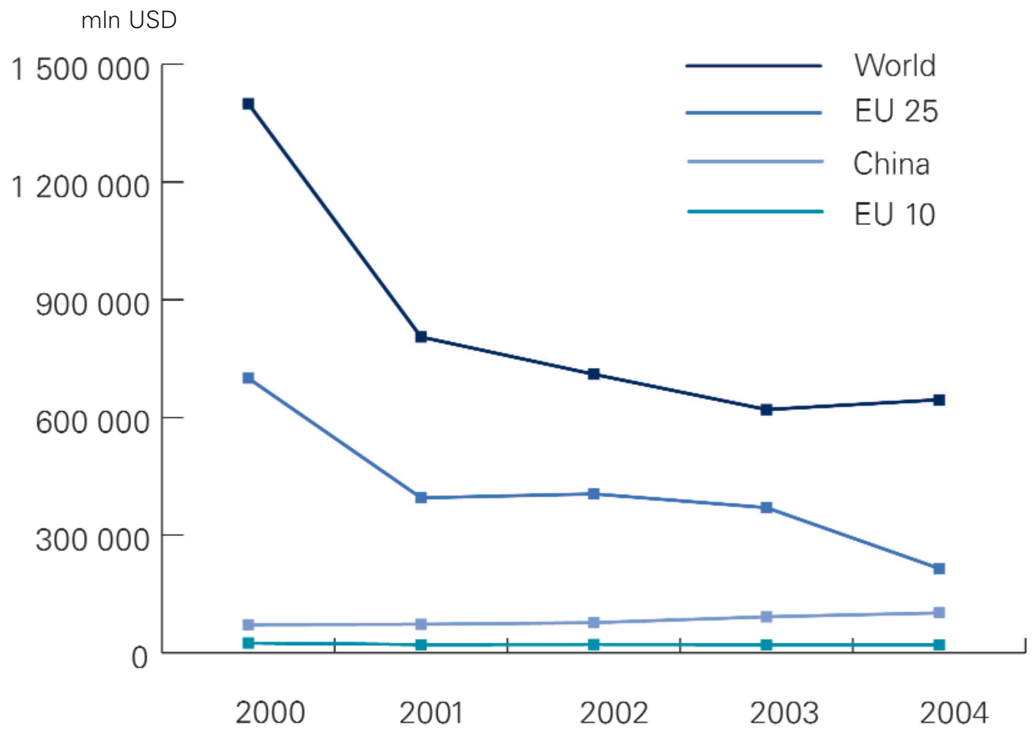
Foreign Direct Investments in Poland and international markets

KPMG: What made a positive impression on you while doing business in Poland?
CEO of a large automotive company: A high level of commitment by people and easy adaptation of new technologies.

Foreign direct investments (FDI) encompass capital which is invested in a country either directly or through subordinate companies. FDI mainly consist of equity capital investments but also include reinvested earnings and intercompany loans. FDI are long-term and may take the shape of acquisitions, greenfield projects, privatisations, joint-ventures or mixed formats.

Global Direct Investments (2000-2004)

2000 saw a considerable decline in global foreign direct investments: from USD 1.4 trillion to $633 billion in 2003. The downward trend first reversed in 2004. According to experts, the decrease in FDI has multiple causes. One of them is a declining rate of cross-border mergers and acquisitions. This phenomenon, in turn, can be traced back to the slowing economic growth on leading global markets (affecting the sales and profits of multinational corporations), a bearish stock market and stalled privatisation processes[2].



Source: KPMG analysis based on UNCTAD data.

[2] Zbigniew Zimny, Foreword to the presentation of global investment report called: Narodowa i międzynarodowa polityka w zakresie FDI i jej znaczenie dla rozwoju [National and International FDI Policy and its Importance for Growth] United Nations Conference on Trade and Development, 4 September 2003.

FDI inflow dynamics in Central and Eastern Europe was higher in China in 2000–2004.

Value of FDI inflow

The value of direct investments flowing in to Central and Eastern Europe in 2004 represented 16% (21% with Russia) of the total FDI in the European Union. On a global scale, this share is about three times lower. However, in contrast to global trends, the inflow of FDI in our region has not changed as dramatically and, in fact, has risen in many countries (e.g. Estonia, Hungary) since 2000.

The inflow of FDI to Central and Eastern Europe is lower than in China. However, the growth rate of FDI between 2000 and 2004 was higher in this region than it was in China (54% and 48% respectively). This reflects the region's immense potential, still largely untapped.

Foreign direct investments worldwide (mln USD)

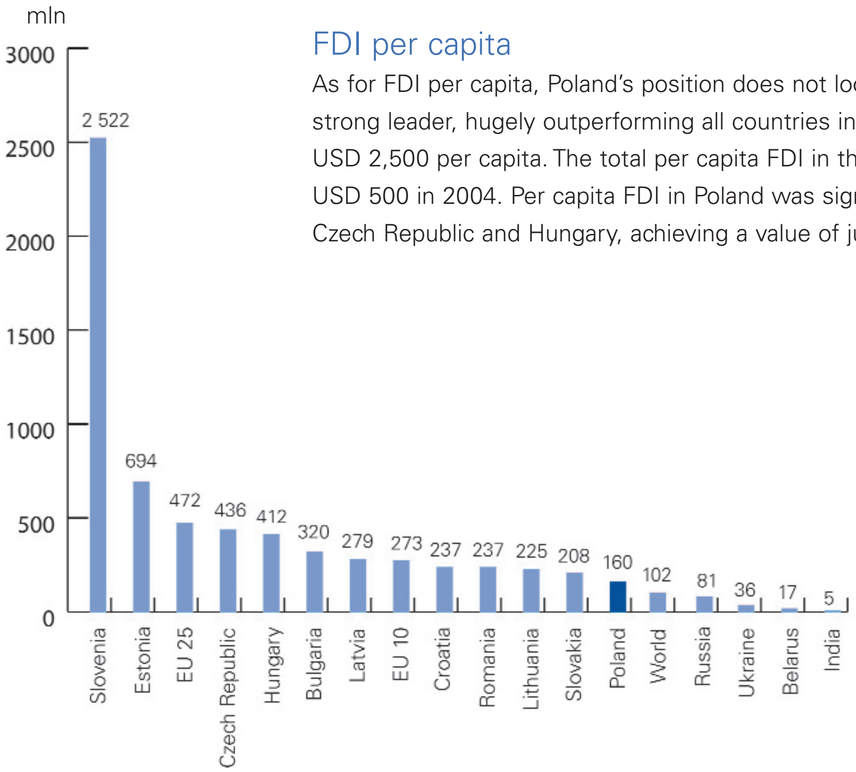
	2000	2001	2002	2003	2004	Dynamics in 2000-2004
World	1 396 539	825 925	716 128	632 599	648 146	-54%
EU 25	696 295	382 620	420 433	338 678	216 440	-69%
EU 10	21 810	19 569	23 288	12 067	20 341	-7%
Czech Republic	4 986	5 641	8 483	2 101	4 463	-10%
Estonia	387	542	284	891	926	139%
Hungary	2 764	3 936	2 994	2 162	4 167	51%
Latvia	413	132	254	300	647	57%
Lithuania	379	446	732	179	773	104%
Poland	9 343	5 714	4 131	4 123	6 159	-34%
Slovakia	1 925	1 584	4 094	669	1 122	-42%
Slovenia	2 894	2 602	4 109	4 446	4 962	71%
Bulgaria	1 002	813	905	2 097	2 488	148%
Croatia	1 087	1 564	1 126	2 042	1 076	-1%
Romania	1 037	1 157	1 144	2 213	5 174	399%
China	40 715	46 878	52 743	53 505	60 630	48%
India	2 319	3 403	3 449	4 269	5 335	130%
Russia	2 714	2 748	3 461	7 958	11 672	330%
Ukraine	595	792	693	1 424	1 715	188%
Belarus	119	96	247	172	169	42%
Central and Eastern Europe	29 645	27 767	32 657	30 777	45 513	54%

Source: KPMG analysis based on UNCTAD data.

Russia and Poland as FDI leaders in the region

Among all the countries of Central and Eastern Europe, Russia and Poland attracted the most foreign investments in 2004. Nearly one in four dollars invested in the region strengthened Russia's economy, one in eight went to Poland and one in ten was invested in Romania. Belarus came last with the lowest rate of foreign investments.

Source: KPMG analysis based on UNCTAD data.



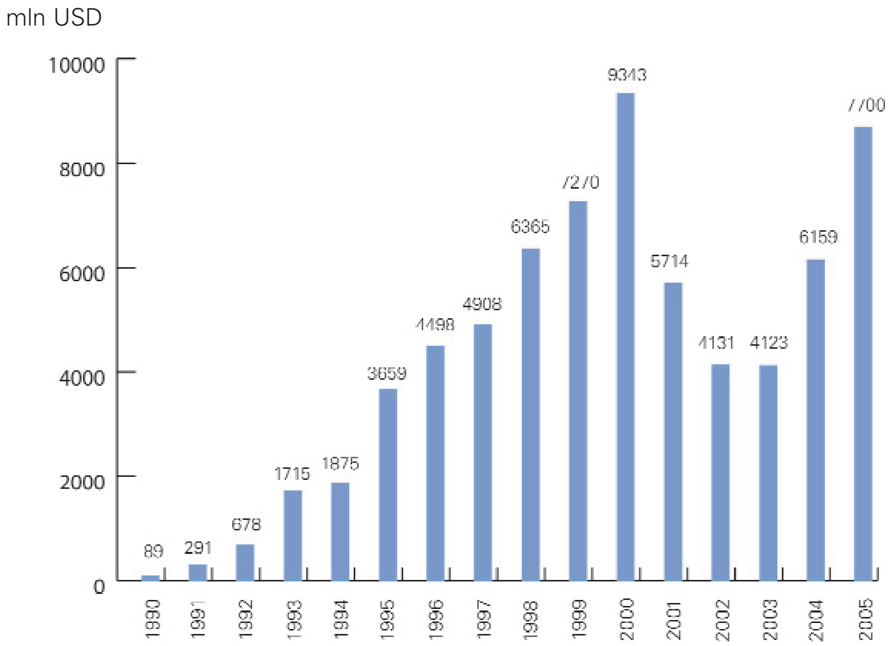
FDI per capita

As for FDI per capita, Poland's position does not look as optimistic. Slovenia is a strong leader, hugely outperforming all countries in the region with FDI exceeding USD 2,500 per capita. The total per capita FDI in the entire EU was just under USD 500 in 2004. Per capita FDI in Poland was significantly lower than in the Czech Republic and Hungary, achieving a value of just USD 160.

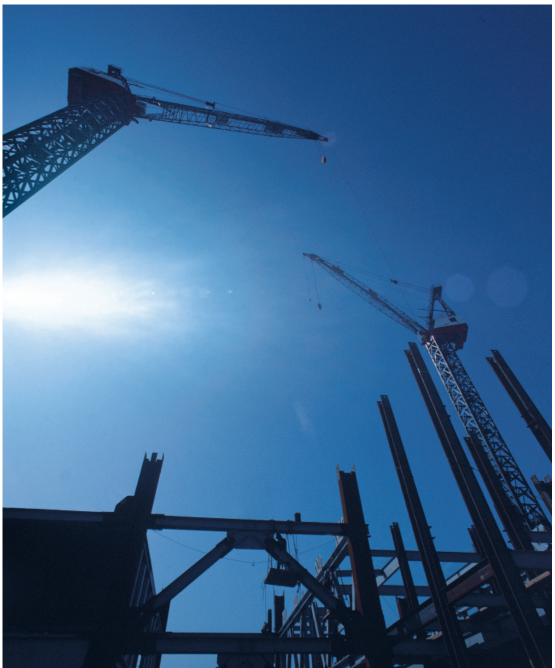
Source: KPMG analysis based on UNCTAD data.

FDI inflow to Poland in 1990-2004

According to data collected by the Polish Information and Foreign Investment Agency international business has invested a total of USD 84 billion since the early 1990s, while UNCTAD estimates this value as nearly USD 61 billion[3]. This figure does not only gives Poland a place in the lead among other countries of the region but, more importantly, also shows that Poland's economy keeps growing and is attractive for investors. The average FDI growth dynamics in the period was 47%. The highest growth rate was observed in 1990-1991 (over 200%) and the bottom was reached in 2000-2001 (-39%).



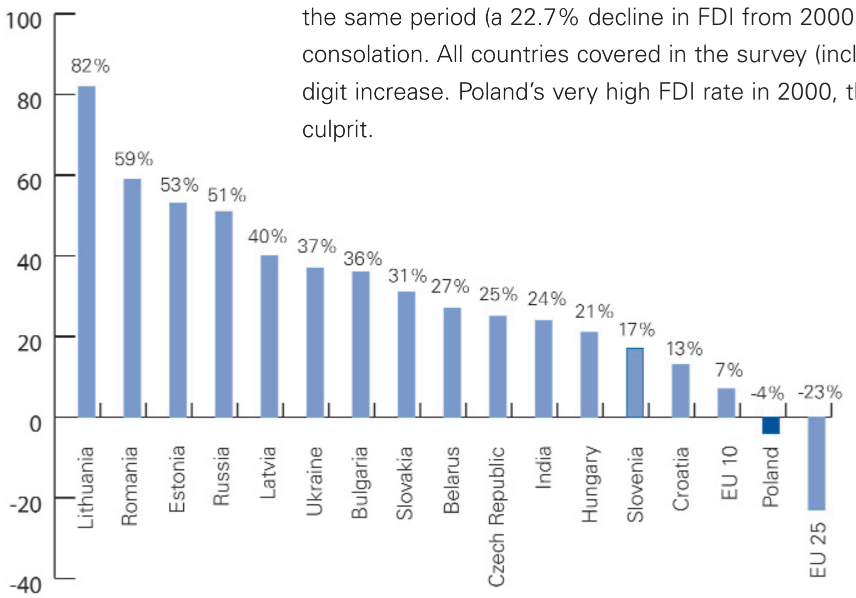
Source: KPMG analysis based on PAIiIZ and NBP data.



3 Differences stem from the fact that UNCTAD collects data from central banks whereas PAIiIZ estimates FDI according to its own, somewhat different, methodology.

FDI in Poland in 2000-2004

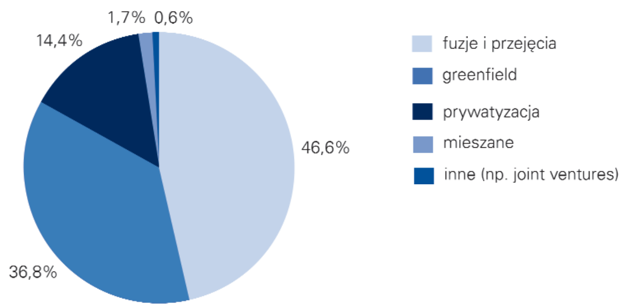
In recent years the FDI growth in Poland has been negative and the lowest in all of Central and Eastern Europe. Although EU countries had five times less during the same period (a 22.7% decline in FDI from 2000 to 2004), this provides little consolation. All countries covered in the survey (including Belarus) saw a two-digit increase. Poland's very high FDI rate in 2000, the reference year, is a partial culprit.



Source: KPMG analysis based on UNCTAD data.

Forms of FDI in Poland

Nearly half of foreign direct investments in Poland in 2000-2005 came through mergers and acquisitions. The second most widespread form chosen by nearly 37% of investors were greenfield investments in which companies or plants were built from scratch. 14% of foreign investors came to Poland as a result of privatisation. Other forms of FDI were chosen by few foreign companies.



Source: KPMG analysis based on PAIiIZ data.

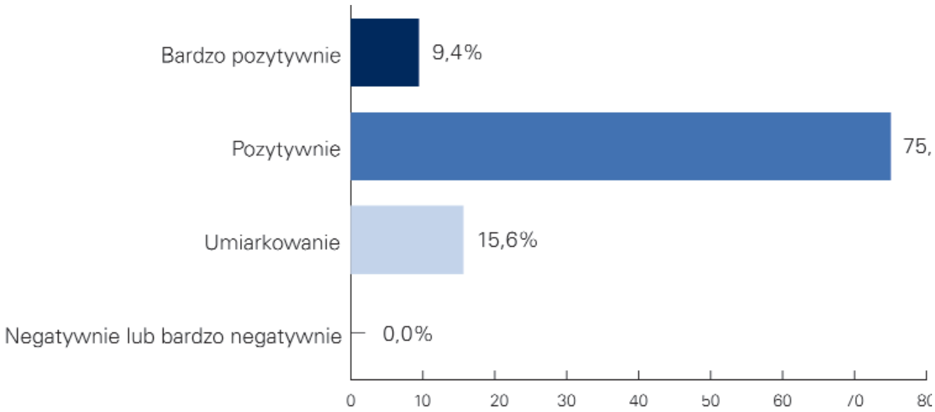
Foreign investors' opinions about Poland

> **KPMG:** What made a positive impression on you while doing business in Poland?
> **CEO of a large food company:** A highly developed work culture and professional skills; workers are more organised than we initially expected.

Perception of investments to date

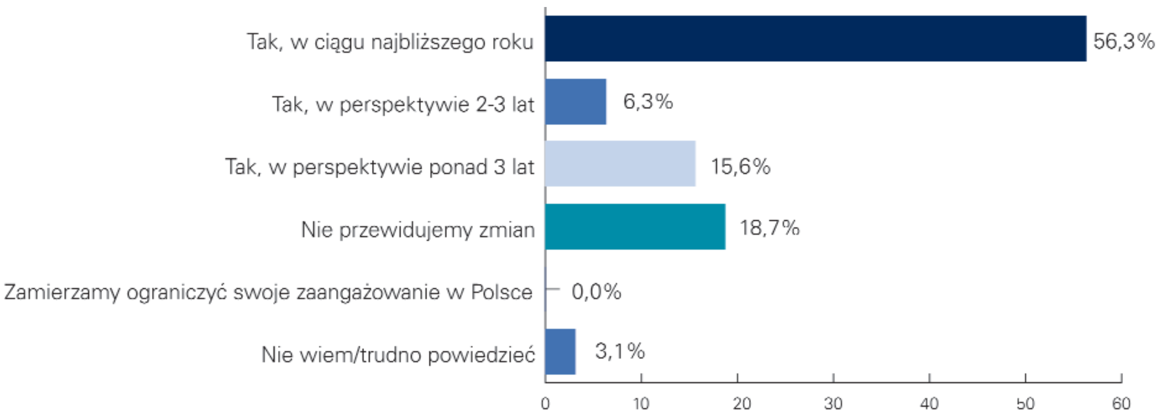
Three-quarters of the interviewed foreign investors positively assess the results of their investments in Poland, with one in 10 expressing a 'very positive' opinion. None of the studied companies expressed a negative or very negative opinion about the outcomes of their business in Poland. These responses seem to confirm our previous observations, i.e. that Central and Eastern Europe now counts among the most attractive locations worldwide and can successfully compete against China and South-East Asian markets.

Question: How would you rate the outcome of your investment in Poland?

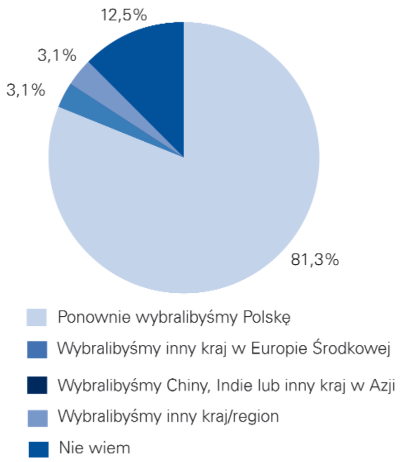


Nearly 80% of the respondents intend to increase their capital commitment on the Polish market. The largest group, 56%, intend to do so in the coming year. One in five companies is considering further investments in the longer term. Also nearly one-fifth of all surveyed companies do not intend to change their capital commitment in Poland. Interestingly, none of the 32 surveyed companies plan to reduce their presence in Poland. This shows that the first few years of market presence have rendered positive results, thus confirming Poland's reputation as a very attractive business destination.

Question: Do you intend to increase your capital commitment in Poland?



Question: If you could re-choose your investment destination, where would it be?



Over 80% of foreign investors surveyed would choose Poland again if they were faced with a choice of location. Despite bureaucratic, infrastructural and administrative obstacles, investments in Poland turned out to be the right choice. Only a handful of respondents mentioned other target countries. 12.5% of the respondents did not provide an answer to this question.

Key selection criteria

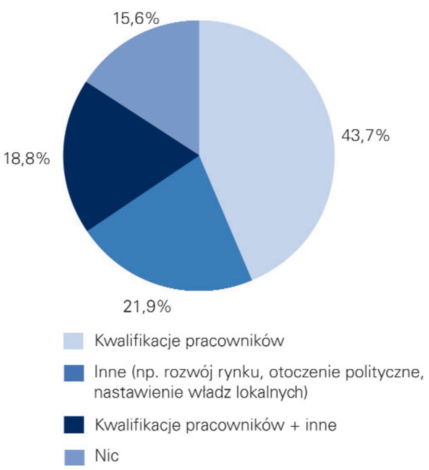
Based on replies obtained from investors we identified key criteria which speak in favour of Poland as an investment destination. Those are, in this order: labour costs and geographic location (22.6% each) and size of internal market (21.4%). Nearly 12.5% of the respondents stressed the importance of qualifications and skills of Poland's labour force. Only 6% mentioned the presence of key competitors and business partners on the Polish market. Government support as well as infrastructure did not play a primary role for the respondents. Notably, only one of the three key factors (i.e. labour costs) can be influenced by the government but the degree of influence is considerably limited. In contrast, location and market size are a given. This means that the country's promotional efforts must be intensified and labour costs must be brought down further.

Question: What were the key criteria for choosing Poland as the target country for your investment? (only 3 responses were allowed)

The key risk areas which the respondents were concerned about included administration, judiciary and government policy. Nearly one in five of our interviewees was most afraid of administrative issues and bureaucracy. 15% were most concerned about legal regulations / judiciary and another 15% worried about the political environment. Tax rates and deductible expenses were the key risks for a mere 10% of the respondents.

Question: What did you see as the key risks when you made your investment in Poland?

Question: What made a positive impression on you while doing business in Poland?



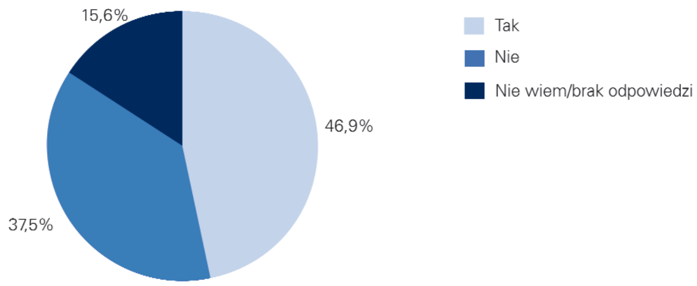
Labour force skills

We were also curious about investors' impressions of the market after they arrived in Poland. In order to avoid prompting, we chose an open-question format. The respondents were free to provide any answer according to what first occurred to them. It turned out that over 60% of all foreign investors were most surprised by the high qualifications of their employees. Such an overwhelming share of a single aspect clearly shows that foreign enterprises are still unaware of the high quality staff available in Poland. If we consider that labour costs are the main driver for companies to invest in Poland, the promotion of high qualifications offered by Poles should become a priority for government agencies that are dedicated to attracting foreign investors. Still, too many foreign investors tend to think that low labour costs in Poland translate in to low skill levels.

Alternative locations

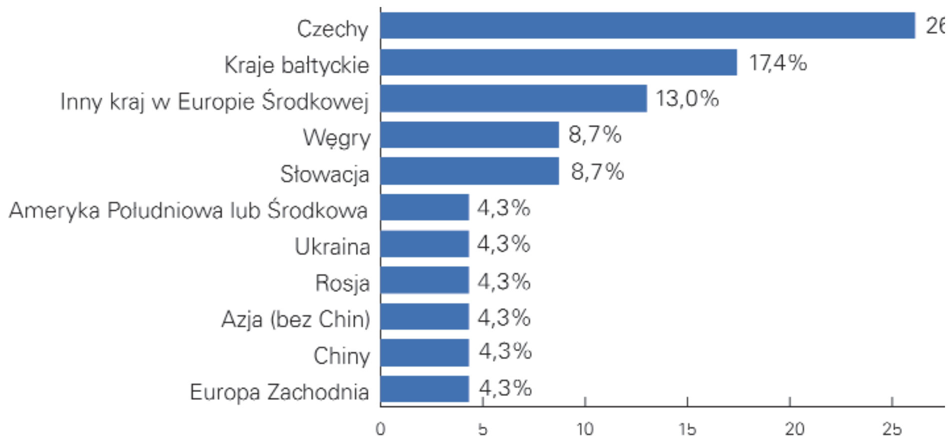
Nearly half of the enterprises contemplated alternative locations before settling on Poland. Slightly more than one-third of the companies knew they would choose Poland right from the start.

Question: Did you consider alternative locations before making an investment in Poland?



One in four foreign investors who considered alternative locations mentioned the Czech Republic. Baltic countries were chosen by a further 17% of investors. Hungary and Slovakia received approximately 9% each. Other Central and Eastern European countries received 13%. In total, over 70% of investors mentioned Central and Eastern European countries. Other alternative locations scored very low, which means that in its efforts to attract foreign investments Poland is in competition with other countries from Central and Eastern Europe rather than with those outside the region.

Question: If you did, which country/region did you consider?



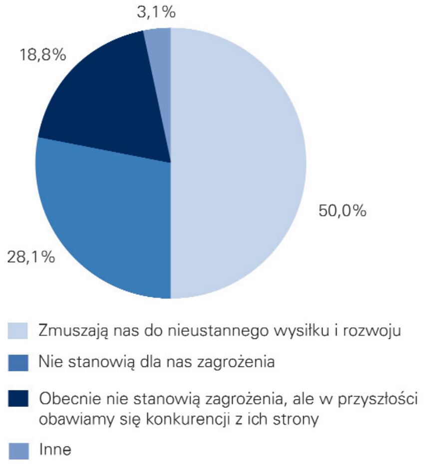
KPMG: What made a positive impression on you while doing business in Poland?

Managing Board President, large electronics company: The high level of commitment shown by the entire team: they were open, there was no resistance towards the investor - in fact people trusted us.

Truths and myths

Four out of nine typical attitudes about Poland put to the test in our study were shown to be more false than true, whereas the other four were supported by our findings. The greatest myth was that Polish workers are inefficient. This opinion was rejected by over 84% of the interviewed investors. More than 71% of the respondents did not agree that 'it is hard to get anything done without a kickback.' Most respondents also disagreed with the myth about Poles 'not speaking foreign languages' and taxes being 'too high' (however, the differences in these cases were not as obvious). However, the other four opinions were supported: First of all, the judiciary in Poland is seen as inefficient and bureaucracy is omnipresent (87% of responses in each case), infrastructure and transport represent a serious problem to business, and the tax system is overly complicated. Opinions about the availability of highly qualified staff were split nearly in half.

Question: How do you perceive local competitors?



Competition

Exactly half of the surveyed foreign investors feel competitive pressure from local players. One in five investors do not see local competitors as a threat at present but believe that such a threat may arise in future. Local companies are not seen as a threat by less than one-third of the respondents.

In a KPMG study conducted in early 2005 on international expansion of Polish enterprises, KPMG asked Polish companies which had entered other markets about the sources of their competitive advantage[4].

This time we posed a similar question to foreign investors operating in Poland. Not surprisingly, the results of both studies were different due to differences in business models. Polish players in other countries build their position on two pillars: high quality of products and services (72%) and lower costs advantage (62%). In contrast, foreign investors in Poland tend to spread their competitive advantages more evenly, with international corporate structure remaining the key advantage: it ensures the necessary resources, expertise and markets. The second, equally important source of competitive advantage for foreign companies lies in technology and know how (this element is mentioned by six times as many foreign companies as Polish investors). High quality and costs were mentioned respectively by one in two and one in three companies.

Question: How do you see your competitive advantage on overseas markets, including Poland?

[4] Ekspansja międzynarodowa polskich przedsiębiorstw [International expansion of Polish enterprises], KPMG report, Warsaw 2005.

Summary

Despite good prospects for Poland and the entire Central and Eastern European region, further inflow of foreign investments will depend on a variety of factors. At present China tops the list of priority destinations for nearly all investors. This trend seems to be reflected in statistics and media headlines. However, it is important to bear in mind that in 1970s Brazil also enjoyed similar popularity among foreign investors, fuelling high expectations in connection with cheap labour, a huge market and spreading industrialisation. However, since the 1980s crisis not only Brazil but nearly the who;le of Latin America has been fighting to regain its past glory.

Foreign Direct Investments in Poland (USD billion)

	2005	2006	2007	2008	2009	2010
FDI inflow	9.40	9.00	8.50	8.60	8.70	8.90
FDI inflow as a share (%) of GDP	3.1	2.7	2.3	2.3	2.2	2.2
Accumulated value of FDI	95.0	104.0	112.5	121.1	129.8	138.7
Accumulated value of FDI Per Capita (USD)	2,490.4	2,729.0	2,955.1	3,184.5	3,417.5	3,656.6
Share in global value of FDI inflow (%)	1.22	1.04	0.89	0.82	0.77	0.73
Share (%) in accumulated value of global FDI	0.95	0.95	0.95	0.94	0.92	0.91

Source: Economist Intelligence Unit.

What is in store for Poland in the coming years? According to Economist Intelligence Unit estimates, the FDI inflows will remain fairly high and stable (ranging from 8.5 to 9.0 billion USD) in 2006–2010. However, the share of FDI in GDP will decline year after year, from 3.1% to 2.2%. Also, considering global trends, both FDI inflows and accumulated value of FDI versus global figures will decline. Does this mean that Poland's capacity for attracting investors will slowly fade?

Not necessarily so. Certainly, Poland's presence in the European Union and further economic growth will create conducive conditions for pay rises and, consequently, will increase labour costs which is now the key factor attracting investors. If this process is not accompanied with modernisation of the economy and development of knowledge-intensive rather than of labour-intensive sectors, Poland will find it increasingly difficult to draw the most attractive investments.

Our survey shows that foreign investors are not quite aware of the high competencies and qualifications of Polish workers. Despite this, we have observed that an increasing number of companies invest not only in manufacturing plants but also in research and development facilities. We may venture to say that the first wave of foreign investments, motivated by the need to establish a presence in Poland and to drive manufacturing costs down, will grow weaker and will be slowly replaced by the second wave of investments driven by knowledge and technology (investments in the form of R&D centres) or services (investments in the form of outsourcing centres).

Both waves of foreign investments will flow in steadily only if Poland manages to redefine its key competencies and communicates them successfully to prospective foreign investors. While low costs are important, their role in driving investments in the future will be declining. Therefore, Poland's other advantages must come into focus: location, market size, tradition and quality, cultural and social affinity to Western countries and, above all, the highly competent and knowledgeable work force.

Moreover, it may be reasonable for Poland to consider an option of positioning itself with other Central and Eastern European countries as a region on the global FDI market. Poland is too small in comparison with the world's emerging giants, notably Brazil, Russia, India and China (the so-called BRIC countries). Poland has a greater chance of being noticed as part of a region that as a single country. Central and Eastern Europe as a whole has a population of 90% of Russia but it is nearly 30% richer than its large eastern neighbour (considering GDP values). Except for demography and macroeconomy, there are more factors that speak in favour of Central and Eastern Europe destinations: proximity to Western Europe, political and economic stability, the right infrastructure including taxation, legal regulations and corporate governance. To avoid being overshadowed by flashy publicity surrounding China and other 'big' emerging markets, Poland might wish to start collaborating with its neighbours to promote this still-not-quite-discovered region of Central and Eastern Europe.

kpmg.pl

KPMG Sp. z o.o.
ul. Chłodna 51
00-867 Warszawa
Tel. +48 22 528 11 00
Fax +48 22 528 10 09
kpmg@kpmg.pl