International Financial Law Review

SUPPLEMENT - The Baltic States

Tired tiger economies

After the recent boom, the Baltic states are experiencing a slowdown. But Sven Papp, Girts Lejins and Irmantas Norkus of Raidla Lejins & Norcous are hopeful about the future

The three Baltic countries, Estonia, Latvia and Lithuania, have often been referred to as the Baltic tigers. Rightfully so, for how else can one describe economies that have had for the past 15 years, ever since regaining their independence in 1991, annual growth rates close to or exceeding double digit figures?

However, beneath this bold performance, less optimistic notes have started to echo. The common sentiment is that the feast for the Baltic economies is over: as predicted the high growth rates have turned out to be unsustainable and the economies are expected to decelerate significantly during 2008. All three are expected to grow below their potential during the upcoming year or two. The speed of the Baltic slowdown raises fears that consumers, businesses and banks will lose confidence and rein in spending and investment, sending the economies into recession.

Downturn unavoidable

The growth in the Baltics has been heavily fuelled by extensive borrowing, which has not come without problems, significant current account deficits for all Baltic countries being the main one. Gross external debt has climbed steadily. But although the main driving force behind the rapid accumulation of external debt has been the liabilities of local lending institutions, the associated vulnerability is less acute than the current problems on the US lending market, for example.

The reason for such optimism is that the overwhelming majority of external funding has come from foreign parent institutions. It is believed that the rollover risks are not relevant (assuming that the parent institutions being reputable Nordic banks have been diligent in their lending to their Baltic subsidiaries).

The degree to which pain is felt differs from country to country. The slowing down of the world economy is certainly expected to have negative effects on economic development in Lithuania, which has so far been buoyant. Now it seems that growth peaked in late 2007 and early 2008.

The pace of growth of business investments had increased considerably since 2004 when the Baltic countries joined the EU. A downturn is widely regarded as unavoidable, but forecasters still dispute the speed of decline and when the bottom will be hit. Economic growth in Lithuania slowed to 6.4% year on year in the first quarter of 2008. Latvian growth more than halved to 3.6%. Estonia's year-on-year figures showed a 0.4% expansion, but the economy went into reverse in the first quarter, contracting by 1.9%. In Latvia, the EU's fastest-growing economy, lending soared by some 60% a year until mid-2007, as banks offered cheap mortgages. This created a property bubble that has now burst, raising fears of a recession and forced devaluation of the exchange rate, which is linked to the euro.

Commitment

However, the spectre of devaluation is more a currency speculator's dream than reality, for two principal reasons. Firstly, it would be extremely damaging because 80% of loans are in foreign currencies. Devaluation simply would not be rational. Secondly, Latvia has strong public finances and currency reserves amounting to more than 120% of the national currency emitted. Therefore the Latvian lat is insulated against speculative pressures. More generally, the lack of public or private debt instruments makes it difficult for speculators to take positions against this and other Baltic currencies.

Admittedly, Latvia is among the countries with big current account deficits – and accordingly high external financing needs – and has come under a degree of pressure. Latvia's deficit was almost 23% of gross domestic product last year, the highest in the EU. Estonia racked up 16% and Lithuania 13%. According to Standard & Poor's, the worsening growth outlook for the US and global economy will create significant challenges for emerging European sovereign states, particularly those with large economic imbalances, such as Iceland, which has already been flirting with a currency collapse, and Estonia and Latvia.

The slowdown is expected principally to affect emerging Europe through reduced capital inflows into the region. But overall it is weathering the storm, partly because even though the risk of investing in emerging markets is believed to have heightened, the potential for growth keeps investors interested.

But the sharply falling economic growth is cutting the Baltic current account deficits back to sustainable levels as imports fall more rapidly than exports. The Estonian current-account deficit fell to 13% of gross domestic product in the first quarter from 23% a year ago. Moreover, manufacturing investment, profitability and exports in the Baltics remain healthy.

A factor to bear in mind is that foreign banks are unlikely to cut off funding in the Baltics as it would harm their investments. As an indication of their commitment, Swedish banks also helped block speculators at the start of last year by refusing to let them accumulate enough Latvian lats to take significant positions.

Warning signs

The banks had already begun scaling back lending at the end of 2006 in response to economic overheating. In Latvia, government controls on lending announced a year ago have reinforced this policy. Loan growth slowed to 37% last year and this year loans are expected to increase by between 15% and 20%. Consequently, property prices have fallen by up to a quarter since last spring but asset quality remains good because less than a fifth of households – typically the wealthiest – have mortgages. House prices have gone into reverse in the other two Baltic capitals as well, undermining consumer sentiment. Construction and property were until recently the fastest growing sectors in the region. In April, residential property prices in Tallinn were 15% lower than a year ago.

There are already concerns that the economy is slowing too rapidly. In response, since early spring the Latvian central bank has been cutting its mandatory reserve requirements to increase liquidity. The government will also relax its credit controls later this year, notably the requirement that clients must put down a 10% cash deposit; according to the banking regulator, this obligation has created a lot of awkward situations. Meanwhile, corporate lending has overtaken consumer lending again.

Another warning signal is the increasing employment costs. Memories of 15% unemployment figures during the nineties have recently given way to double digit real wage increases (20% in Estonia in 2007). Such accelerating pay increases are not matched by productivity growth, which still lags behind. This development clearly undermines the competitiveness of the Baltic tigers, making the investors vary. The competitiveness issue is particularly acute for exporting companies, including those providing services in international markets.

The textiles and clothing industries have been the first to feel the pressure, followed by the electronics industry, and also wood and timber processing companies, which in addition are affected by the growing cost of raw materials. Higher local prices have diminished flows of shopping-tourists so some companies in the retail industry see lower sales. However, with highly diversified production, there are companies in almost every sector that are doing well, while others may do badly.

Eurozone access delayed

Inflation, which was at a modest level of between 4% and 5% per year, has doubled since the end of 2007, Latvia topping the grim list with 14% of inflation in December 2007 and 17.5% year on year in April 2008; Lithuanian and Estonian annual inflation neared 12% in April. In Lithuania, further inflationary pressures are likely to arise from strained relations with Russia and an obligation towards the EU to close the nuclear power plant in Ignalina. However, companies are increasingly becoming aware that price growth is not the long-term solution. So the reorganisation of businesses and provision of new, more sophisticated (and higher added value) products has become the priority. One can expect that this will be on the agenda of most businesses for the next few years.

While such inflation rate is in itself not extraordinary for fast converging economies, it is far ahead of the hopes of the governments of the Baltic countries and most importantly well above Maastricht requirements, thus postponing the expectations of the tigers to join the eurozone until 2011 or 2013 at the earliest. Lithuania's bid to adopt the euro in 2007 was rejected in May 2006, because inflation was marginally above the required level. Nevertheless, despite the problems, it is commonly expected that the Baltic currencies' euro pegs will survive and none will have a crashlanding. Such optimism assumes a continued slowdown in credit expansion.

Real estate focus

This sedate perspective for economic development in the Baltics, global credit tightening and increased controls on funding will no doubt have its repercussions on mergers and acquisitions activity in the region.

While in the nineties the mergers and acquisitions activities in the Baltics were focused on mass privatisation of state-owned industries, the mergers and acquisitions focus during this decade has clearly been on real estate. This market probably peaked in 2006, when for example in Estonia the aggregate value of real estate deals was €5 billion ($7.75 billion). The beginning of 2007 seemed to continue at the same pace, but by the end of the year the market had already started to make corrections.

The beginning of 2008 witnessed only a modest number of real estate transactions, mainly the overspill from 2007, projects that have proved strong enough to convince the banks to grant funding. The main investors in the region have been Baltic Property Trust, Linstow, Citycon, Explorer Property Fund, Amber Trust and Boultbee. The transactions have mostly included the acquisition of major commercial properties (shopping malls, hotels, office buildings). The first quarter of 2008 has signalled a marked slowdown in real estate throughout the region.

Although all Baltic countries had experience with auction sales of companies during the period of privatisation in the nineties, there has been little of this type of mergers and acquisitions activity since then. But recent years seem to witness the rebirth of such activity. Local investors have discovered the value of a properly arranged bidding process for divesting companies compared with one-to-one negotiated deals. Major foreign players have also reviewed their company structures and portfolios in the Baltics, resulting in some notable mergers and acquisitions transactions recently. The deal list by value is probably topped by SEB banking group, which divested its total real estate portfolio in the Baltic countries in 2007. The first quarter of 2008 is witnessing the continuation of this type of process.

No feast for lawyers

Interestingly, the Lithuanian mergers and acquisitions market is booming as mid-2008 approaches. A change of fortunes is expected in late 2008 and the start of 2009. Private equity funds used to have a great deal of difficulty finding businesses for sale. Now the number of undertakings seeking buyers is increasing, especially in the market of small and medium sized enterprises. A later slump in the number of mergers and acquisitions transactions is forecast due to global credit tightening. Consequently, it is expected that 2009 might be the perfect year for strategic investors to enter the Lithuanian market. Bargain prices could be seen in mergers and acquisitions transactions, since in a downturn companies are unlikely to achieve sparkling financial results.

The calendar for IPOs in 2008 seems rather empty, although recent years have offered lawyers a number of lucrative assignments in that area. With constraints on state budget, discussions have emerged in Estonia regarding potential IPOs of the handful of infrastructure companies that remained state owned after the mass privatisations in the nineties.

The somewhat gloomy perspectives for the upcoming year in the Baltics sets some challenges for Baltic law firms. Many firms have expanded rapidly, surfing on the high waves of the growing economy. They have increased their head count (often poaching from competitors), setting up Baltic or Nordic co-operations of various types. The upcoming year or two will offer a rough road, forcing the most solid to sustain their rapid growth during good years and return to their earlier expansion strategies once the difficult times are over.

Baltic law firms seek to tackle increasing competition by resorting to eastwards territorial expansion. In response to clients' growing interest in eastern investment opportunities, law firms are exploring the market in Belarus. On closer inspection, Belarus appears to be on the path to economic liberalisation and is expected to welcome foreign businesses in the near future, possibly trying to emulate the Baltic success story.

Despite some colleagues' optimism that lawyers always have good times, either as transaction or bankruptcy lawyers, it is difficult to believe that the profession could feast in ignorance when clients are suffering. The hope of Baltic lawyers is that larger private-public partnership projects will also pick up in this region. Also, EU funds have finally started to pour in (especially in the infrastructure development), which could also increase demand for legal work. The energy sector is going through restructuring in all three Baltic countries and potentially in the EU, the biggest single regional project probably being the Ignalina new nuclear reactor. Projects like the Nord Stream gas pipeline could also offer opportunities for a warmer relationship with Russia, as hopes are higher after the Russian presidential elections. So the outlook for 2008 might not be so gloomy for mergers and acquisitions lawyers in the Baltics after all.

Volatile

Much work has been done to nurture the investment climate. The Doing Business indicators prepared by the World Bank show that Latvia has some of the least complicated business registration procedures of all the new EU member states. For example, Latvia requires only five procedures to start a business, and Estonia six. It takes only about 16 days to start a business in Latvia, whereas the same procedures require about 72 days in Estonia. These figures imply that the business registration system in Latvia functions well. Latvia does have minimal capital requirements to start a business; these are relatively expensive.

On the basis of a wide range of data and information, there have been significant improvements in the investment climate in Latvia – namely, in customs and trade, the regulatory environment, access to information and government service provision, and corruption. The other two Baltic countries have had similar successes.

Net FDI inflows are inevitably volatile in all transition economies. In Latvia, per capita net FDI inflows improved in the period between 1994 and 1997 and reached their highest levels in 1997 at $210 per capita. A noticeable temporary decline followed in 1998, but a continuous improvement in FDI inflows then occurred again (except in 2001, when net per capita FDI inflows declined to $72). The largest increases occurred in 2004 and 2005 (net per capita FDI inflows of $270 in 2005), and the figure for 2005 was roughly double that of 2003. An increase in FDI inflows into Latvia has taken place more recently, but the results are volatile.

Hope

Although according to the Doing Business report Latvia has one of the least regulated business environments of the EU accession countries, this is not reflected in the well-known Heritage Foundation and Freedom House indexes, which are largely based on perceptions of foreign investors. One possible explanation for this is that it takes time to change the perception of foreign investors. A large portion of FDI is initial investment; subsequent inflows follow. This in turn implies that Latvia has great potential to attract FDI in the future as a result of reforming administrative barriers.

The Baltic countries tout their admittedly moderate tax burdens, which are particularly low by regional standards. The corporate tax rate in Latvia and Lithuania is only 15% and Estonia has a tax rate of 21% on income distributed to investors. According to the Deloitte Baltic private equity country rating, Latvia comes first as the country with the best tax and legal environment.

The relatively small size of the national markets has fuelled an integration of stock exchanges. The Baltic Market stock exchanges in Tallinn, Riga and Vilnius are a part of the Nasdaq OMX Group and offer listing opportunities in the main market as well as First North, an alternative marketplace for smaller growth companies. The OMX Baltic Membership gives members the right to trade equity and fixed income products in all three Baltic markets through the exchanges in Tallinn, Riga and Vilnius. This membership offers a single access point to all three exchanges as well as a simple and relatively cheap application process.

The Baltic Market makes possible instantaneous cross-border trading and settlement between the exchanges in Estonia, Latvia and Lithuania, thereby rendering the Baltic region more accessible and attractive to investors and listed companies that would otherwise be held back because of thin domestic capital markets. By utilising a common trading system, harmonising trading hours, rules and requirements between the exchanges, and offering an advanced delivery versus payment (DVP) link, since 2007 investors have been able to trade and settle efficiently and seamlessly between the three markets.

The Baltic central securities depositories have established a unique clearing and settlement solution between their systems, which allows members, custodians and investors to settle transactions with securities registered in any of the Baltic central securities depositories in their home depository. This so-called Baltic link solution supports the clearing and settlement of the full set of transaction types on the cross border secondary market – stock exchange trades, over-the-counter delivery versus payment and free of payment transfers. Interest in the Baltic securities market is growing and many new investors are entering the market regardless of the slowdown, or probably because of it, in anticipation of bargain deals.

All in all, it appears that there is room for hope that the slowdown will be but a short adolescent issue, and that it will provide valuable experience for future growth.

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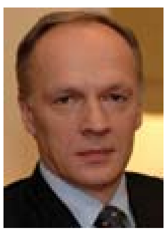
Sven Papp has been a partner at Raidla Lejins & Norcous Tallinn office (formerly Raidla & Partners) since 1994. He leads the transactions and corporate advisory practice group and specialises in M&A, corporate law, employment and electronic communications law.

Papp has spoken at various conferences. He helped draft the Commercial Code and the Investment Funds and Telecommunications Act. He is a member of the Listing Committee of Tallinn Stock Exchange, the Expert Council of Independent Legal Profession and Insolvency Law at the Ministry of Justice.

Papp advised Estonian Telecom and the Estonian government on the first ever IPO in Estonia and on restructuring the Estonian Telecom Group. He helped renegotiate an exclusive concession on the fixed-line telephony of the Estonian Telephone Company, and advised the National Energy Company and the Estonian government on restructuring the energy sector. He has advised the energy sector during Estonia's accession talks with the EU, and the Estonian government on the restructuring of Estonian Railways and the privatisation of the company.

He has advised domestic and foreign investors on acquiring businesses in Estonia, and assisted big Estonian commercial banks on their acquisitions of banks in Latvia and Russia.



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Norkus obtained his Master's degree from the Faculty of Law of Vilnius University and continued his studies at the Business School of Leeds University (UK). In 2001 he completed a doctorate at Vilnius University. Norkus lectures at the Faculty of Law of Vilnius University Department of International Law and EU Law.

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