

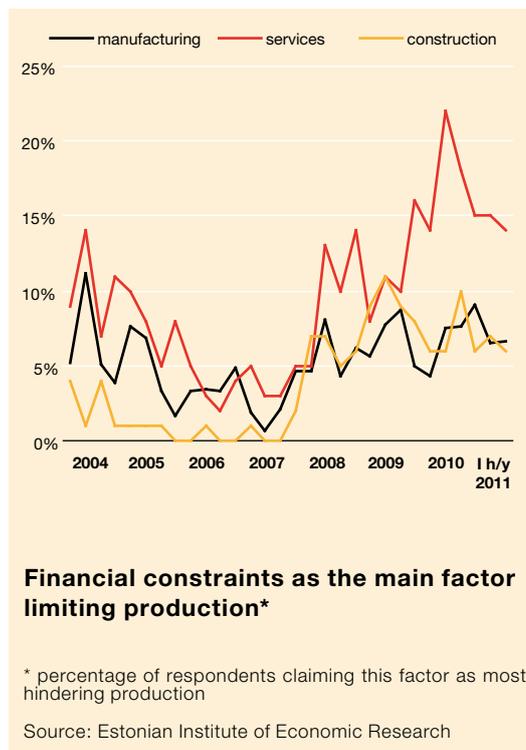
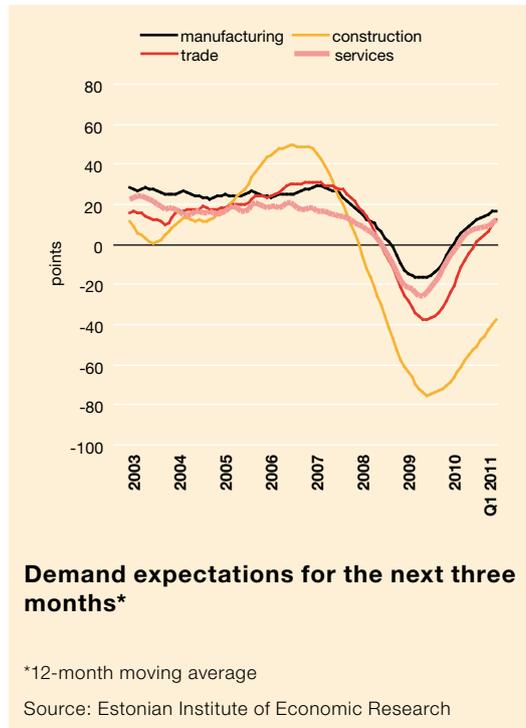
FINANCING OF COMPANIES IN ESTONIA

The impact of the economic environment on financing

Although gradually recovering, the economic environment continues to be quite volatile and negative news may easily affect the future outlook and expectations. The external conditions that are important for the Estonian economy and companies have improved in recent quarters, despite many negative events on the global scale. Economic growth of Estonia's main trading partners – Finland, Sweden and Russia – exceeded the European average, which has had a particularly positive impact on the Estonian economy. Exports posted a record level in April and in light of low domestic demand, companies see a solution in expanding to foreign markets.

According to the Estonian Institute of Economic Research, by the end of the first quarter of 2011 the confidence of Estonian companies had risen to the level recorded at the beginning of 2008. Expectations regarding near future trends and the increase in orders are more positive than they were earlier. In April, 36% of the respondents in the manufacturing sector expected a growth in orders; this indicator was almost 50% in trade and services. In April, manufacturing companies considered export demand to be higher than domestic demand, but the amount of domestic orders will probably increase along with the rising consumer confidence. However, the construction sector is clearly different, as the decline-induced economic difficulties have had a considerable impact on expectations, which are much more pessimistic than before the boom.

In April 2011, 50% of the respondents in all sectors mentioned demand as the main obstacle to doing business, but the prevalence of this factor over others is clearly abating compared to recent years. From the aspect of financing the economy it is important that with the rising loan demand, the share of companies that see

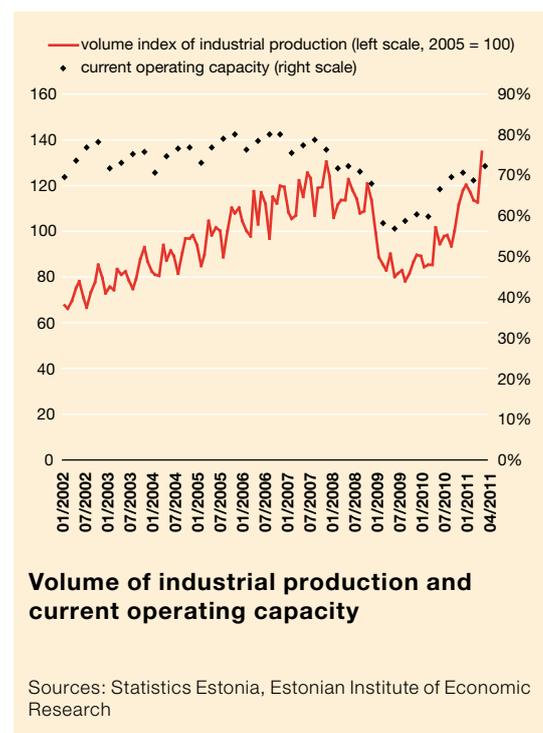


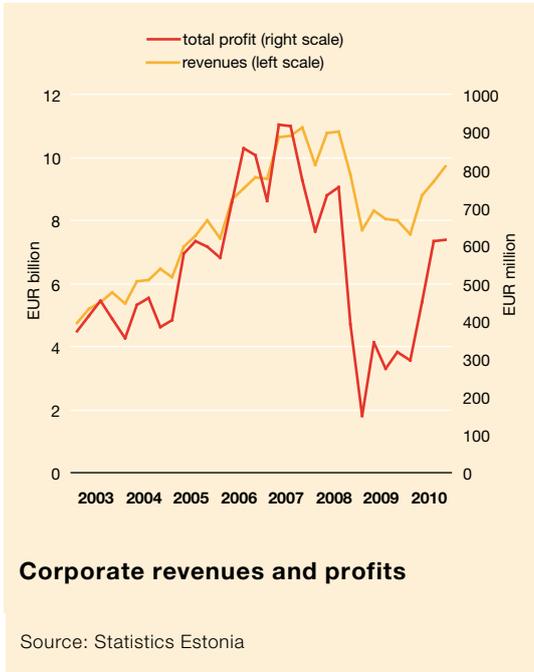
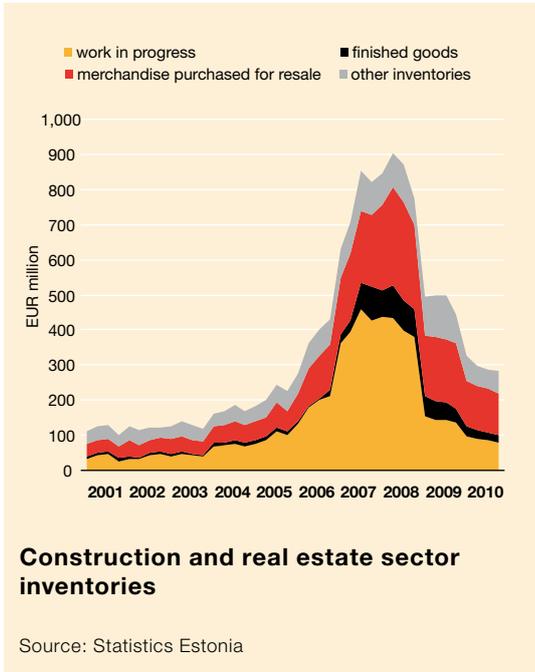
financial problems as the biggest obstacle to business activity has not increased. In April, it was 14% in services, 6% in construction and 7% in manufacturing. At any rate, there was nothing normal about the situation that prevailed in 2005–2007 when the share of companies that saw financial problems as a hindrance to their expansion was nearly non-existent.

The boom-time sales records created a need, and sometimes unjustified expectations, in almost all sectors to increase their stocks. However, the amount of stocks decreased during the recession. After sales picked up again, trading companies returned to purchasing goods for sale in the last quarters of 2010 and manufacturing companies started to restore their material and commodity reserves. Increasing stocks is presumed to continue along with the rising economic activity and, as a result, the need for working capital will also grow.

Entrepreneurs' estimates regarding the shortage of materials and equipment, which refer to investment needs, have remained relatively stable over the last year. The shortage of materials and equipment is remarkable only in manufacturing, where in April 14% of entrepreneurs mentioned it as the main obstacle to production (8% in January 2011). Meanwhile, the utilisation of production capacity in manufacturing increased to 72%, which, considering the swift output growth, is not far from its historical peak of 80%. Presuming that the economic environment remains favourable, manufacturing companies will probably have to invest in expanding their production capacity in the near future.

The utilisation level of building capacity rose to 62% by the end of 2010. In 2010, the value of performed construction works totalled 1.9 billion euros, which is over 50% less than the peak of the boom in 2007. The turnover is greater in the construction of facilities, where, according to Statistics Estonia, nearly 90% of the production capacity of 2005 had been restored by the end

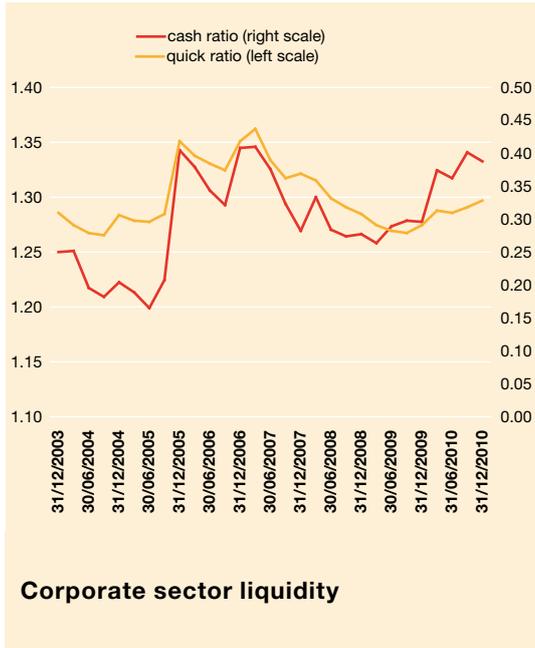




of 2010; however, in building construction this indicator was only 70%. Statistics Estonia says that the stocks of construction and real estate companies also dropped to pre-boom levels at the end of 2010. If this trend continues, demand for new investments and for funding them will probably increase.

Internal cash flows

The primary sources of financing, cash flows from business operations, continued rapid growth in the two final quarters of 2010. This was fostered by increasing exports and the gradually recovering domestic consumption. The success of expenditure cuts reveals itself in profit growth, which is occasionally even stronger than the growth in sales revenues. All sectors, excluding education, posted profits in the fourth quarter of 2010. Manufacturing was the most successful sector, where both sales revenues and profits picked up significantly within the two final quarters of 2010. In the fourth quarter of 2010,



profits grew by nearly 14% and totalled 196 million euros.

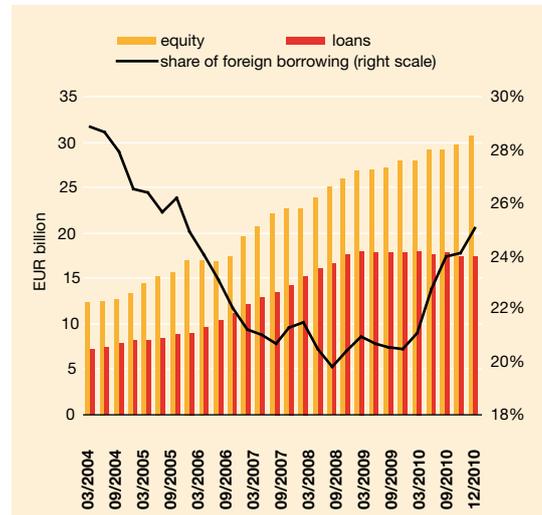
Corporate liquidity indicators improved further at the end of 2010, as sales revenues and profits recovered, and the volume of deposits increased to 4 billion euros. However, in the first three months of 2011 corporate deposits contracted, which has probably also slowed down the further rise of liquidity indicators. On the one hand, the improving liquidity of companies refers to the sufficient availability of circulating capital and to the fact that they have no need to borrow from banks. On the other hand, liquidity indicators refer to the strength of the companies' economic situation, and this is one of the prerequisites for obtaining a loan. In other words, it would be easier for companies to receive bank loans in the future. Generally, however, companies' conservative behaviour in the post-recession situation is common and greater buffers allow them to hedge risks better during a growth cycle.

External financing

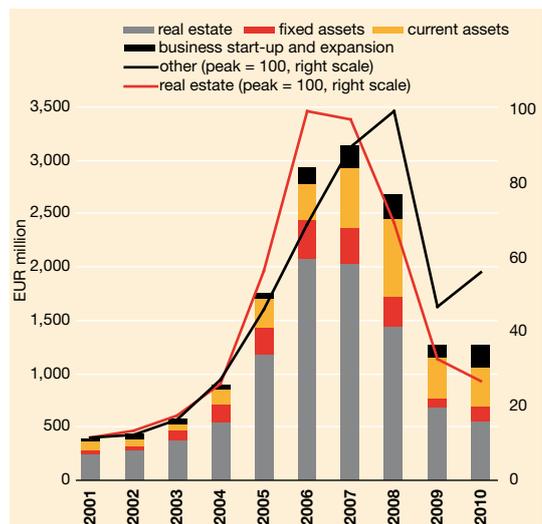
In 2010, companies continued to repay their loans and to increase equity, reducing their dependence on external financing. With the year, the stock of loans decreased by over 0.4 billion euros, while equity grew by a total of 2.7 billion euros. Non-financial companies' debt has shrunk due to the repayment of domestic loans, but raising funds from abroad has increased. At the end of 2010, the share of foreign loans had climbed to 25% again after several years. Foreign borrowing has grown mainly owing to local manufacturing companies who have obtained intra-group loans, while liabilities to creditors outside the group have generally decreased.

Domestic borrowing

In addition to the more than 50% drop in the turnover of domestic loans, the objectives of



Corporate sector's equity, loans and share of foreign loans



New lending to companies by loan purpose

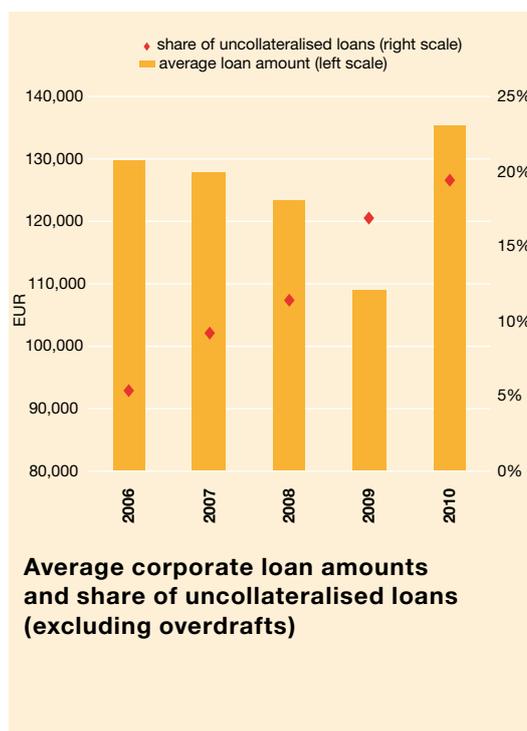
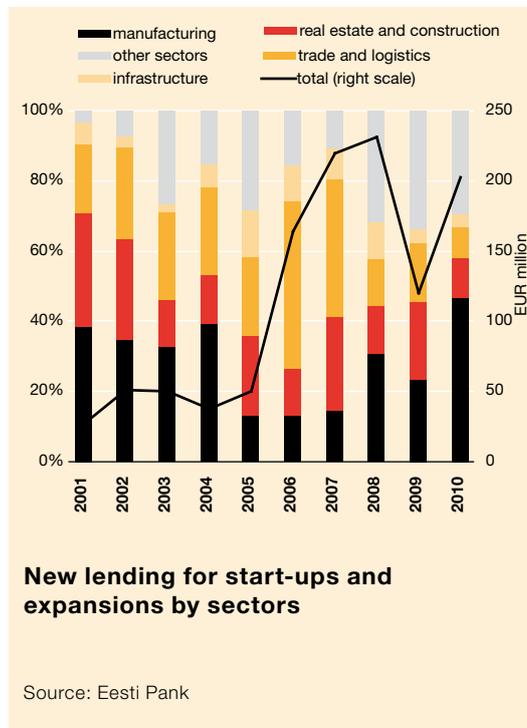
borrowing also changed considerably with the recession. Contrary to the boom period, when over two-thirds of loans were obtained to purchase real estate, in 2010 the majority loans were taken for other purposes than real estate. Their turnover also dropped significantly during the recession, but contrary to real estate loans the turnover of loans for other purposes increased by nearly 20% in 2010.

Borrowing to finance real estate has started to recover in 2011 and is expected to increase further in the near future, considering that confidence is improving and the real estate market is regaining momentum.

Borrowing to finance fixed assets, however, is still marginal. Companies need to start replacing their depreciated fixed assets sooner or later, which probably requires also bank financing. Looking at the distribution of investments by sectors, it is the manufacturing companies that prevail, which uses financing resources different from those of other sectors. Contrary to earlier periods, investments are probably funded much more with own funds and foreign loans. Moreover, the still high level of non-financial sector debt may curb the desire to take on new long-term liabilities.

In the coming quarters the loan turnover will probably grow on account of short-term financing, which is increasingly needed in the current improving economic environment due to growing business volumes.

The fact that it is possible to receive funding for good ideas and strong business plans is indicated by the growth in the turnover of loans obtained for starting or expanding business. In 2010, the turnover of such loans increased by nearly 70%. Naturally, the majority of the growth stemmed from manufacturing, which relies on export growth. In 2010, the turnover of loans granted for starting or expanding business also increased in some other fields of activity,



including companies engaged in knowledge-intensive professional, scientific and technical activities, although the volumes of this sector are nonetheless quite small. With domestic demand improving, loans to the trading sector to start or expand business witnessed strong growth in the first quarter of 2011. The need to expand operations and to try out new ideas in the recovering economic environment will probably grow in the near future, and this will increase also borrowing activity.

The increase in the average loan size and the growth in uncollateralised loans point to the dominant role of large companies on the loan market, while the loan activity of smaller companies dropped further in 2010. Developments in recent quarters indicate, however, that the loan market bottomed out at the end of 2010 and the loan activity of smaller companies is expected to recover in 2011.

Companies also express further interest in obtaining loans that are guaranteed and collateralised by KredEx, as confirmed by the statistics for the first four months of 2011. The fact that the products of KredEx are popular among large companies is indicated by the growing share of large sureties among the applications approved.

