

BUSINESS PERFORMANCE

INVESTMENT BEHAVIOR OF ENTERPRISES IN 2005-2006

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1. General Indicators of the Investment Process

In 2005, as the REB surveys show, investment activity of industrial enterprises, as before, remained very high. This is evidenced, first of all, by declining SHARE OF ENTERPRISES NOT BUYING ANY EQUIPMENT. While in 1999, about 58% of all surveyed enterprises did not buy any equipment for two and more successive months, this indicator went down to 45% by 2002; to 42% in 2003; to 41% in 2004 and finally, to 40% in 2005. Consequently, the remaining 60% were buying their equipment regularly. This is the record high level of investment activity in the whole period of its measurement (since 1993).

Shifting from equipment investment to TOTAL CAPITAL INVESTMENT (in 12-months intervals), we find even better results.

In 2005, the average share of enterprises having made no capital investment in the preceding 6 months and expecting not to make any in the following 6 months (relatively to the poll moment) was 18% on the average. This was 7 percentage points less than a year ago and is the record low value of this indicator since 1993.

THE DEGREE OF FULFILLMENT OF INVESTMENT PLANS is an indirect measure of investment activity in the REB investigation. In 2005, the degree of fulfillment of the plans remained the same as it had been in 2004 - 71% (total volume of planned investment at an enterprise was taken as 100%). Let us remind that this was the highest level of this indicator in the whole period of market-oriented reforms.

2. Factors Limiting Capital Investment

"Shortage of financial resources" is still holding the first place among the FACTORS TO RESTRAIN CAPITAL INVESTMENT at the

enterprises. In 2005, 78% of the respondents on the average pointed at this reason - exactly the same percentage as a year ago. Consequently, it is yet impossible to conclude that financial constraints have become easier: this indicator stays practically at the same level as where it stood during the whole post-default period of 1998-2001 (see Table 1).

The next and an already usual factor is "high prices of equipment and construction works" - 51%. This figure is just 1 percentage point lower than in 2004. Nevertheless, in this case we can perhaps assert that we are dealing with a downward trend. This decline has been observed for the fourth consecutive year, and besides, it is followed with a genuine inflation slowdown.

"High borrowing rate" is the third in terms of frequency of mentioning- 31%. Here we have a long-run (ongoing since 1997) tendency towards increase in the rating. At first sight, this trend may look like a paradox, taking into the account a conspicuous decline in nominal borrowing rates that took place in recent years. However, this paradox can be explained in a very simple way. the number of industrial enterprises using bank borrowings to finance their capital investment has become remarkably larger (see below for a more detailed discussion of this phenomenon).

The rating of such unfavorable for capital outlays factor as "high indebtedness" of enterprises has declined by 4 percentage points on the year-to 13%. However, it has declined to one third from 1997-1998 and actually fell into the category of unimportant factors of investing. Let us point out that this situation has arisen for the first time in the whole period of market-oriented reforms (since 1992).

Another important factor is "general uncertainty of the situation". Its rating remains practically the same in the recent four years - 13%. However, in 2005 its rating has increased to 17%, which is, nevertheless, still far away from the level of 1997-1998 (21-24%).

However, "low rates of return on investment projects" were mentioned in 2005 by a fewer number of the respondents - only 12%. On the other hand, the level of this indicator is still higher than it was in 1997-2003 when it fluctuated around 4-8%.

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Table 1
Factors to Limit Capital Investment

(Share of respondents having pointed out each point as important, %)¹⁾

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|--|------|------|------|------|------|------|------|------|------|
| 1. Shortage of financial resources | 73 | 81 | 82 | 81 | 81 | 84 | 80 | 78 | 78 |
| 2. High prices of equipment and construction works | 50 | 46 | 54 | 58 | 58 | 55 | 53 | 52 | 51 |
| 3. High borrowing rate | 22 | 24 | 24 | 24 | 25 | 28 | 26 | 30 | 31 |
| 4. High indebtedness | 40 | 38 | 27 | 23 | 22 | 22 | 17 | 17 | 13 |
| 5. General uncertainty | 21 | 24 | 18 | 15 | 13 | 13 | 14 | 13 | 17 |
| 6. Excess of production facilities | 20 | 16 | 16 | 13 | 12 | 13 | 11 | 11 | 12 |
| 7. Low rate of return on investment projects | 7 | 4 | 5 | 5 | 7 | 5 | 8 | 14 | 12 |

¹⁾ Respondents were offered to choose no more than three factors.

Differentiation of the ratings by industry has slightly decreased from the preceding year. This is especially true for such factors as high prices and interest rates. Nevertheless, hardness of the investigated restraints on investment activity of the enterprises still much differs by industry. For example, "shortage of financial resources" restrained capital investment at 81% of the surveyed enterprises in logging, woodworking, pulp and paper, and only at 60% of enterprises in chemicals (see Table 2). "High borrowing rate" was placed among three main restraints of investment behavior by 36-40% of metal and machinery makers, and by only 20-24% in chemicals, petrochemicals and building materials.

Table 2**Factors to Limit Capital Investment by Industry, 2005**(Share of respondents having pointed out each point as important, %)¹⁾

| | 1. Shortage of financial resources | 2. High prices of equipment and construction works | 3. High borrowing rate | 4. High indebtedness | 5. General uncertainty | 6. Excess of production facilities | 7. Low rate of return on investment projects |
|--|------------------------------------|--|------------------------|----------------------|------------------------|------------------------------------|--|
| Iron and steel and non-ferrous metals | 68 | 55 | 40 | 0 | 20 | 6 | 12 |
| Machinery and metalworking | 80 | 50 | 36 | 12 | 18 | 15 | 12 |
| Chemicals and petrochemicals | 60 | 56 | 24 | 8 | 9 | 0 | 13 |
| Logging, woodworking, pulp-and-paper | 81 | 52 | 37 | 11 | 16 | 2 | 13 |
| Building materials | 79 | 42 | 20 | 18 | 14 | 18 | 6 |
| Light industry | 74 | 46 | 33 | 17 | 23 | 12 | 16 |
| Food industry | 74 | 50 | 28 | 13 | 19 | 17 | 12 |
| Gap between highest and lowest ratings (percentage points) | | | | | | | |
| 2005 | 21 | 14 | 20 | 18 | 14 | 18 | 10 |
| 2004 (reference) | 11 | 30 | 31 | 17 | 18 | 18 | 14 |

¹⁾ Respondents were offered to choose no more than three factors.**3. Sources of Funds for Capital Investment**

Speaking about the most plausible SOURCES OF FUNDS FOR CAPITAL INVESTMENT in the next two or three years, 48% of the respondents identify accumulated earnings of their enterprises. This is 6 percentage points higher than in 2004 and a record high indicator during the last ten years.

The share of enterprises hoping to get investment loans from banks has gone up to 41 % (which is 10 percentage points higher than in 2004). This is also a record in its category.

The number of pessimists - those who do not believe in availability of any funds for capital investment at all in the next two or three years - continued to decline. While in 2002, the share of such respondents was

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32%, it was 27% in 2003, 23% in 2004, and only 22% remained in this group in 2005. This was the lowest share of pessimists in the whole period of our observation (see Table 3). We can suggest that a certain part of them is gone to the line of those who have found difficulty in answering (the lowest line in the Table 3). However, even if this is true, we still get the lowest share of this answer summing up the figures in these two lines (#8 and #9) - 30%.

As for other potential sources of funds for investing, all of them except borrowing from a domestic partner became items of marginal importance with rating not higher than 3-4% (see Table 3).

Table 3

Sources of Investment Funds in the Next Two or Three Years

(Share of respondents having pointed out each source as the most plausible one, average data of two surveys, %)¹⁾

| | 1996 ²⁾ | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|-------------------------------------|--------------------|------|------|------|------|------|------|------|------|------|
| 1. The enterprise will make savings | 18 | 22 | 27 | 42 | 41 | 44 | 42 | 43 | 42 | 48 |
| 2. Borrowings from commercial banks | 13 | 15 | 10 | 18 | 24 | 26 | 30 | 37 | 31 | 41 |
| 3. From a domestic partner | 7 | 9 | 8 | 8 | 12 | 10 | 9 | 9 | 9 | 10 |
| 4. From a foreign partner | 7 | 8 | 7 | 4 | 4 | 4 | 2 | 2 | 3 | 2 |
| 5. From selling shares, bonds | 5 | 5 | 4 | 3 | 5 | 3 | 4 | 3 | 4 | 3 |
| 6. From the government | 9 | 7 | 8 | 8 | 8 | 6 | 3 | 4 | 4 | 4 |
| 7. Other sources | 2 | 10 | 5 | 2 | 4 | 4 | 5 | 3 | 3 | 3 |
| 8. Funds will come from nowhere | 49 | 41 | 44 | 37 | 30 | 28 | 32 | 27 | 23 | 22 |
| 9. Hard to answer | 19 | 19 | 18 | 12 | 10 | 10 | 9 | 8 | 12 | 8 |

¹⁾ Respondents were offered to choose no more than two versions of answer.

²⁾ Second half-year.

4. Borrowing from a Bank

As in earlier years, the vast majority of the surveyed producers don't make even any attempt to seek BANK BORROWINGS TO FINANCE THEIR CAPITAL INVESTMENT. However, their share was declining for the third year in a row and fell down to 61 % in 2005.

As for other producers, we have been seeing since 1998 that their bargaining power in negotiating for their loans with banks is getting

apparently stronger. While in 1998-1999, the likelihood of their success was 0.15-0.17 (i. e., only one or two in each ten seekers could get their investment loans), it has surpassed 0.5 for the first time by 2002 and rose to 0.56 in 2005 (see Table 4). As a result, the share of the enterprises that acquired investment loans in 2005 has become record high - 22% (in 2002-2003, it was 17%).

Table 4
Distribution of Enterprises by Activity and Success
in Seeking Investment Credit in Last Twelve Months
(Average share from two semi-annual surveys, %)

| | Enterprises seeking no bank credit for financing investment within a year (%) | Enterprises seeking bank credit for financing investment for a year | | |
|------|---|---|-----------------------|---|
| | | Of which: | | Share of successful seekers in total number of seekers (4) = (3):[(2)+(3)] |
| | (1) | Got no credit (%) (2) | Got credit (%) (3) | |
| 1998 | 58 | 35 | 7 | 0,17 |
| 1999 | 66 | 28 | 5 | 0,15 |
| 2000 | 69 | 22 | 9 | 0,29 |
| 2001 | 63 | 21 | 16 | 0,43 |
| 2002 | 67 | 16 | 17 | 0,52 |
| 2003 | 65 | 17 | 17 | 0,50 |
| 2004 | 63 | 17 | 20 | 0,54 |
| 2005 | 61 | 17 | 22 | 0,56 |

As before, high borrowing rate was mentioned in the first place among DIFFICULTIES IN NEGOTIATING CREDIT AGREEMENTS. As follows from Table 5, this very problem is the key issue at the stage of conclusion of the majority of credit agreements. Moreover, its rating has soared by 7 points at once from 2004 and reached 55%.

The second place is steadily occupied by the problem of collateral - 42%. The third and fourth places, as before, belong to terms of borrowing and risk of default on a loan - 23 and 21%, respectively. The issue of volume of the loan, which, as a year ago, was mentioned by 15% of all seekers of investment credit, is at the bottom of our list.

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Table 5
Main Difficulties in Concluding Credit Agreements with Banks for Financing Capital Investment (Share of enterprises having singled out this point in total number of seekers of investment loans in the last 12 months, %)

| | Main difficulties in concluding agreements | | | | |
|------|--|-------------------------|--------------|-----------------------|-------------|
| | High interest rate | Risk of default on loan | Term of loan | Problem of collateral | Loan volume |
| 1998 | 66 | 60 | 37 | 26 ¹⁾ | 17 |
| 1999 | 75 | 46 | 36 | 29 | 18 |
| 2000 | 91 | 55 | 36 | 36 | 18 |
| 2001 | 53 | 24 | 27 | 34 | 18 |
| 2002 | 49 | 27 | 26 | 27 | 13 |
| 2003 | 48 | 21 | 25 | 45 | 16 |
| 2004 | 48 | 22 | 24 | 48 | 15 |
| 2005 | 55 | 21 | 23 | 42 | 15 |

¹⁾ *Second half of 1998.*

5. Rates of Return and Purposes of Investing

In the REB surveys, the respondents evaluate potential profit rates and risks of investment in an indirect way, using a MARGINAL INTEREST RATE (MIR), which is defined in the questionnaire as the highest interest rate on bank loans in rubles for a term of 2 to 3 years, affordable to an enterprise to finance its capital investment. On the average of four 2005 surveys, the marginal interest rate was 7.9%. This is 0.2 percentage points higher than in 2004.

In spite of going slightly up, the MIR is still remarkably lower than the anticipated annualized rate of price increase in 2005 (11%). Consequently, as well as in 1996-2004, the great majority of enterprises were willing to get additional loans from banks for investment purposes no more costly than at a negative (in real terms) interest rate.

Let us mention that since 1996 till 2002 the marginal "real interest rate" followed an upward trend (although it was in negative territory throughout this period). This trend was seemingly broken in 2003-2004 when the real interest rate was more or less stable. However, the real interest rate resumed rising in 2005. The value of real rate has closely

approached zero (at least when the relevant assessments are made on expected prices of output, see Table 6).

Table 6
Marginal Interest Rate, Anticipated Price Increase
and Marginal Real Interest Rate (Percentage points)

| | Marginal interest rate (MIR) | Annualized rate of price increase, anticipated by the respondents | | Difference between MIR and anticipated rate of price increase | |
|------|------------------------------|---|-----------------|---|---------------|
| | | On inputs and outputs | Only on outputs | | |
| | (1) | (2) | (3) | (4) = (1)-(2) | (5) = (1)-(3) |
| 1996 | 15.0 ¹⁾ | 34.4 | 25.4 | -19.4 | -10.4 |
| 1997 | 8.8 | 8.2 | 5.1 | +0.6 | +3.7 |
| 1998 | 9.4 | 22.7 | 17.0 | -13.3 | -7.6 |
| 1999 | 10.6 | 39.8 | 30.0 | -29.2 | -19.4 |
| 2000 | 10.0 | 28.8 | 22.1 | -18.8 | -12.1 |
| 2001 | 9.4 | 18.3 | 13.4 | -8.9 | -4.0 |
| 2002 | 8.9 | 15.0 | 11.3 | -6.1 | -2.4 |
| 2003 | 9.0 | 14.5 | 11.3 | -5.5 | -2.3 |
| 2004 | 7.7 | 13.4 | 10.2 | -5.7 | -2.5 |
| 2005 | 7.9 | 11.1 | 9.2 | -3.2 | -1.3 |

¹⁾ 2nd—4th quarters.

The MAIN PURPOSE OF INVESTING, as a year before, is to improve quality of products. This purpose was reported by 44% of the respondents (this point had gained 33% in 2004). The second place was taken by cost reduction - 37% (22%). The longstanding leader, mastering of new products, went down to the third place - 32% (a year ago, 29%). The more efficient utilization of existing capacities gained 19% (22%).

Expansion of productive capacities was named one of key purposes by just 13% of the respondents (in 2004, 19%). It is not surprising, because excessive capacities are still quite sizeable in the industry in general, as well as in most large-scale industrial sectors.

Assessing the EXISTING VOLUME OF PRODUCTIVE CAPACITIES AGAINST THE DEMAND FOR PRODUCTION EXPECTED WITHIN 12 MONTHS, directors of the enterprises used the term "excessive" (39%) over three times more frequently than the term "deficient" (12%).

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Nevertheless, 2005 was one of the best years in this respect in recent years. Although the overall balance of valuations is still negative, let us remind that it was much worse in 1998-2002 (see Table 7).

Table 7
Distribution of Enterprises by Volume of Productive Capacities
against Expected Demand for their Products in 12 Months (Average
of four quarterly surveys, %)

| Volume of capacities against future demand | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 1 st quarter |
|--|------|------|------|------|------|------|------|------|---------------------------------|
| 1. Excessive | 60 | 50 | 43 | 42 | 43 | 37 | 37 | 39 | 33 |
| 2. Normal | 35 | 40 | 45 | 48 | 49 | 51 | 53 | 49 | 53 |
| 3. Insufficient | 5 | 10 | 12 | 10 | 8 | 12 | 10 | 12 | 14 |
| 4. Balance: (4)=(3)-(1) | -55 | -40 | -31 | -32 | -35 | -25 | -27 | -27 | -19 |

6. Innovative Activities of Enterprises

Innovative activities of the surveyed enterprises remain at almost the same level in recent years. The share of respondents having answered in summer 2005 that in the last year and a half, there were TECHNOLOGICAL INNOVATIONS AT THEIR ENTERPRISES was 79%. This was a strict reiteration of the result that had been obtained a year ago, and one of the highest values of this indicator in the whole period of our measurements.

There was a remarkable shift in the structure of innovations. In all preceding years, product innovations remarkably dominated over process innovations. However, this dominance gradually came to naught. For instance, as early as in 2004 the share of enterprises that introduced mostly new products was 29%, and of those that introduced mostly new technologies (processes), 17%. In 2005, their shares became almost equal: 21 and 20%, respectively. The share of enterprises that introduced both types of innovations equally was record high (38% against 33% in the previous poll) (see Table 8).

Table 8
Distribution of Enterprises by Type of Innovative Activity (%)

| Time of survey ¹⁾ | Share of enterprises having introduced innovations in past 1.5 years (%) | | | |
|------------------------------|--|---------------------|---------------------|---------|
| | Total | Of which, mostly: | | |
| | | Product innovations | Process innovations | Equally |
| 1990-1992 ²⁾ | 58 | 31 | 27 | 4) |
| 1993 ³⁾ | 62 | 38 | 24 | 4) |
| 1994 | 60 | 38 | 22 | 4) |
| 1995 | 63 | 46 | 17 | 4) |
| 1996 | 62 | 41 | 21 | 4) |
| 1997 | 52 | 35 | 16 | 4) |
| 1998 | 68 | 41 | 15 | 12 |
| 1999 | 76 | 43 | 33 | 4) |
| 2000 | 76 | 39 | 10 | 26 |
| 2001 | 76 | 33 | 14 | 28 |
| 2002 | 80 | 31 | 14 | 35 |
| 2003 | 77 | 31 | 17 | 29 |
| 2004 | 79 | 29 | 17 | 33 |
| 2005 | 79 | 21 | 20 | 38 |

¹⁾ Surveys are conducted once a year in August.

²⁾ Estimation in retrospect, obtained in the January 1993 survey.

³⁾ The July survey.

⁴⁾ This version of answer was not envisaged.

The share of new products introduced not earlier than a year and a half ago (before the moment of the relevant summer survey) in total output was 11%. This was 4 percentage points less than in the 2004 survey. This result is the record low value of this indicator in the whole period of our observation. However, there is no reason to see any real collapse. For example, in 2003 and 2001 the share of new products was actually the same (12%). Nevertheless, the current result looks discouraging against 1993-1994, when the share of new products was 19-26% (see Table 9). It appears that in spite of six years of economic growth and the increased innovative activities, the share of new products in the enterprise output is still extremely low.

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Table 9
Structure of Output by Type of Products (Data of yearly summer surveys)

| | New products ¹⁾ | Old products, output of which was ²⁾ | | | Balance |
|------|----------------------------|---|--------|-----------|---------------|
| | | Growing | Stable | Declining | (5) = (1)-(4) |
| | (1) | (2) | (3) | (4) | (5) |
| 1993 | 26 | 13 | 38 | 23 | +3 |
| 1994 | 19 | 7 | 38 | 36 | -17 |
| 1995 | 16 | 12 | 45 | 27 | -11 |
| 1996 | 16 | 13 | 34 | 37 | -21 |
| 1997 | 16 | 16 | 42 | 26 | -10 |
| 1998 | 14 | 18 | 38 | 30 | -16 |
| 1999 | 14 | 33 | 40 | 13 | +1 |
| 2000 | 14 | 29 | 47 | 10 | +4 |
| 2001 | 12 | 29 | 46 | 13 | -1 |
| 2002 | 16 | 23 | 46 | 15 | +1 |
| 2003 | 12 | 26 | 46 | 16 | -4 |
| 2004 | 15 | 31 | 40 | 14 | +1 |
| 2005 | 11 | 21 | 53 | 15 | -4 |

¹⁾ Products that were introduced not earlier than a year and a half before the survey moment.

²⁾ Products that were introduced not later than a year and a half before the survey moment.

The above mentioned data on the structure of innovations and on the goals that the enterprises pursued in their investment activities may, to some extent, help to solve this "contradiction". In recent years, as we have seen, the main vector of innovative activities of the enterprises was actually directed towards technological improvements in the output of old products rather than towards introduction of new products. The enterprises probably have accumulated large reserves in this field, and time has come to utilize them. Generally speaking, shifts in the objectives of investing tell the same story: a strong increase (by 11 percentage points) in the ranking of such objective as "improvement in the quality of output" and the rise of "cost reduction" to a leading position (a 15-points soar in ranking).