Foreign direct investment

→Warsaw packed

KIM REED, a senior associate with US law firm Hogan & Hartson in Warsaw, looks at the reasons for the high level of US investment in Poland and the investment climate for would-be investors

Foreign investors pumped $10.6 billion into Poland in 2000, bringing the total of foreign investment since 1990 to almost $50 billion. The United States has consistently been the top investor in Poland – in 2000, US investors poured $7.35 billion into the country. As a result of this foreign investment, as well as Poland's drive to become a developed nation, the country has one of the fastest-growing major economies in Europe.

Hundreds of US corporations have invested in Poland since 1991, including major enterprises such as Procter & Gamble, Ford, AT&T, Citibank, Coca-Cola, General Electric, General Motors, Levi-Strauss, Philip Morris, McDonald's, and many major law, accounting and consulting firms. At the same time, the Warsaw Stock Exchange – which opened in 1991 with just five companies and a market capitalisation of $142 million – now lists 225 companies and has a market cap of about $30 billion.

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THE CENTRAL AND EAST EUROPE BUSINESS INFORMATION CENTRE

Why the interest in Poland? Despite its almost trendy status, many investors are still unaware of the advantages of this country and wary of Poland's communist past, including inefficient, state-owned industry and the associated scant experience with the free market system. The savvy investor should be aware, however, of how different Poland is from its former Soviet bloc sister countries, and how these differences make it one of the most exciting emerging market investment opportunities in the world. Poland presents several advantages as an investment locale.

Size, location and growth potential

Poland is by far the largest developing country in Europe, with a population of almost 40 million people, half of them living in seven metropolitan areas. The population is relatively well educated and 99% literate. Likely to become a member of the European Union (EU) in 2004 or 2005, the country has already taken several major steps on the road to EU accession – as of August 2001, Poland had completed 17 of the 31 legislative chapters required for EU membership. Accession will add further value to the country's highly advantageous location in the centre of Europe. A major export centre, with easy access to EU markets as well as those of Russia and other eastern European states, almost 500 million people live within 1,000 miles of Poland. It also has excellent port facilities and an extensive rail system. And unlike many of its neighbours to the south and east, Poland's homogeneous population is virtually free of religious or ethnic conflict.

Because Poland now has more than a decade of intensive experience working with foreign investors, Polish businesses and entrepreneurs are increasingly sophisticated. Business schools in Poland have wholeheartedly adopted the American model, so graduates have the same basic skills as the American MBA graduates to which many investors will be accustomed. The Polish labour force (especially the younger generation) is eager for Western business knowledge, and is increasingly fluent not just in English, but also German, French or Russian as well. Although Poles have not traditionally been taught to think creatively or to operate 'outside the box', the under-40 crowd are particularly keen to learn Western business approaches. It is important to note that with a significant proportion of foreign investment in the information technology and telecommunications sectors, Poland is party to the major international conventions on the protection of intellectual property (IP) and brought its law into compliance with the EU in 2000. Bootlegging of videotapes and CDs is still an issue, but technology patents and copyrights are protected and generally well respected, with penal provisions available for violation of IP laws.

Financial factors

Poland offers investors full profit and dividend repatriation – free transfer of profits and dividends out of the country after taxes. Furthermore, Poland has signed double-tax treaties with the US and all other major countries, ensuring foreign investors only pay taxes either in Poland or at home. Even so, Polish corporate taxes are on the decline: as a result of legislative changes, they fell from 34% in 1999 to 30% in 2000 and 28% in 2001. They will fall to 24% in 2003 and finally to 22% in 2004.

Foreign investors are exempt from customs duties on non-cash or fixed-asset contributions to foreign-owned equity capital, and are allowed free re-transfer of profits from a company's liquidation or from the sale of shares. Capital brought into Poland by foreign investors may be freely withdrawn from Poland in instances of liquidation or decrease in capital share, and the 1991 Law on Companies with Foreign Participation guarantees the availability of foreign currency for payment of dividends to shareholders. The Central and East Europe Business Information Centre reports that "foreign investors have not complained of any significant difficulties or delays in remitting investment returns such as dividends, return of capital, interest and principal, lease payments, royalties or management fees." Additionally, Poland does not generally impose any performance requirements on establishing or maintaining an investment (the exception being purchases of certain large, formerly state-run businesses). For companies planning to manufacture and export a significant amount of goods from Poland, another tax incentive exists – they may deduct up to 50 percent of investment expenses from taxable revenue if their export earnings account for over 50 percent of their total sales, or if their export revenue in a taxable year exceeds €8 million.

Small and medium-sized enterprises (SMEs) can deduct qualifying investment expenditures from pre-tax profits for corporate tax purposes. This deduction is generally limited to 10% of an SMEs taxable income in the year of the investment, and 50% of the deduction can be deducted the following year. One area in which Poland differs substantially from the US is litigation – in Poland, legal procedures are infrequent and damages are comparatively very low in tort cases. Frivolous suits are extremely rare, as Poland generally requires an upfront filing fee equal to 5-8% of the amount in controversy, with a maximum of 100,000 zloty ($24,000), plus other fees in some cases. Poland has also adopted the English system of "loser pays all," and contingency fees are illegal. While certainly not encouraging dangerous products or negligent behaviour, the Polish legal system is much more business-friendly than many other countries' models with respect to tort cases.

US investors can also benefit from available equity financing and political risk insurance from the Overseas Private Investment Corporation (OPIC). OPIC offers medium- and long-term financing in Poland through its direct loan and guarantee programmes. Direct loans are reserved for US small businesses or co-operatives and generally range from $2-10 million. Loan guarantees are issued to US lending institutions and range from $10-75 million, although in certain instances may be up to $200 million. Government credit guarantees are available from the US Export-Import Bank. The World Bank's Multilateral Investment Guarantee Agency (MIGA) also offers investment insurance for investments in Poland. In addition, a large number of Western banks have a significant presence in Poland, and are willing and able to offer debt financing to investors (and, in some cases, may even participate in equity financing themselves).

Competitive factors

Several elements combine to make operations in Poland highly competitive:

- Poland has low labour costs and the labour unions, so important in Poland's recent past, are no longer as powerful

- Supply costs are low, with many raw materials available locally or at prices much cheaper than in the West

- There are relatively few laws mandating contract terms of any kind, so parties are able to negotiate freely the terms of their agreements with little or no interference from the government or the courts

- The Polish government is eager to encourage foreign

HOW TO INVEST

Foreigners may enter the Polish economy by means of a new (greenfield) investment or by acquisition of, or merger with, an existing Polish company. In the case of greenfield investments, two corporate forms are overwhelmingly used by foreign investors: the Limited Liability Company (LLC, known in Poland as the Sp zoo) and the Joint Stock Company (known as the SA). Both types have a formal management board composed of the top managers of the corporation, that oversees the everyday affairs of the organisation on a micro level.

The JSC also requires a supervisory board, the rough equivalent of the board of directors in the US – certain acts of the corporation may require the approval of one or both of these boards. There are far more LLCs than JSCs in Poland (150,284 versus 8,105 registered in 2000). The only benefit of a JSC is that it can offer its shares to the public. In return for this benefit, however, it is subject to more onerous reporting and disclosure requirements. Thus, the LLC is considered a better form for corporations with a small number of shareholders.

investment, and is therefore interested in discussing incentives (beyond those already formally introduced) for some projects or areas of investment. In addition, 20 Special Economic Zones exist in Poland, wherein foreign investors are exempt from income tax – and usually real estate taxes as well – if they invest a certain amount

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- Unlike Russia, where investors remain anxious over the possibility of state nationalisation of their businesses, there has not been an expropriation in Poland since reforms began in 1990 – indeed, the Polish government is firmly committed to privatising industry and has already sold off the majority of formerly state-run businesses to private investors.

The formerly state-run steel, petrochemical and energy industries are slated for privatisation in the coming two to three years. Furthermore, Article 21(2) of the Polish constitution, adopted in April 1997, assures that expropriation requires full and equitable compensation

Drawbacks to investing in Poland

Despite the excellent investment opportunities in Poland (see box), there are also some obstacles to investing that the savvy investor should be made aware of. First and foremost are the sometimes unclear and inconsistent legal procedures, and the attendant bureaucracy that goes with them. For Western investors accustomed to transparency in government regulatory practices, doing business in Poland can be frustrating. The unwary investor will be shocked at the number of official stamps a Polish transaction is required to have – each stamp carries its own fee, of course, and is subject to the schedule of the officials controlling the stamps, which is usually not conducive to a quick turnaround transaction. Having a Polish partner or adviser can be enormously helpful in navigating the bureaucratic maze.

Second, while Poland has cracked down on corruption in government, it is still a problem – a Polish-born investor who made his fortune in the US recently complained that while Polish government officials used to take bribes to do favours for businessmen, they now take bribes but do nothing in return. Public debate on this issue has grown, with the acknowledgement that corruption severely restrains economic growth and development, as well as foreign investment. Non-governmental organisations, such as the US Chamber of Commerce, are pushing the government to enforce its anti-corruption laws more diligently.

INVESTMENT SECTORS

Telecommunications
Much-needed modernisation is underway, but much more is necessary – for instance, Warsaw lacks a fibre-optic network, and many of the major suburbs do not have cable television or adequate internet access. However, there are limits until 2003 on the share of foreign ownership of telecommunications entities.

Electronics
There is a large gap between Polish and Western electronics companies, but Poland has big market potential and a high level of professional competence in electronic engineering and research and development.

E-commerce
Internet usage in Poland has more than trebled in the past two years, with the number of users climbing from 2.5 million in 1999 to around 8.5 million in 2001.

Infrastructure/municipal projects
Motorway/road projects and water/sewer projects, for example, were begun recently, but have a long way to go.

Environmental protection
Poland is behind schedule in its mandatory pre-accession EU requirements on environmental regulation, especially in the heavily industrialised parts of the country.

Laboratory/scientific/healthcare equipment
Despite having the largest research and development sector in central Europe, Poland lacks primary care facilities and family practices, as well as sophisticated medical equipment. This is primarily because the state-run healthcare system has hitherto not encouraged private investment in this area.

Services
A growing consumer middle class – and thousands of expatriates living in Poland – is demanding a more diverse service sector, but investors should carry out in-depth market studies before entering the market, as not all Western services do well in Poland, while some that flop in the US have become wildly popular there.

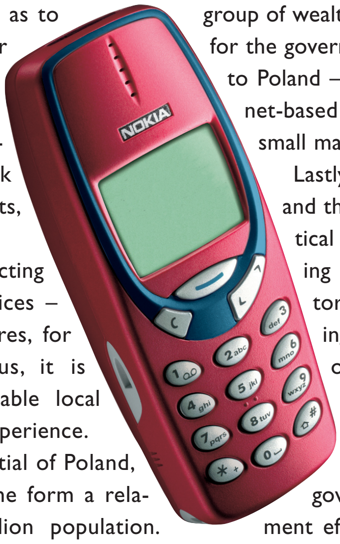
Pharmaceuticals
Approximately 50% of Polish demand for pharmaceuticals is met by imports, and sales in the sector are growing every year.

Coal, steel, and heavy industry
Investment is needed to modernise these areas, while the plentiful range of products that rely on them are also attractive

Apartment buildings and residential projects
It is estimated that one million pre-WWI apartments will have to be torn down in the next 10-15 years.

Power
In the next seven to 10 years, the Polish power industry will need an estimated $8 billion to replace and modernise generation capacity. Poland will also need $9 billion for transmission and distribution networks.

Third, Poland is a civil law jurisdiction, meaning that case law is merely persuasive, not controlling; therefore, businesses must look to statutory law to see what is actually permitted. Unfortunately, Poland's young democracy has not gotten around to pronouncements on all areas of business law, leaving large gaps of uncertainty as to whether a particular investment vehicle or financing arrangement is allowable, or how it will mesh with other regulations. For instance, the Polish legal system has little or no experience with employee stock option plans, real estate investment trusts, and securitisations.



There are frequently statutes obstructing the use of common US corporate practices – the concept of unissued authorised shares, for instance, is of limited application. Thus, it is absolutely essential to have knowledgeable local counsel, preferably with US investment experience.

Fourth, despite the huge market potential of Poland, the middle classes with disposable income form a relatively small percentage of the 40 million population. Outside the seven major urban centres, most of the population is still agrarian, and doesn't yet participate in the consumer economy. While EU accession will bring much-needed agricultural subsidies to the country, presumably placing farmers in a better financial position, it is unlikely that this sector of the population will soon spend much on goods or services.

Fifth, although Poland's internet usage is increasing dramatically, the connection cost is second highest in Europe, so new economy investments are presently aimed at a small group of wealthy people. Unless costs decrease – a priority for the government, likely to happen if fibre-optics make it to Poland – internet usage will cap out soon, and internet-based investments will continue to have a very small market.

Lastly, there exists a disconnect between inventors and theoreticians on one hand, and engineers/practical applicators on the other. Investors approaching the myriad of professors, chemists and doctors at Poland's leading universities about funding their research in exchange for the patents on their discoveries or inventions have been met with disinterest at best, and at worst, contempt for the 'crass' proposal of making money from 'pure' theories. Although the government funds some research and development efforts, the Central and East Europe Business Information Centre reports that no foreign investor has participated in those projects. However, with the right approach, opportunities exist for the creation of for-profit research institutions linked to industries that can find practical applications for their findings.