# Erste Group analysts: The robust credit quality of CEE corporates outperforms the sector indices



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- Interbank markets are functioning well in CEE
- CEE banks have much greater effectiveness in mobilizing funds from the public than its Western Europeans peers
- Robust credit quality of investment grade CEE corporates
- CEE telecom and utilities bonds outperform the sector indices
- Investors focus on short-term papers to reduce the duration risk
- Credit spreads at high levels until confidence returns

The double burden comprising the global liquidity crisis and fears about a painful slowdown in the Eurozone have negatively affected risk premiums in Central and Eastern Europe (CEE). After the peak in mid-September CEE credit spreads again rose sharply in the last couple of weeks and reached new all-time highs, mainly due to the liquidity problems of European financial institutions (Fortis, Dexia, Hypo Real Estate, Icelandic banks). The cost of insuring sovereign debt has soared, pricing in an increasing risk of default. The CDS of sovereigns of Hungary and Poland widened to 396bps and 185bps respectively, as the CDS of Czech Republic reached 145bps. The development of sovereign CDS as well as the news for some CEE financials reflect the lack of confidence among investors. They are sending the message - credit tightening can evolve very quickly - and are charging high risk premiums.

“Concerns regarding the credit tightening in CEE are fundamentally not supported, in our view. The banks in CEE are not at all involved in any sub-prime related investments and so had no need to write off their assets. Spreads between key interest rates and money market rates indicate much higher confidence among local banks. Furthermore, the effectiveness of CEE banks in mobilizing funds from the public (and in channelling them in the form of credits) is much greater than in Western Europe, says Alihan Karadagoglu, Credit Research Analyst at Erste Group.

Interbank rates vs. Key interst rates

| | Interbank Rates 3 Months | Key Interest Rates |
|---|---|---|
| Czech Republic | 4.09% | 3.50% |
| Eurozone | 5.38% | 3.75% |
| Poland | 6.82% | 6.00% |
| Slovakia | 4.29% | 5.00% |

Source: Bloomberg, as of10.10.2008

In times of financial turmoil, investors are looking for safety. Treasuries and government related issuers (GRI) are particularly in demand. Besides that, investors are looking for corporations from defensive sectors assumed to generate stable cash flows. "When we look at the performance of some euro-denominated bonds from defensive sectors like telecoms and utilities in CEE (incl. Austria), they all have outperformed the sector indices since mid-September. In particular, securities with short-term maturities had a positive return. This can be explained by the current market conditions, in which investors focus on short-term papers to reduce the duration risk”, points Karadagoglu out.

On the primary market, issuers are also showing a preference for short maturities as a way of avoiding having to bear the burden of the (on average) high refinancing cost over many years. The new issues must be attractively priced. Thus, due to the high spreads of the new Eurobonds, a revaluation of existing bonds may be expected on the secondary market in some cases. There will be high volumes of outstanding bonds of CEE corporations and financials maturing only in the year 2009: The outstanding securities maturing until the end of 2008 amount by corporates to about EUR 1,283mn (here, a great portion by Polish telecom TPSA) and by financials to EUR 2,136mn. Credit markets are expected to remain "closed" in the coming months. “Considering these conditions (high credit spreads), we expect the companies in 2008 to refinance outstanding debt mainly by cash flows and bank loans, although banks in CEE are also becoming more selective in lending and thus charging higher risk premiums”, closes Karadagoglu.

The credit quality of CEE corporates remains relatively robust, with only a few rating impacts. The deterioration in the upgrade/downgrade ratio is mainly due to the negative rating impacts on speculative-grade corporations. In the last three quarters, there have been seven downgrades on four issuers (three issuers were downgraded twice) and two upgrades in the Moody's CEE universe, including Russian and Bulgarian corporations.

**Outlook**

The credit markets welcomed the coordinated approach of European countries in supporting their financial systems. “However, we expect it will take a period of time until the credit freeze comes to an end. So, the volatile movement by CDS spreads will continue until confidence returns and the credit spreads should remain at a high level.”
CEE investment-grade companies have in general strong cash flow generation. Moreover, funding is backed up by loan facilities with banks. Therefore, we do not expect firms to witness a liquidity risk. However, the economic slowdown is indeed a threat to operating cash flows, particularly in cyclical industries and at speculative-grade firms, which are assumed to suffer a deterioration of credit quality into 2009.
In the coming months, we expect the primary market to remain closed. In case any new bonds are issued, a revaluation of existing bonds may be expected on the secondary market in some cases. “We favour mainly CEE Eurobonds from the defensive sectors - telecoms and utilities - which typically generate stable cash flows and have a more positive risk return profile than their Western European peers”, summarizes Alihan Karadagoglu, Credit Research Analyst at Erste Group.

**Total Return Index Level and Performance of Benchmark Eurobonds (iBoxx Non Financial Corporates)**

| Sector | since 15.09.2008 | since 01.01.2008 |
|---|---|---|
| Oil & Gas | -4.75% | -4.81% |
| Telecoms | -4.18% | -2.17% |
| Utilities | -3.33% | -0.15% |

| Bond | Issuer | since 15.09.2008 | since 01.01.2008 |
|---|---|---|---|
| CEZCO 5 1/8 10/12 | CEZ AS | -0.80% | -0.39% |
| CEZCO 4 1/8 10/13 | CEZ AS | -1.52% | -0.12% |
| CEZCO 4 5/8 06/11 | CEZ FINANCE BV | 0.89% | 0.52% |
| MOLHB 3 7/8 10/15 | MOL HUNGARIAN OIL & GAS | -0.95% | -9.62% |
| TPSA 4 5/8 07/11 | TPSA EUROFINANCE FRANCE | 4.84% | 1.81% |
| TKA 3 3/8 01/27/10 | TELEKOM FINANZMANAGEMENT | 0.28% | 0.91% |
| TKA 4 1/4 01/27/17 | TELEKOM FINANZMANAGEMENT | -3.77% | -3.98% |
| TKA 5 07/22/13 | TELEKOM FINANZMANAGEMENT | -1.44% | -2.27% |
| OMV 3 3/4 06/10 | OMV AG | -0.84% | -0.86% |
| VERBND 5 06/25/14 | VERBUND INTERNATIONAL FI | -1.30% | -0.32% |

*Source: Bloomberg, Market iBoxx; as of 10.10.2008*

Example:
Telecom sector shows a performance of -4.18%, the Polish Telekom of +4.84%.
Utilities sector shows a performance of -3.33%, the Czech energy company CEZ of +0.89%.

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