

CEE is not to Europe what sub-prime is to US

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- Massive sell-off should have seen its peak, but markets remain volatile; sideways movements could happen within wide bandwidth
- Low level of indebtedness makes exposure to deleveraging-driven crisis lower in CEE. Growth rate differentials to Western markets still standing
- Investors to watch balance sheet quality, stick to defensive sectors, favor Austria, Czech Republic, Poland

As the crisis continued through 2008 Erste Group analysts point market has been searching, if not for a turning point, for a bottom at least. They say fund flows and stock exchange turnovers indicators show that the massive sell-off should have seen its peak.

We believe that markets have found a resting point but will remain volatile. Despite volatility having settled down, it is still at extreme highs and we expect markets to move sideways for a while in general. This could still happen within quite a wide bandwidth, says Henning Esskuchen, Head of CEE Equity Research at Erste Group. He further points out that profit warnings, bankruptcy and refinancing news might feed volatility. Equally though, he states that governments reacting with support packages at unprecedented speed will at last give some comfort to markets, avoiding further panic-stricken sell-offs.

Sector performance

Sector*	1M	3M	6M	12M
Real Estate	0.3%	-55.3%	-78.6%	-84.3%
Chemicals	-21.6%	-52.7%	-49.4%	-68.1%
Basic Resources	-7.6%	-39.0%	-66.4%	-67.8%
Industrial Goods & Services	-7.5%	-42.2%	-58.3%	-66.4%
Construction & Materials	4.3%	-37.8%	-56.9%	-65.3%
Food & Beverages	-17.0%	-46.8%	-61.1%	-63.7%
Oil & Gas	-5.8%	-43.9%	-57.6%	-63.5%
Retail & Distribution	-11.0%	-39.4%	-51.9%	-60.4%
Banks	-1.9%	-42.8%	-47.9%	-58.5%
Travel & Tourism	19.1%	-25.1%	-42.2%	-57.7%
Technology	-3.7%	-38.6%	-40.3%	-56.8%
Media	0.9%	-37.8%	-43.2%	-55.5%
Erste Universe	-4.1%	-36.4%	-48.5%	-55.5%
Personal & Household Goods	-15.5%	-24.4%	-33.8%	-52.6%
Insurance	10.0%	-21.9%	-30.0%	-45.7%
Healthcare	-4.0%	-23.5%	-32.0%	-43.0%
Utilities	-5.2%	-31.0%	-46.5%	-42.3%
Telecom	-7.1%	-23.9%	-28.0%	-38.3%

*based on Erste Group Research Coverage; Source Factset

Erste Group analysts say risks are present and growth in CEE will undoubtedly slow down in 2009. However, they stress CEE is not to Europe what subprime is to the US. While the region is not as homogeneous as some see it, it generally has a low level of indebtedness (despite the strong growth in credit) and, consequently, the exposure to any deleveraging-driven crisis should be lower.

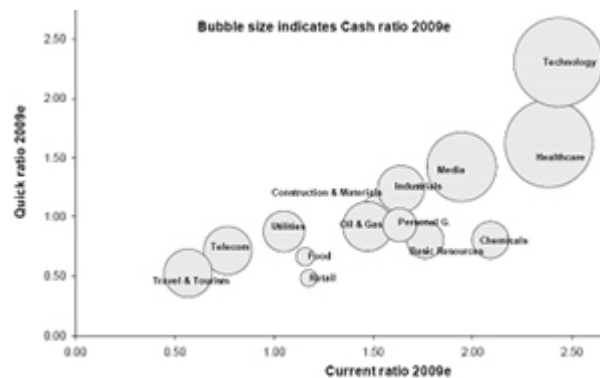
The analysts of Erste Group estimate growth rate differentials to Western markets will remain and economies such as Romania (exports contributing only 25% to GDP) should be able to fare well on domestic demand. Currencies remain a weak point for the moment, but on the other hand, they see room for positive surprises in all markets.

Balance sheet quality

Within the current environment, balance sheet quality should be viewed as a crucial criteria. Profitability and growth prospects should also be considered, says Henning Esskuchen while pinpointing some basic indicators which should help differentiate among sectors.

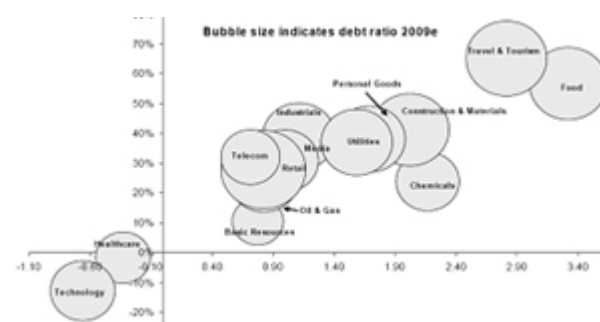
Short-term balance sheet quality

Winners of the category are technology and healthcare partly due to their ability to produce sound cash flows (and retaining IPO/SPO proceeds in their pockets – Intercell). The assumed higher risk of the technology business made the sector reliant on internal financing. Sectors at the other end of the scale are either potentially in real trouble (travel & tourism) or can rely to a larger extent on external financing (telecom, utilities). The food & beverage industry, which would have been a defensive pick, is unconvincing. A lot of Polish companies in this sector are suffering from previous business expansion.



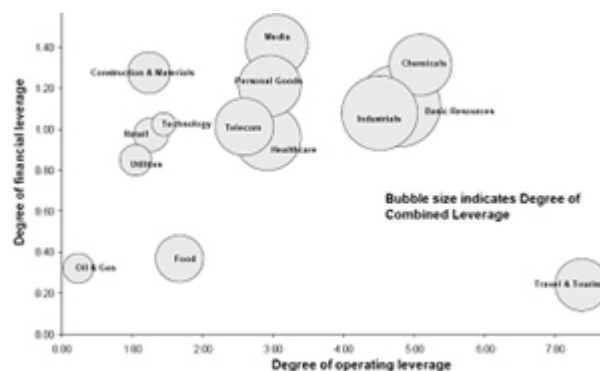
Long-term balance sheet quality

Healthcare and technology are again persuasive on long-term balance sheet quality, backed pretty much by the same arguments as above. The negative picture for the food industry is confirmed, while the argument holds for other defensive sectors. Narrow access to external long-term liquidity will make life difficult for construction & materials. Retail and distribution at least produces sufficient cash to keep net debt-based measures at bay, which to some extent holds true for industrials as well.



Operating and Combined Leverage

When looking at the impact of weaker sales on the P&L, lowering EPS via a high fixed asset base and financing costs, basic resources are clearly circled out, as well as industrials and also travel & tourism (Austrian Airlines). Construction & materials should see limited impact from operating leverage, but the higher indebtedness results in a corresponding high vulnerability on financial costs.



Sector allocation

Given the expected length of the economic downturn Erste Group analysts still stick to defensive sectors with the exception of food (Poland), but would add technology. They feel nevertheless more optimistic for oil & gas in the region - their mostly integrated business profile provides some shelter against oil price development and debt indicators do not paint a worrying picture.

Erste Group analysts still think it is too early to step into cyclical industries (except energy equipment). The only exception here would be on a stock-picking basis driven by the arguments of a technically motivated bear rally and for reasons as outlined in our special on potential M&A activities in 2009. The same rationale would apply to the real estate and financial services sectors, where some stocks are clearly being punished excessively for being part of their sector (CA Immo International, Vienna Insurance Group).

Country allocation

- Austria and the Czech Republic at Overweight. Assuming that CEE will keep its growth differential to Western markets, Austria as the CEE gateway should benefit from this as well.
- The Czech Republic without doubt is suffering from the downswing, with consensus forecasts still at about 5% EPS growth for the PX for 2009 and 2010.
- Poland continues to do well economically and the fear is that this is one of the markets that still has the most to lose. However, Erste Group analysts put Poland at the edge between Neutral and Overweight.
- Hungary is a different case, currently at really depressed levels and so things can surely only get better? Erste Group analysts have put Hungary at Neutral, which is admittedly a stronger bet.

- SEE remains Underweight, but Erste Group analysts would keep an eye on Romania. They do not expect any outperformance from Romanian equities, but the country could still have the power to prove certain more than bearish economic expectations wrong.
- Among the bigger non-EU markets in the region, Erste Group analysts continue to favor Turkey over Russia. Russian equities have the strongest potential of (volatile) short-term gains, though.

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