CEE companies generate double return on capital compared to Western counterparts

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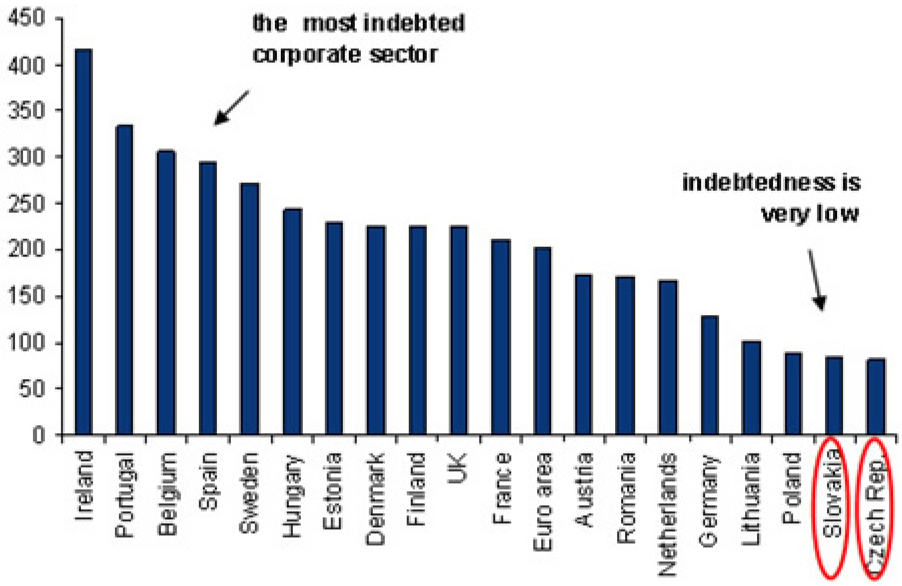
- CEE companies – more efficient and profitable, less indebted – as frontrunners in the competition for capital
- Slovakia and Czech Republic have the least indebted but most efficient non-financial corporate sector
- German corporate sector the only sector to compete with CEE companies in terms of operating efficiency

Central and Eastern European (CEE) companies are significantly less indebted, more profitable and generate double return on capital, also due to higher operational efficiency. Thus, CEE countries are more appealing in the race for capital compared to their Western peers. These are the main key findings of Erste Groups special macro report, assessing the operating efficiency of the different sectors in the economy (households, government, non-financial and financial corporations).

"Over the last decade, the non-financial corporate sector has been a net borrower in many European countries. Investments soared and boosted revenues, but, on the other hand, companies cumulated a huge pile of debt. Thus, the corporate sector had to rebalance too – by increasing the profitability of its business operations and deleverage (reduce the amount of debt)", says Juraj Kotian, Co-Head CEE Macro Research at Erste Group. "It is clear that the economic rebound in the next couple of years will rely on the corporate sector – whether it is competitive, able to efficiently utilize capital and create new jobs. Fortunately, CEE countries have been doing very well, as capital has been relatively efficiently utilized, generating about twice as high a return on capital compared to Western Europe (about 8%). Also labour productivity has increased in many CEE countries during the crisis, in order to preserve their competitiveness/profitability."

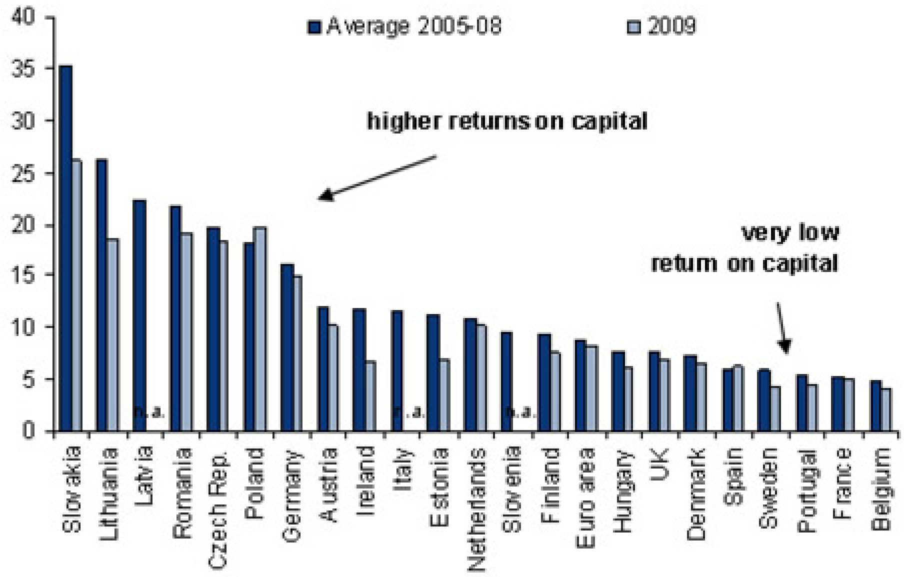
Gross debt as % of Gross Value Added
(non-financial corporate sector, 2009)



CEE companies significantly less indebted and more profitable than Western Europeans
Ireland, Spain, Portugal and Belgium have the most indebted corporate sector. Their gross debt totals about 300-

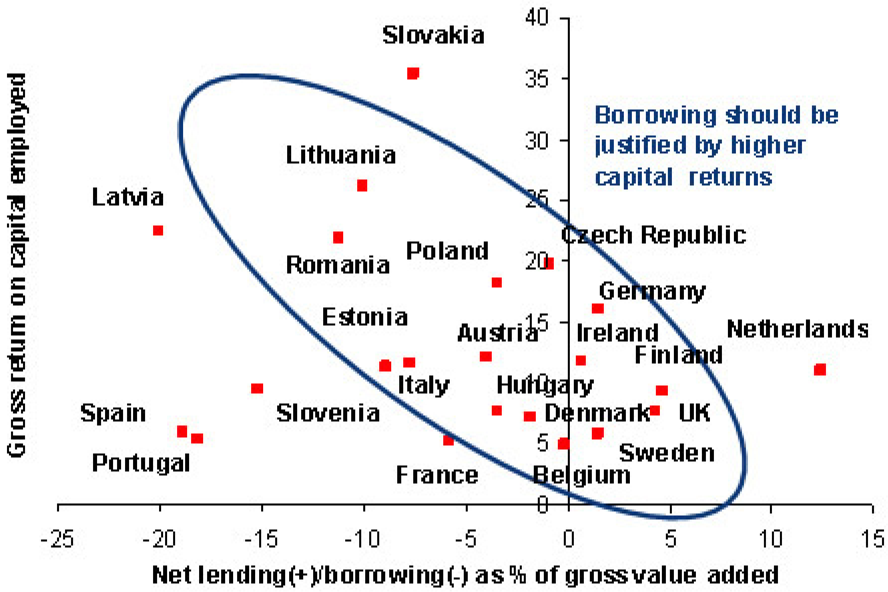
400% of the gross value added they produce and corresponding to 9-20 years net after tax profit. CEE companies are in general less indebted in terms of value added they produce and net profits compared to Western European economies. Thus, Slovakia and Czech Republic have the least indebted non-financial corporate sector with gross debt being lower than the value added they create in one year or corresponding to 3-4 years net after tax profit. From CEE only Hungary ranks above the Euro Area average. Kotian points out that "due to the implications of the global financial crisis, companies had to reduce their net borrowing(1). They have done so mainly through a substantial cut of investments (Baltic countries) and retaining a cash buffer or even a reduction of overall debt. A big reduction of the net borrowing ratio was already realized in the Baltic countries, Hungary, Romania and Slovakia, where non-financial corporations switched from net borrowing to net lending positions compared to other sectors."

Gross Return on Capital
(before taxes, non-financial corporations)



15% return on capital ratios reflects high operating efficiency in CEE
Looking at the efficiency of the accumulated capital, the results clearly show that despite the economic downturn, CEE companies have been producing much higher returns on capital(2) compared to their western counterparts. The most productive capital allocation in the non-financial corporate sector was registered in Slovakia, generating about 26% gross return on capital and 19% net after tax return on equity even during the economic downturn. In Western Europe, only Germany has been able to compete with CEE companies in terms of operating efficiency, with an average gross return on capital of about 15% and a return on equity close to 20% over the last five years. Belgium, Spain and Portugal were ranked at the very end, where return on capital has ranged about 4-6% over the last five years. The least efficient/profitable corporate sector in CEE was in Hungary (7% on average in 2005-09). Overall, there was a clear bias for countries with fixed exchange rates (Euro Area members, countries with pegged currencies) to borrow more than their return on capital would explain.

Gross return on capital vs. net borrowing of non-financial corporate sector
(average 2005-08)



Need for deeper structural changes and/or deleveraging

"Much higher return on capital partially justified the net borrowing of many CEE companies. For Spain and Portugal, this was not the case, as their low return on capital points to a less efficient capital allocation.", comments Kotian. Deleveraging has already started in Ireland, the UK, Belgium, Hungary, the Baltic countries and, surprisingly, in countries experiencing a strong economic rebound, like Germany, the Czech Republic and Slovakia, which could afford to pay off debt from their cash flow. “Given higher return on capital, CEE should stay attractive for capital inflows into the corporate sector. Much lower indebtedness and high return on capital enables CEE companies to take benefits from leveraging their balance sheets once their investments start to grow", concludes Kotian.

(1) Net-borrowing of non-financial corporations from other sectors of the economy and/or the rest of the world. Net borrowing/lending is equivalent to Disposable Income less Investments in Household Sector accounts and should roughly equal the change of financial assets and liabilities.

(2) Erste Group Research adopted methodology used by Eurostat in their reports for calculation of Return on Capital Employed and Return on Equity on the national level for the whole non-financial corporate sector.

Special Report

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