ERSTE Group

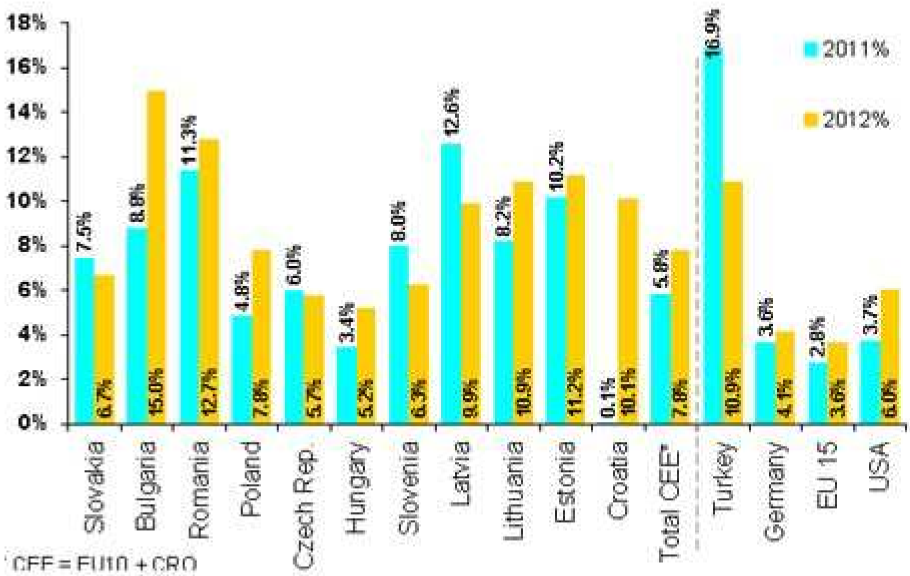
IT industry growth to propel 2012 economic development in Central and Eastern Europe

13.12.2011

- **CEE countries to post IT growth of roughly double their GDP in the mid to long run; EU cohesion funds will fuel public IT projects**
- **Sound IT spending between 8%-15% expected next year in Poland, Romania, Bulgaria and Croatia**
- **Key IT growth drivers: lower costs and higher efficiency; increased mobility and flexibility (cloud computing, smart phone & tablets, mobile network expansion)**
- **Small IT companies offering scalable solutions to be potential targets for M&A in CEE**
- **Top picks: ComArch offers the best risk/reward profile among our IT coverage, Sygnity has strong potential at a higher risk, Asseco Poland & Ericsson Nikola Tesla seen neutral.**

IT market expectations for 2011 and 2012 have been somewhat rebalanced lately due to growing fears of a spillover of debt issues from Western Europe. However, Erste Group analysts say that so far hardly any changes can be recognized in terms of IT spending behaviour. This fact is reflected in sound IT spending growth forecast for 2012, with countries like Poland (+7.8%), Romania (+12.7%), Bulgaria (+15.0%) and Croatia (+10.1%) are to lift overall growth rates.

CEE IT market set to grow by 6-8% in 2011 & 2012e

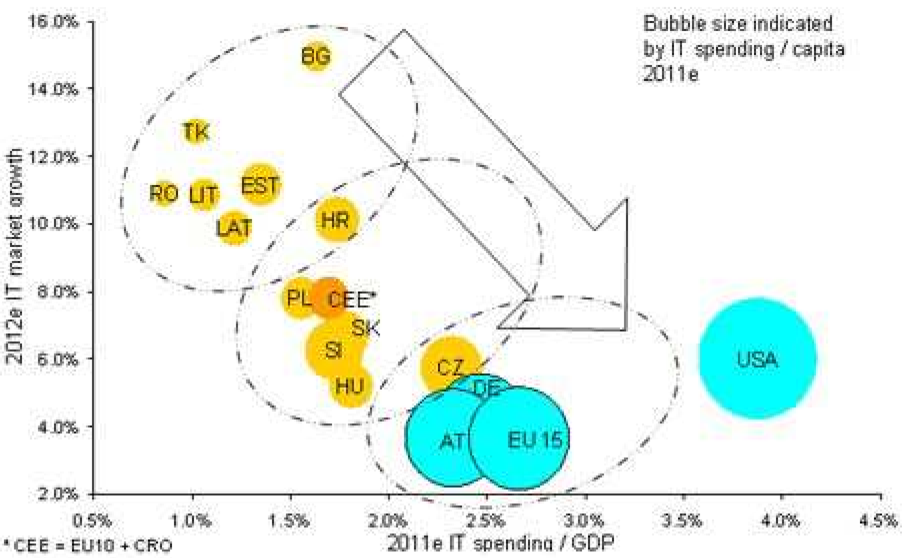


Source: European IT Observatory, Sept. 2011

"In general, CEE countries are expected to show IT growth of roughly double their GDP growth in future years, thereby at least narrowing the gap with their Western peers. It becomes obvious that EU convergence will still take years in most cases and drive IT demand in the region. Funding is thereby supplied by EU Cohesion Funds, which are used both for public IT projects as well as company-related IT investments'', emphasizes Daniel Lion, CEE Technology analyst with Erste Group Research and author of the report.

“We need to differentiate between growth drivers for the IT sector in CEE: on the one hand we have fundamental drivers and on the other trend drivers. Convergence as the main fundamental driver will gradually help CEE companies and the public sector increase their IT spending; EU funds will fuel these investments. Trend based growth drivers include cloud computing, the need for higher efficiency, operational and strategic excellence. Exponentially increasing data volumes spur demand for faster mobile communication networks. Generally strong balance sheets (Low debt / excess cash) as well as the need to improve market position in a fast changing technologically dynamic environment will drive the M&A activity,” adds Lion.

CEE IT markets: higher IT spending growth rates help less mature markets to close the gap towards mature Western European peers



Quelle: EITO, IDC, Erste Group Research

In contrast to the main fundamental driver - EU convergence, a series of market trends have developed that are expected to back IT growth even in a negative environment. The drive behind most of these trends is mobilization and flexibility, of course also paired with lower costs and increased efficiency.

Growth driver No. 1: Cloud computing to be particularly attractive for SMEs and start-ups in CEE
The main idea behind cloud services is to rent IT-related services only when needed (e.g., software, business platforms, server space, etc.) instead of buying licenses and infrastructure (hardware), which call for an upfront investment. While the benefits are optimized costs and use of resources, it also increases flexibility and mobility.

The cloud’s advantages make it particularly appealing for small and midsized companies, as well as start-ups, given the lack of an initial CAPEX for licenses. Additionally, pay-per-use offers access to solutions that would have hardly been demanded under a license agreement, but now becomes attractive from a cost perspective. Also, costs for IT staff can be reduced significantly. Given the fact that SMEs are the backbone of the Central and Eastern European region, the acceptance rates for cloud services are expected to be high in CEE.

Growth driver No. 2: Mobile communication networks are forced to develop dynamically
Expanding mobile communication networks goes hand-in-hand with the dynamic growth of smart phones, tablets and Internet-based applications like cloud computing, machine to machine communication, video streaming, or data and voice communication. The recently-issued mobile traffic data report revealed that global mobile penetration is at 82% (or 5.8bn users), with an exponential mobile data increase just starting. While mobile data surpassed voice in 4Q09, it has already doubled voice in 1Q11. Smartphones represented 26% of mobile phones sold in 3Q11, but only about 10% of the installed base (i.e.total number of smart phones already in use), leaving a considerable upside to this trend.

Growth driver No.3: Increase in efficiency, operational and strategic excellence
The motivation behind this growth driver is the aim is to incorporate applications supporting higher efficiency at reduced costs. Another aspect of this growth driver is to implement management information systems that improve both operational as well as strategic decisions, which is crucial especially in a demanding environment. In this respect, e.g., the implementation of service oriented architecture (SOA) is aimed at optimizing companies IT landscape. Streamlining available applications by exploiting the entire set of information collected by various sources helps to reduce redundancies and increase efficiency at reduced costs. While the SOA approach has been targeted to on-premise systems (on-premise: hardware, software operated by the company using it itself), cloud computing can be seen as an approach providing additional features for further optimization.

Growth driver No. 4: EU funds fuel public IT projects
The current Cohesion Fund program is set for the years 2007-13, with a net worth of EUR 308bn; out of this, Poland is the biggest beneficiary in the EU, receiving EUR 65bn net overall and about EUR 1bn (PLN 4.4bn) related to IT. From 2014 on, there should be a new Cohesion Fund program, but, given the current political turmoil, there is some uncertainty attached to that.

While public procurement in the Czech Republic, which receives about EUR 6bn (CZK 150bn) of EU funds related to IT, makes continuous use of co-financing, with EU funds having already reached >10% of the total value, the Slovak projects aimed to be tendered under the funding program have been suspended due to the fall of the government. A list of tenders has been prepared in Slovakia, which now might be at best only delayed until the new government is in place (possibly March 2012). Romania has been provided with EUR 252mn for ICT projects, while for Croatia has given access to EUR 750mn for overall EU funded investments in 2007-2011. Other SEE countries also receive EU funding as pre-accession assistance (e.g.: Serbia ~ EUR 200mn p.a.; Montenegro ~ EUR 35mn; Kosovo ~ EUR 70mn).

Growth driver No.5: Low debt / excess cash will drive M&A activity
Given the highly-fragmented IT market in CEE, M&A activity should increase going further. In general, following the latest developments and announcements, acquisition targets are small companies with focus on scalable solutions/products (cloud computing). The usual candidates on the list of potential buyers are IT companies like SAP, Oracle, HP, Google, Software AG, IBM, while Asseco Poland Group is for the moment one of the dominant market consolidators in the CEE region.

Erste Group analyst's recommendation and target price overview

We have downgraded **Asseco Poland** from Buy to Hold. We believe that the fundamental undervaluation of the stock will remain as long as initiatives to set up a global focus within the group will not be introduced. Our target price has come down to PLN 52.5 from PLN 73.8.

ComArch's share price has come down significantly in the last year as the previously announced break-even of ComArch SuB has by far not managed. After another cost cutting initiative at the German subsidiary in 2011, chances for a break even in 2012 are favourable, which would immediately double EBIT. Given this strong leverage combined with hardly any downside we upgrade the stock to Accumulate from Hold. Our target price is at PLN 60.0, down from PLN 100.2.

Sygnity can, similar to ComArch, be regarded as an option, which will end up deep in the money in case the guidance holds. After 5 years of restructuring and streamlining, Sygnity needs to increase revenues for the operating leverage to kick and transform into a profitable company again. The lack of references of the newly introduced strategy leaves us with a Hold recommendation on the current share price level. Our target price has moved up to PLN 18.7 from PLN 13.2.

Ericsson Nikola Tesla has been exposed to a gradual decrease in spending into communication networks, especially on the domestic market and in CIS. As the region is about to roll out investments into the next generation mobile networks (LTE=4G) we anticipate the bottom in terms of spending to be reached soon. Our Hold recommendation is based on not knowing, from when on spending will pick up again. Our target price came down to HRK 1,176, from HRK 1,545.

Research Report [pdf; 1.8 MB]