

Separating wheat from chaff: CEE seen as a value-driven play

- CEE remains rather a value story, with reasonable growth rates attached
- Markets driven by sentiment, but start to differentiate between CEE and heavy-debt countries
- CEE investors' risk appetite decreasing; stocks with high target price upside preferred

To the burning question 'is a double dip in the cards?' Erste Group analysts give a negative answer, although, they point out, downside risks remain. At present, markets will remain extremely nervous and past experience shows that it might take some time before they start reflecting improving fundamentals. In this context, valuations and outlook present CEE as a value story for the moment. While many countries worldwide are caught in a catch-22 situation - how to reduce high debt levels without stifling growth - CEE has the comfort of not facing mounting debts. Growth rates overall appear to be flattening, which seems natural after the strong gains posted in the immediate recovery period. Nevertheless, while growth rates are stabilizing or even decreasing, they are still at reasonable levels.

In the current environment, sentiment is clearly driving markets, most likely resulting in stronger reactions than fundamentals would actually justify (as we already saw last year). Overreactions are dominating the market – both on the upside and on the downside. However, *“the good news is that markets are starting to differentiate, after a period in which CEE countries were overly beaten down by exaggerated comparisons with heavy-debt PIIGS countries. It might not help us out of the current sentiment trap, but at least it seems to be a step in the right direction, separating the wheat from the chaff,”* explains Henning Esskuchen, Co-Head of CEE Equity Research.

In 2Q, investors in the CEE region clearly reduced their risky stock positions, as high-risk stocks and small caps witnessed an underperformance. As shown by the price momentum factor, these were mainly stocks that showed strong gains in the months before. On the contrary, companies with high sales and earnings growth continued their outperformance. The best factor in 2Q was once again recommendations, with high target price upside stocks showing the strongest gains (+13%), while buys vs. sells alone showed an underperformance (-4%).

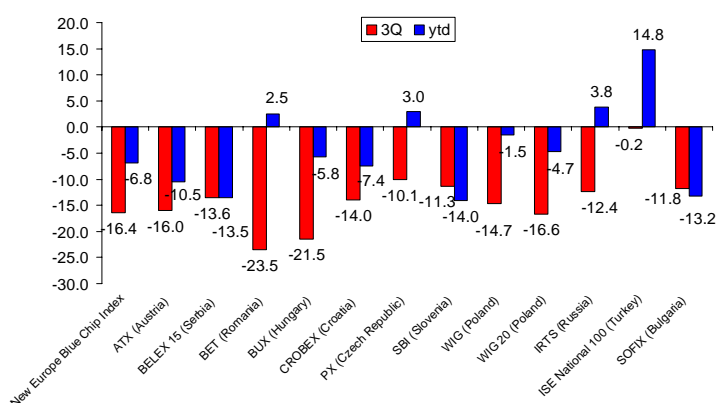
CEE is traded well below western markets, and posts a discount of 22% based on valuations relative to bond yields (Austria takes the lead, with a discount of 30%). PIIGS come in with better multiples on 2011 and 2012, but we see a risk in the implied growth rates (albeit from depressed levels). In particular, on the longer view, Latin America does not score well against CEE, with its weak implied growth outlook. Asia is also traded at a premium to CEE, while the change in valuation from 2011 to 2012 does not look too impressive. Finally, Africa comes in with quite competitive numbers, but (without being experts on this region) we would see some risks in areas such as corporate governance, etc.

Outlook

As was the case in recent stock market recoveries, such as 2003-05 in Europe, after the initial outperformance of high-risk equities (volatility, beta, gearing), growth stocks and companies that previously had above-average estimate momentum witnessed an outperformance. Looking ahead, Erste Group analysts believe that investors will prefer stocks that have a high target price upside. (This factor mainly incorporates stocks that have low valuations and growth potential.)

Country allocation

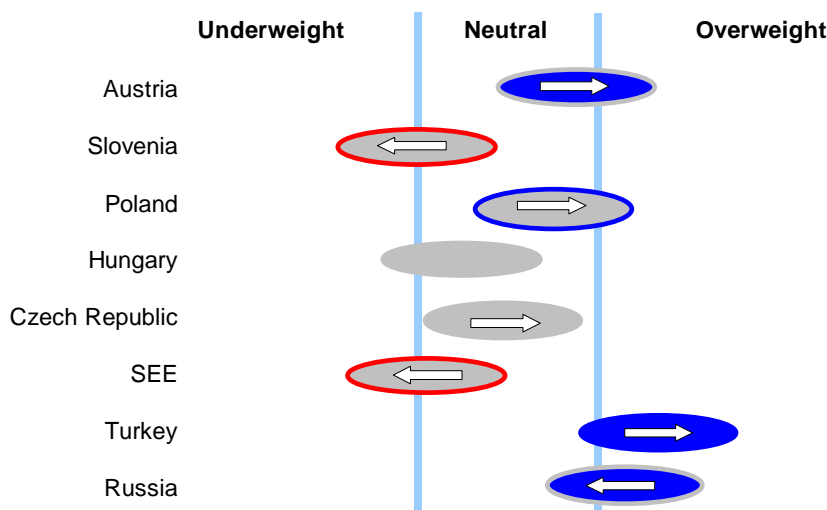
Performance overview (in EUR)



*3Q 2010 = 3month performance, close price 30.06.2010; Source: Factset Partners, Erste Group Research

- **Austria - neutral to underweight** The mechanical valuation model emphasizes valuation and growth as the main negative arguments. We are not able to follow this arguments, since valuations relative to bond yields indicate an implied undervaluation of 30% and earnings revisions have been gaining speed.
- **Poland - sound neutral.** The Erste Group allocation model mentions size as the main positive argument for the Polish market, while valuation contributes mostly to negative return expectations. However, implied valuations based on consensus numbers indicate an undervaluation of about 14 % for the WIG 20. Also on the growth side Poland is not as convincing, but still reasonable. Given the facts that domestic investors are back to giving a helping hand and the weighting of Poland in respective foreign equity funds has increased, analysts opt to improve the pure model outcome.
- **Hungary - soft neutral.** Growth is the main contributor to positive expected returns, while size is by far the biggest negative contribution. However, liquidity on the Budapest market has been improving. Valuations remain somewhat inviting, even though the Hungarian market has been quite efficient in pricing in any recovery expectation already earlier. A weaker picture of slightly deteriorating earnings revisions and of course things such as banking taxes should be holding the market back.
- **Czech Republic - neutral.** The model sees the strongest points in growth while liquidity is mentioned negatively for the market. Valuations are pretty inviting, ranking second after Austria. Growth rate appear to be still okay, but earnings revisions do not paint such a rosy picture.
- **Southeastern Europe - neutral to underweight.** While size has been the most positive factor of the allocation model, this argument is only acceptable, when assuming that any additional liquidity in these markets could have a higher marginal impact. Valuations are not too inviting, when compared to historical averages. Biggest risk is still on the macro side, with markets in this part of the region leaving recession last.
- **Turkey, Russia – both overweight.** The two biggest markets in the region should remain in the spotlight. We actually would still prefer Turkey over Russia, given the latters dependence on commodities. Admittedly, Turkey does not show as attractive valuations than Russia and might face some political tensions. Nevertheless, we opted to veto against the pure model outcome and put it aside with Russia to overweight.

Country allocation proposal



Source: Erste Group Research

Buy recommendations

	Current price (LC)	Target price (LC)	Rating	MCap (EUR mn)	Upside
Sojaprotein AD	783.0	1,406.0	Buy	57.2	79.6%
RHI	18.8	32.0	Buy	749.4	70.0%
Raiffeisen International	29.7	50.0	Buy	4,593.6	68.4%
CME	19.9	33.0	Buy	1,015.7	65.7%
OMV	24.2	38.0	Buy	7,230.3	57.0%
PannErgy	800.0	1,228.0	Buy	51.1	53.5%
BWT	18.5	27.3	Buy	323.2	47.4%
New World Resources	212.0	306.0	Buy	2,175.5	44.3%
Türkiye Sinai Kalkınma Bankası	1.8	2.6	Buy	635.2	43.7%
Semperit	26.9	38.0	Buy	553.6	41.2%
Krka	65.5	92.0	Buy	2,320.4	40.5%
CEDC	21.4	30.0	Buy	1,212.2	40.4%
Türk Telekomunikasyon AS	5.0	7.0	Buy	8,942.1	38.9%
Asseco Poland	53.2	73.8	Buy	920.6	38.7%
CA Toit	6.9	9.5	Buy	337.9	37.5%
Cersanit	13.6	18.5	Buy	468.9	36.5%
KGHM	88.5	120.0	Buy	4,246.4	35.6%
ACE	11.8	16.0	Buy	60.1	35.5%
Astarta Holding NV	58.8	79.2	Buy	352.7	34.7%
Kapsch TrafficCom	28.4	38.0	Buy	346.0	34.0%
Isbank	4.9	6.6	Buy	11,268.9	33.6%
Vienna Insurance Group	33.5	44.5	Buy	4,283.5	33.0%
Sparkassen Immobilien	4.9	6.5	Buy	333.1	32.9%
Mostostal Warszawa	67.9	90.0	Buy	325.8	32.5%
voestalpine	21.8	28.0	Buy	3,633.2	28.7%
conwert	8.4	10.7	Buy	677.1	28.1%
ArceLIK	6.6	8.4	Buy	2,260.8	27.3%
RFV	5,920.0	7,176.0	Buy	49.5	21.2%

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