

The emerging markets disease never fully developed in Central and Eastern Europe, writes Jane Grigson.

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Resilience in crisis pays off with tentative recovery

Central and Eastern European markets have shown remarkable resilience in the wake of the emerging markets crisis triggered in July 1997 by the devaluation of the Thai baht, escalated a year later by the Russian crisis. While the region showed early signs of contagion, the disease never fully developed and there are now signs of a tentative

recovery in the equity markets. The big remaining question is whether 1999 will be the turning point in terms of unleashing the longer-term potential for equity issues in the region.

Signs are encouraging. Last week the Czech government announced the sale of as much as \$575m (€558.25m) of shares in its state-

owned telecoms company. Jamie Stewart, head of equity capital markets at Austrian bank RZB, says: "Global influences – including low interest rates, a recovery in the oil price, a better outlook for some commodity prices, the relationship between bond and equity valuations, the positive momentum of the equity asset class, privatisation

trends and the growth in global capitalism – have all contributed to spurring progress in the Central and Eastern European markets."

However, the Russian crisis, economic slowdown in Germany and slow domestic reform have adversely affected external and budget deficits in the region and checked investment activity. Hungary's current-account



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deficit could total 5% or 6% of GDP this year, a figure that would fall outside most emerging market investors' comfort zone. In this respect Hungary is fortunate in that a large part of its privatisation programme is complete because the Hungarian equity market has underperformed Poland so far this year.

The secondary issue for Matav, the Hungarian telecoms company, for example, only just scraped through the door earlier this year, due to poor market sentiment. The country's burgeoning deficits overhang prospects for the planned \$100m IPO of Antenna Hungaria later this year.

But liquidity, not budget deficits, is the biggest obstacle to the development of a healthy new issue market in Central and Eastern Europe.

Michael Boardman, head of EMEA capital markets at Nomura, says: "Many new issues planned this year have been postponed or cancelled throughout the region as a result of what has happened in the market and investors being more selective." In Hungary, postponed issues this year include: OTP Bank – now expected in the third quarter – which at \$200m will be the largest issue this year; two electricity companies; software company Graphisoft; K&H Bank; and a convertible bond issue by Borsodchem. In Poland, PZU, the insurance company, has been put back this year.

There have been few exceptions to the dominance of large privatisation offerings and strategic sales, most notably the Polish media company Agora and the Hungarian IT company Synergon, both corporate issues which came to the market earlier this year. These represent a streak of entrepreneurial culture which remains rare due to the legacy of state ownership. "Since the Russian crisis, international equity investors have shown a clear preference for larger and more liquid issues rather than the smaller issues common before the summer of 1998," says Constantine Gontikas of equity capital markets at Credit Suisse First Boston.

The slowdown in IPOs in Poland in the past year can be attributed mainly to investor concerns over liquidity and the size of issues coming to the market. "Polish companies tend to be very small and undergeared and investors are increasingly concerned about liquidity, staying away from companies with a market capitalisation of less than \$100m," says Steve Pettyfer, a director in equity capital markets at Merrill Lynch. Last autumn's bumper \$930m flotation of state telecoms company TPSA broke every record in the book for Central European equity issues and investors are now eagerly awaiting the proposed IPO of Polish petrochemicals company Koncern Naftowy, which is expected to be the second biggest equity issue yet in the region.

One advantage of the Russian crisis is that it highlighted the sharp divide between Central Europe on

the one hand and, in the words of one analyst, "the wheeler dealer territories in the East". This has increasingly focused investor attention on Central Europe, with many seeing Hungary, Poland and the Czech Republic as convergence plays, with potential entry into the European Union within five years. Estonia and Croatia are not expected to be too far behind them.

Signs of convergence are already evident in falling bond yields in Poland, Hungary and the Czech Republic and the decoupling of their economies from Russia. Over two thirds of exports from these three countries now head west to the EU.

This has put pressure on governments in the region to loosen their regulatory stranglehold on state-owned companies. In Hungary Matav, the telecoms carrier, has already been sold off in a successful IPO in 1997 and in a secondary sale this year. The government looks likely to sell part of its stake in MOL, the state-owned oil company, this year and the sale of petrochemicals company Gideon and Richter is expected to follow by 2001.

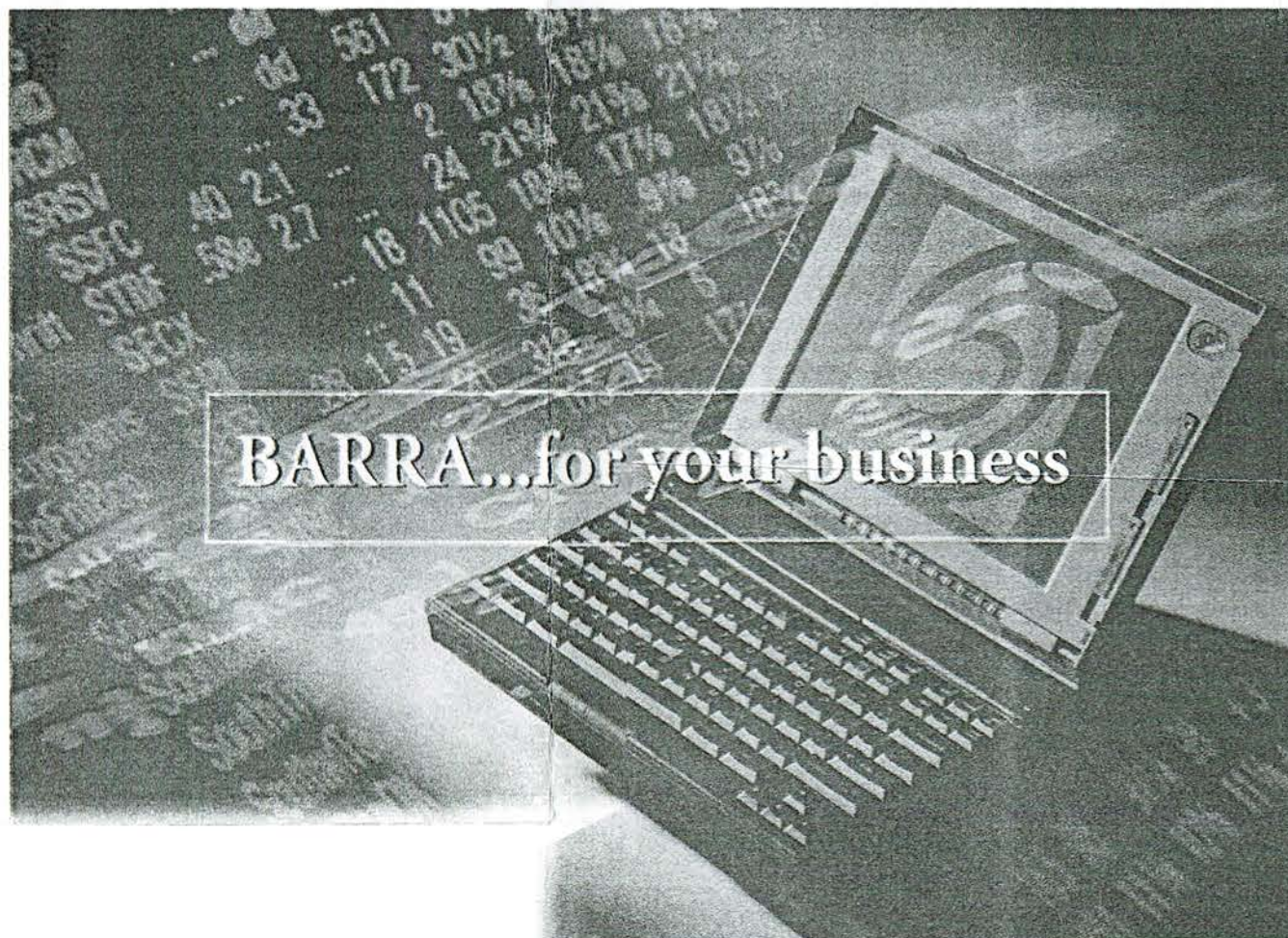
A string of financial crises has begun to usher financial capitalism into Central Europe, and many see the privatisation of banks in the region as crucial not only to the emergence of an equity culture, but to the restructuring of non-financial corporations. Foreign investment and competition could go a long way to filling holes in government revenue and rebuilding bank and corporate balance sheets burdened with bad debts.

RZB's Stewart says: "The Czech Republic has been held back by the slow progress of reform, but market prospects could turn around if the intended sale of the residual government stakes in the two largest banks succeeds." This has meant few private companies have achieved the requisite size to access the international equity market.

The case is similar in Croatia where slow progress in extending privatisations beyond the pharmaceutical company Pliva has resulted in a dearth of foreign investment and consequent lack of industry restructuring. Planned privatisations include Croatia Telecom, state oil company INA and three banks.

In the longer term, the development of pension funds will add significant liquidity to these markets. In this respect, Poland has an important advantage over other economies in the region; its huge market and potential pool of local investors. "The development of a domestic investment base, both institutional and retail, is crucial for bringing the markets of economies in transition in line with Western Europe," says Boardman.

The Polish government adopted a three-tier pension system at the beginning of the year. Currently just 5% may be invested in equities. Unleashing investable funds from debt to equity will provide a huge long-term boost to the market.



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