Emerging Europe investment
Why screen for qualitative risks?

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OTP Fund Management

Market leader in Hungary
➢ > 25% AUM – Euro 3.5 billion
➢ > 42% retail fund market – Euro 1.8 billion
➢ > 20% pension funds market – Euro 1.3 billion

Geographical expansion to Bulgaria, Slovakia, … Romania….Serbia, Croatia…

Funds under management 30 April 2005

- Retail: 1,848 Million Euro
- Pension: 1,309 Million Euro
- Other institutional: 349 Million Euro
Emerging Europe investment - context

• “convergence story” running up to and post EU accession
• In 2004 CEE grew at 5%, more than 2 x EU15 (inc. Romania and Bulgaria growth 5.5%)
• DowJones’ EU Enlarged TMI Index up 44% year on year in March 2005
• MSCI Emerging Europe up 25% in 2004
• Diversification benefits significant

• Yet CEE perceived to be a riskier investment
Correlation between movements in CEE indices and the S&P500

BUX - S&P500
WIG20 - S&P500
PX50 - S&P500
DJ EuroStoxx50 - S&P500
Bovespa - S&P500
Why screen for qualitative risks?

- Emerging Europe fund managers already do it
- **Rationale:** company stocks vulnerable to uncertainties stemming from macro-economic and political uncertainties
- **Investment process:** Top-down and bottom-up
- **Three key areas:**
  - Liquidity and volatility risks
  - Housekeeping risks
  - Plumbing risks
**Target: identify quality management**

- **McKinsey (2002):** *investors willing to pay a 30% premium for equity in well-run companies in emerging markets*
  - No fund systematically examines “next generation” social & environmental risks
  - ….and corporate governance analysis often superficial

- **Why?**
  - Not important? (x)
  - Low awareness? ✓

- Not so different from the majority opinion in Western Europe right now…
Why screen for qualitative risks in CEE?

• **EU aquis communitaire** - the most significant legislative & institutional change relating to environmental, social & CG issues since communist rule

• **Customer demand** – high education & increasing awareness – April 05 Eurobaromoter poll:
  - 7 of top 10 countries where respondents weighed environment most highly in CEE
  - In CEE, air and water pollution, man-made disasters (e.g. oil spills & industrial accidents) and waste management top the list
  - Only 2% trust companies on environmental matters
  - 40% would be willing to pay a bit more for eco-friendly products (vs. 29% in W Europe)
Gap analysis

- Environmental, social & CG regulations
- Corporate practice
- Probability caught & charged
- Level of penalty
- Risk
- Time
What are the key corporate governance risks?

History of shareholder abuse

- Excessive power of controlling stakeholders – including through “shadow” directors
- Inadequate Board independence
- Board advisory committees – lack professionalism and power
- Insider trading
- Poor remuneration disclosure
- The use of poison pills to deter takeovers
- Non-transparent intra-group relationships, especially auditors
• Deutsche Bank (2003) - premium higher in CEE than Western Europe
  - Top 10% of companies with respect to CG in the MSCI Emerging Europe and Middle East index outperformed the worst performers by 156% (price to BV).
  - Similar out-performance with price to earnings, price to cash flow, enterprise value to EBITDA, and return on equity.
• Out-performance stronger than in Latin America or South Africa
What are the environmental risks?

- Rapid increase in regulatory and legislative risk
  - Water management
  - Waste management and recycling
  - Air emissions (excluding greenhouse gases)
  - Climate change and energy use
  - Biodiversity impacts
  - Environmental liability
  - Public procurement
  - Product stewardship
- “Corporate Readiness for Enlargement in Central Europe” (2003)
  - “moderate” corporate compliance with EU environmental law
- NMS must invest > Euro 72 billion to meet water, wastewater, waste management and air pollution requirements
- **Fines ⇒ corrective actions ⇒ closure**
Map 1  Recurrence of flood events in Europe 1998–2002

Source: ETC/TE, 2003 (based on NASAsupported Dartmouth Flood Observatory/Digital Elevation Model (GISCO)/Rivers (GISCO)/Watersheds 1M (JRC-IES) / Administrative boundaries (GISCO)).
What are the social risks?

- Size of informal economy: pension and social security problems
- Lack of formal labour relations
- Health & safety at work: longer and less flexible working hours; exposure to stress
- Discrimination: Roma, age, disability and gender – internal & supply chains
- Underdeveloped customer responsibility
- Bribery, corruption and nontransparent political contributions
- Low awareness of broader stakeholder community
In 2004 a middle manager for the discount grocery chain, Biedronka, sued her employer for unpaid overtime

First ever such suit in Poland

Case went to appeal, and in May 2005 awaiting final verdict

Case worth Euro 8,500, but other staff suits against Biedronka total Euro 24 million

Senior management face criminal investigations

The aftermath:

- Carrefour (70 cases), Auchan (30), Geant (30), Tesco (around 20), Real (10), Leclerc (2)
- Sharp increase in sexual-harassment cases
What about the opportunities?

- Missed opportunities - the flip-side of risks
- Not just about avoiding the rotten apples, but identifying the “Golden Delicious”:
  - Improved management – training & proper corporate governance
  - Eco-efficiency improvements
  - Improving labour productivity through training and better working conditions
  - Competitive advantage – private & public procurement (0.2-1.3% GDP environmental expenditure in 2002); brand development; customer loyalty (17% will take account of environment in making large purchases)
  - Increased access to capital – driven by self-preservation and pressure from EIB and EBRD
Recycling is big business...

- 4.1 tonnes of total waste per capita are generated in CEE, markedly more than the OECD average (ca 2.2 tonnes)
- Packaging recycled target: 55-80% by Dec 2008 – currently around 30% (Hungary)
- End of Life Vehicles (ELV) directive - car manufacturers and importers must recycle 80% cars by January 06 (currently for cars sold after 1980 – o.w 70% target)
- Proposed Battery Directive – 100% of collected batteries recycled within 1 year after published in OJ
- Waste Electrical and Electronic Equipment (2002/96/EC) – between 50-80% recycling (by item type) by Dec 2006
Our vision

**Product:** Emerging Europe SRI product

**Structure:** Stand-alone and Fund of Funds (emerging market, Pan-European)

**Style:** Alpha-enhancing &/or ethical

**Geographical scope:** Baltics, Czech Republic, Croatia, Hungary, Poland, Romania, Slovakia, Slovenia, and possibly Ukraine, Russia & Turkey

**Market:** International – Western Europe and CEE