



## Deals of the Year 2009 - Riders on the storm

Guy Norton in London

Given the global economic downturn of the past 12 months, 2009 won't be fondly remembered by too many people across emerging Europe and beyond. But in a year when the going got tough, the tough got going. As a result, 2009 boasted a series notable of financial transactions that demonstrated Central and Eastern Europe can still attract precious capital from across the globe.

*bne's* inaugural "Deals of the Year" poll canvassed opinion from issuers, investors and investment banks across the region, and the results clearly show that in the face of challenging market conditions, a wide range of countries, companies and banks were able to triumph over adversity.

On a general level, therefore, most countries in the region were able to re-access the international financial markets, if only on a modest scale in many cases. While 2010 won't be an easy year by any stretch of the imagination, the successes of 2009 point to the fact that in capital market terms this year won't be a write-off either.

### Poles apart

Prime among the winners is Poland, which on both a sovereign and a corpo-

rate level showed that it was made of the right stuff in 2009 and spawned a gamut of noteworthy transactions as a result. Russia also put in a strong showing last year, with a string of landmark deals, which demonstrated that while the Russian economy may have been bloodied, it remains largely unbowed and a number of its corporates remain go-to names for both debt and equity investors.

Poland proved to be the standout sovereign in CEE in 2009, enjoying great success in both the debt and equity markets. Thanks to a proactive approach – **Poland** reopened a number of currency markets for CEE sovereigns last year – the country was able to leverage its reputation as the most successful of the major regional economies to sell more than \$8bn of bonds denominated in euros, dollars, Swiss francs and Japanese yen – more than double the \$3.5bn it raised in the international bond markets in 2008. "Poland knew beforehand that a successful programme of issuance in 2009 would require flexibility on issue timing, choice of currency and market and maturities. Its strategy of diversified issuance in previous years meant that Poland could weigh up the relative merits of issuance in all four of the core currencies – Japanese yen,

Swiss francs, US dollars and euros - and could prioritize those sectors where demand was strongest," says Vince Purton, managing director, debt capital markets at Japanese investment bank Daiwa SMBC. "And of course, by spreading the funding programme over four currencies, Poland avoided overreliance on any one area and achieved optimum funding terms, and has entered 2010 with all four investor bases keen to buy more paper this year too. Poland's 2009 issuance record is a text book case of highly effective debt management." Given the positive investor sentiment towards Poland at home and abroad as a result of it being the only member of the EU not to enter into recession in 2009, the government was also able to sell sizeable stakes in a number of companies on the Warsaw Stock Exchange, including the near PLN6bn (\$2.1bn) initial public offering (IPO) of power company PGE – the largest IPO in Europe in 2009.

In a year when the global economic downturn provided more than enough grounds for investment bankers to hit the bottle, a Polish corporate, booze distributor and vodka producer **Central European Distribution Corporation** (CEDC), supplied some much-needed cheer with a troika of transactions

Special Report:



Deals of the Year 2009

totaling almost \$1.5bn, earning it *bne's* "Best Corporate Issuer" title. First, it kicked off a highly successful year with two secondary offerings in July and November that raised more than \$500m. Commenting on the success of its equity deals, Christian Steffens, head of equity capital markets at UniCredit Group, says: "CEDC is a great name, the largest spirits company in Central and Eastern Europe, and a well-known story with investors given its listings in both the US and Europe. The two equity deals it launched represented a great opportunity to clean up its balance sheet and to build up the liquidity of its stock in Europe."

CEDC then notched up a noteworthy hat-trick with the launch of a \$950m high-yield bond – the largest such transaction from the region in 2009 and one which was heavily oversubscribed. More on that later.

On the fixed-income front, Poland's \$3.5bn, 6.375%, July 2019 Eurobond in July proved to be the cream of the crop in the sovereign bond category, with lead managers Barclays, Citigroup

scarcity value, thus attracting a diverse profile of investors. Over 400 accounts participated in the geographically diverse orderbook for the combined \$3.5bn offering. The US bought 59%, UK 21%, continental Europe 19% and Asia 1%. Real money accounts dominated the book with investment advisers/asset managers buying 76%, banks and investment trusts 12%, hedge funds 6% and pension funds and insurance companies 6%. "This deal really reestablished the Poland name in dollars," says the head of emerging market debt syndicate at Barclays Capital.

#### In good company

On the supranational front, the **Eurasian Development Bank's** (EDB) \$500m, five-year Eurobond in late September really grabbed investors' attention, with the EDB's debut dollar issue attracting more than \$5bn worth of orders. As a result, the bank, established by Russia and Kazakhstan in 2006, was able to tighten the coupon pricing on the deal from an initial target of 7.75% to 7.375% - the tightest yield yet for a borrower from the Commonwealth of Independent States (CIS)

in 2009. The deal, lead managed by Deutsche Bank, JP Morgan and Royal Bank of Scotland, also achieved the borrower's aim of achieving diversified distribution, both by geography and investor type. Geographical distribution was 42% US, 25% UK, 18% continental Europe and 15% Asia. Demand by investor type was 60% asset managers, 29% banks, 7% hedge funds and 4% insurance companies. "The transaction confirmed the renewed interest in the CIS from emerging markets investors and as the highest rated borrower from the region, EDB offered an ideal investment proposition," says Stefan Weiler, executive director, debt capital markets at JP Morgan.

Commenting on the blowout reception for the issue, Dmitry Krasilnikov, head of corporate finance and financial institutions at the EDB, says: "Everybody appreciated the fact we were a strong quasi-sovereign story of Russia and Kazakhstan, both of which have not issued internationally for a long time, and that we had a very high level of capital adequacy and liquidity. These two sets of factors, as well as the fact that despite the substantial oversubscription we decided not to increase our deal size, ignited broad investor interest in the issue and allowed us to tighten our pricing below the initially indicated levels."

On the corporate bond side, **Lukoil's** \$1.5bn Eurobond perfectly illustrated the extent of the recovery in investor sentiment towards Russia in general and Russian oil companies in particular, after oil prices had tanked in 2008. As a result, bookrunners Barclays, ING and RBS were able to attract an orderbook of almost \$7bn for the transaction, which was split between a \$900m, five-year and a \$600m, 10-year tranche. Altogether 410 accounts bought into the two elements, producing a well-diversified orderbook in terms of both geographic distribution and investor type. Overall, demand was split 30% US, 66% Europe and 4% Asia. Some 44% went to asset managers, 43% to banks and 13% to insurance companies, pension funds and other types of investors. Commenting on the reception for the issue, Jan Mutsaers, managing director, debt capital markets at ING, says: "Investors were impressed by the way that Lukoil has managed its business during the economic downturn in Russia, its high level of corporate transparency and its relative scarcity as a borrower." He adds that the combination of these factors not only enabled to raise far more than the \$1bn it was initially targeting, but also helped it price both tranches inside where comparable deals from state-owned Gazprom were trading – a notable achievement for a privately-owned oil company from Russia. The combination of five- and 10-year elements also proved a draw, allowing Lukoil to tap a wide spread of investors.

## "Everybody appreciated the fact the EDB were a strong quasi-sovereign story of Russia and Kazakhstan"

and HSBC drumming up more than \$8bn worth of demand for the original transaction. Consequently, the issue was upped to \$2bn from an initial target size of \$1bn-1.5bn and pricing was pared from 300 basis points (bps) over US Treasuries to 290 bps over. Demand for the deal was so strong that it was later increased by \$1.5bn at a tighter spread of 272 bps over. The transaction was Poland's first dollar benchmark in four years and provided clear proof of the scale of demand for well-regarded emerging market issuers such as Poland. As a rare, high-yielding issue from an investment-grade EU sovereign, the deal benefited from positive supply and demand dynamics as well as

### bne's Deals of the Year 2009

Deal categories	Issuer	Transaction (volume, pricing, bookrunners etc)
Best supranational bond	Eurasian Development Bank	\$500m 7.375% 2014 issue via Deutsche Bank, JP Morgan and RBS
Best local currency bond (any currency, any type of issuer)	Sistema	RUB20bn 14.75% 2014 via Renaissance Capital and Sberbank
Best sovereign bond	Poland	\$3.5bn 6.375% due July 2019 Barclays, Citigroup and HSBC
Best corporate bond	Lukoil	\$1.5bn 2014 and 2019 bonds Barclays, ING and RBS
Best high-yield bond	CEDC	\$380m and €380m issues via Goldman Sachs, Citi, Deutsche Bank
Best convertible bond	Evraz	\$650m 7.25% 2014 via Goldman Sachs and Morgan Stanley
Best overall IPO (domestic/international)	PGE	PLN6bn UniCredit and Goldman Sachs
Best international IPO	Exillon Energy	€62m via BofA Merrill Lynch and ING
Best domestic IPO	PGE	PLN6bn UniCredit and Goldman Sachs
Best overall secondary offering (domestic/international)	Magnit	\$527m via VTB Capital and Morgan Stanley
Best international secondary offering	Magnit	\$527m via VTB Capital and Morgan Stanley
Best syndicated loan	MDM Bank	\$250m equivalent Calyon, ING, RZB, Standard Chartered Bank and VTBD
Best restructuring deal	Naftogaz	\$1.59bn via Credit Suisse
Best overall M&A deal (domestic/international)	CVC	\$2.2bn purchase of AmBev breweries. Barclays Capital and Lazard acted as financial advisors to AB InBev and Clifford Chance acted as legal advisor. Freshfields acted as legal counsel to CVC
Best private equity deal	CVC	\$2.2bn purchase of AmBev breweries. Barclays Capital and Lazard acted as financial advisors to AB InBev and Clifford Chance acted as legal advisor. Freshfields acted as legal counsel to CVC
Most innovative transaction (any asset class)	HSCI	RUB143.5m IPO via Alor Invest
Best infrastructure deal	R1 Motorway	€980m

"This was the standout corporate trade of the year," says Mike Elliff, head of emerging market debt origination at RBS. "This was a true market-placed issue from a borrower with scarcity value." Brown at Barclays adds: "Investors wanted renewed exposure to corporate Russia in a good size and at a good price, and this Lukoil deal provided that."

On the high-yield bond front, new issue activity revived in the last few months of the year, with a bevy of deals from the likes of Polish broadcaster TVN, regional broadcaster Central European Media Enterprises and Croatian retailer Agrokor. The pick of the bunch though proved to be the \$950m equivalent deal from Poland's CEDC. Bookrunners Goldman Sachs, Citigroup and Deutsche Bank were able to quickly build a strong orderbook for bond, enabling them to increase it by \$79m from the original target size. Overall, the book was more than three times oversubscribed, with just under 300 accounts across the two tranches. Roughly 80% of the euro book went to high-yield long-only funds, with most of the rest going to emerging markets funds, alongside a small bid from retail investors. The dollar book was almost entirely institutionally focused, with around 70% going to high-yield funds and 30% to emerging-market accounts.

Commenting on the reception for the issue, William Carey, CEDC's founder and chief executive officer, tells *bne*: "We are the largest vodka producer in the world, so we have an unquestionable leading position in our industry. For years we've been delivering strong and stable results and we've met the guidance we set up. With the work we have done in Poland and Russia to restructure our business, develop our brands and cut costs, we have prepared CEDC Group to come out from the crisis a stronger company, ready to benefit from the improving demand, as soon as positive changes appear." He adds that the fact an important part of CEDC's business is located in Poland, which has come through the global financial crisis exceptionally well, was a definite plus from an investor perspective.

The local bond markets across CEE proved to be risky places to be in the early part of the year, nowhere more so than in Russia, where a combination of currency weakness and increasing default risk proved to be an unpalatable mix for investors. But by the time Russia's leading conglomerate Sistema came to market in late August with a RUB20bn bond via Renaissance Capital (RenCap) and Sberbank, there were clear signs of a recovery in the Russian market. Consequently, **Sistema** was able to launch what proved to be the biggest corporate issue of the year in Russia, thanks to strong demand from a mix of Russian and overseas investors, split 70% commercial banks and 30% asset managers. As a result, the five-year deal, which features a put option after three years, was priced at 14.75%, 20 basis points lower than the initial price guidance of 14.95% - particularly impressive given that the spreads on most first-tier and second-tier issues in the Russian bond markets had widened by 25 bps to 70 bps when the deal was marketed to investors. The deal also signaled how a growing number of Russian corporates sought to manage the foreign exchange risk elements of their debt portfolios following the managed devaluation of the rouble at the start of 2009. "Russian issuers are becoming more and more sophisticated about risk management in terms of looking to mitigate factors such as foreign exchange," says Dimitri Sredin, head of debt financing at RenCap in Moscow. "All the top Russian names want to issue in roubles and we expect the market to improve further... in terms of the level of investor demand and the pricing for issuers."

In a year when a number of debtors - most notably Kazakh lenders BTA and Alliance Bank - dismayed creditors with the miserly terms of their restructurings, the Credit Suisse-led restructuring of Ukrainian energy company **Naftogaz's** debts won nothing but praise for the way that it successfully met the expectations of a variety of creditors. Naftogaz effectively exchanged its entire foreign bond and loan liabilities into a new \$1.6bn Eurobond, guaranteed by the Ukrainian

government, which ultimately created a sovereign risk instrument deliverable into a corporate CDS auction - a world first. When Credit Suisse was mandated to restructure the firm's debt in structure, it knew it would have to design a process that would address the requirements of both hedged and unhedged investors with exposure to Naftogaz through a variety of different assets. "With the completion of this transaction and the subsequent CDS auction, substantially all foreign currency bond, loan and CDS exposure to Naftogaz has been removed from the market," says Andrew Burton, director, liability management, at Credit Suisse.

#### Driving convertibles

2009 also saw a renaissance in the convertible bond market, with Russian steelmaker **Evrax** stealing the limelight with its \$650m, 7.25%, 2014 issue via Goldman Sachs and Morgan Stanley in July. The transaction highlighted the fact that heavily indebted companies such as Evrax, which saw their access to the international bond and loan markets effectively barred for most of 2009, were able to turn to equity investors in the search for much-needed capital for debt repayment purposes. The convertible was launched in conjunction with a \$315m placement of global depositary receipts (GDRs), which made the deal the largest equity transaction from Russia in more than 18 months and revived hopes that Russian issuers will return to being the major players in the international equity markets they were before the onset of the credit crunch. Although Evrax is far from out of the woods in terms of servicing its \$8.5bn debt burden - in November the bank had to pay investors to agree to covenant changes on \$750m of bonds maturing in 2015 - bankers at Goldman Sachs and Morgan Stanley deserve praise for convincing investors to part with the best part of \$1bn to at least ease Evrax's leverage problems.

On the equity capital markets stage, Polish power company **PGE** (full name: Polska Grupa Energetyczna) proved a star performer, with its PLN6bn (\$2.1bn) IPO via Goldman Sachs and UniCredit on the Warsaw exchange

more than seven times oversubscribed. PGE's transaction was the largest IPO from Europe in 2009 and one of the highlight deals in a very successful year for the WSE, which witnessed over 20 new issues in 2009. The deal was priced at the top end of the pricing range of PLN17.5-23 per share and enjoyed a successful debut on the market when its stock rose 16% at the open, lifting the market capitalization of Poland's largest electricity provider to PLN44.96bn, making it the biggest company listed on the exchange. "We offered investors a chance to invest in a company that is a key to Poland's energy sector," says PGE chief executive Tomasz Zadroga.

PGE is Poland's largest producer, generating 42% of its energy. The IPO also

## "Poland proved to be the standout sovereign in CEE in 2009 and reopened a number of currency markets for CEE sovereigns"

marked the latest in a number of asset sales by the Polish authorities, which have enjoyed an enthusiastic reception from both retail and institutional investors at home and abroad. Commenting on the success of the deal, Christian Steffens, head of equity capital markets at UniCredit Corporate & Investment Banking, says: "PGE is considered by many to be the best utility in Poland. It was important for the PGE deal to be a success as it would create a positive slipstream for the other power utilities Enea and Tauron that will follow it to market in 2010." He adds that in addition to the strong demand from Poland, which accounted for 70% of the book, there was also keen interest from abroad. "For insurance companies and pension funds that are seeking exposure to Central and Eastern Europe, this is the stock to hold."

International IPOs from emerging Europe were thin on the ground in 2009, but the £62m offering by oil producer **Exillon Energy** gave investment bankers some pre-Christmas

cheer in December when it listed on the London Stock Exchange, selling 40.5m shares at 153 pence each. The share sale, which represented around a 30% stake in the company and valued it at £192m, was lead managed by Bank of America Merrill Lynch and ING. Although registered in the Isle of Man and headquartered in Dubai, Exillon's core operations are in Western Siberia and Komi regions of northern Russia, and so as such it represented the first foreign listing from Russia since 2008. Exillon will use the cash to fund the full acquisition of production licences and develop drilling projects up to 2011. "Although at an early stage of development, Exillon attracted a high-quality book of investors that bought into the fact the company is cashflow genera-

tive and largely debt free," says Chris Goodman, director, equity capital markets at ING. The investor base was largely composed of sector-specific oil and gas funds, supplemented by specialist emerging market buyers, principally from the UK alongside some US interest.

On the secondary offering front, Russian supermarket chain **Magnit's** \$527m transaction via Morgan Stanley and VTB Capital in October proved to be the star attraction of the year, fighting off competition from a bevy of smaller deals from independent oil and gas companies in Russia and Kazakhstan. Magnit's budget supermarket format has proved a hit with cash-strapped consumers in Russia and Magnit is using the proceeds from the share sale to further expand its network, which with more than 3,200 stores is already the biggest in Russia. With less money in their pockets, Russians have traded down from expensive imported food products to the cheaper Russian made goods that Magnit sells en masse, mak-

ing Magnit one of the few companies in Russia to maintain not only its headlong growth but to keep its expansion plans in tact. "We are an ugly duckling story," says Magnit director Oleg Goncharov. "We went from a wholesale operation in a small regional town 15 years ago, to one of the fastest growing retail operations, not only in Russia, but the whole world." Magnit posted net retail sales of RUB169.6bn for 2009, up 28.1% from the year before.

The offering, which took the form of Global Depositary Receipts combined with a pre-emptive rights issue, was the largest secondary share sale from Russia since the onset of the global credit crunch and attracted strong demand from both domestic and international investors. As a result, it raised far more than the \$300m initially targeted by the company's management earlier in the year.

While blockbuster IPOs by the likes of Russian aluminum giant Rusal may have failed to reach the markets in 2009, the **Human Stem Cell Institute** (HSCI) managed to steal some limelight for itself when it became the first Russian company to launch an IPO since the second quarter of 2008. Lead managed by local broker Alor Invest, the pioneering RUB143.5m (\$4.8m) deal, the first ever by a Russian biotechnology company. The IPO saw the sale of 15m shares, representing a 20% stake, sold at RUB9.5 apiece - the lower end of the RUB9-11 indicated pricing range. The shares were listed on the Innovative & Growing Companies (IGC) sub-sector of the newly created Innovation and Investments Market small cap segment of the Moscow Interbank Currency Exchange (Micex). According to Alor Invest, more than 300, predominantly retail, investors bought the stock. Commenting on the deal, Vladimir Savov, head of research at Otkiritie brokerage in Moscow, says: "It's encouraging that a small hi-tech company like HSCI has the guts to go to the market."

The HSCI placement comes at a time when the Kremlin is pouring billions of petroroubles into creating hi-tech industries to reduce Russia's perceived over-reliance on natural resources.

HSCI general director, Artur Isaev, the firm's largest shareholder, claims the IPO marks an important step in creating a dynamic new biotechnology sector in Russia. "In addition, the capital we raise will allow us to implement research and development projects to develop our own innovative and unique stem cell-based medications, which are aimed at treating blood cancer, heart attacks, and skin defects."

HSCI was founded in 2003 to advance projects in stem cell technologies. "According to our pessimistic scenario, we expect 40% annual growth in capitalization and revenues. But the main growth in capitalization will be driven by the launch of three innovative medications, the licenses for which may be worth hundreds of millions of dollars," Maxim Dremin, head of corporate finance at Alor Invest, says.

On the lending front, *bne's* "Best Syndicated Loan" deal of the year goes to the \$250m syndicated IFC B-loan facility for **MDM Bank**, which at the end of October was the first privately-owned Russian bank to sign an international syndication since the onset of the global credit crunch. Given the fears about growing non-performing loans in the Russian banking sector, for much of the year it looked as if the country's banks, and especially those without government backing, would be frozen out of the international loan markets. In the end though, MDM managed to break the logjam with its well-supported loan. Mandated lead arrangers on the transaction were Calyon, ING, RZB, Standard Chartered Bank, and VTB Deutschland. Altogether a total of 16 banks from 10 countries joined the facility, which was upped from an initial amount of \$175m due to an oversubscription. The World Bank's IFC arm acted as the lender of record for the loan, which will be used for trade-related financing and other trade-related projects undertaken by MDM Bank's customers. "We are very pleased to announce the first international transaction for a privately-owned Russian financial institution since the beginning of the financial crisis. The success of the transaction demonstrates the trust and confidence in MDM Bank

shown by the banks participating in this syndication," MDM Bank's chief financial officer, Vadim Sorokin, says.

The groundbreaking loan is a feather in the cap of the funding team at the "new" MDM Bank, which was created in August through the merger of retail banking-focused Ursa Bank and corporate banking-focused MDM Bank. The merged bank is the largest privately-owned bank in Russia by retail deposits and retail loans, and second by total assets and total capital. "Other Russian banks followed the deal very closely and we expect more to follow MDM's example," says Thomas Hädicke, head of primary loan distribution at RZB Group, adding that support from international financial institutions such as the IFC will play an important role in opening up the syndicated loan markets for borrowers from CEE.

#### M&A

*bne's* "Best Private Equity and M&A" deal of 2009 goes to **CVC Capital Partners'** acquisition of Anheuser-Busch InBev's (ABI) emerging European operations, which exemplified that the global giants of the alternative asset management industry are still taking the region seriously. In its first deal in emerging Europe, CVC stumped up an initial \$2.2bn to acquire breweries in Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Montenegro, Romania, Serbia and Slovakia. CVC will also brew and/or distribute Stella Artois, Beck's, Lowenbrau, Hoegaarden, Spaten and Leffe in CEE under license from ABI. "Among the key attractions of the AB Inbev's [Central and Eastern European] business are its fantastic portfolio of brands, leading positions in fundamentally attractive markets, and strong local management," says Istvan Szoke, senior managing director at CVC. "We are acquiring a business that already has a very good structure and model. We plan to build on the good foundations already in place." As part of the transaction, CVC raised around \$1bn of senior debt from a group of international and regional banks, demonstrating there is still strong lender support for the acquisition of well-run businesses in New Europe.

*bne's* "Best Infrastructure Deal" of 2009 is the financing for the **R1 motorway project** – the first ever public-private partnership (PPP) road project in Slovakia. The deal paired the European Bank for Reconstruction with a consortium of commercial bank lenders. The EBRD committed €200m, while commercial banks stumped up €780m, which will help cover the majority of forecast €1.3bn cost of the R1 motorway. The project will involve the construction of a 47-kilometre stretch of dual carriageway between Nitra and Tekovske Nemce and a 5.7-km northern bypass for the city of Banska Bystrica in the south west of the country, which has been awarded to the Granvia Consortium under a 30-year availability fee-based concession.

Granvia is a joint venture between France's Vinci Concessions (70%) and its Dutch Partner ABN Amro Highway (30%), which won a public tender hosted by the Slovak transport ministry in February 2009. Construction of the east-west road link has already started and is set to be completed by mid-2012. Commenting on the deal, Thomas Maier, business development director for infrastructure at the EBRD, says: "This is a landmark transaction in a time of crisis as it signals a return to the more normal functioning of the banking markets." He adds that while the EBRD had to step in to plug a funding gap for the project, the fact that €780m of the €1bn loan was still provided by commercial banks was testament to the financial viability of the project and the professional and transparent management of the Slovak authorities. As result the financing package did not require any sovereign guarantee. The R1 project is set to be the first in a trio of road PPPs in Slovakia, with construction of the D1 motorway link, which is likely to cost around €5bn, set to spawn two separate PPS and will likely require further support from the EBRD. "Although the banking markets are returning to more normal parameters, we would still expect to be involved in financing part of the D1 project," says Maier. ●

# OUTLOOK 2010

Russia  
Ukraine  
Central Europe  
Southeast Europe  
Kazakhstan  
Eurasia

# RUSSIA 2010: Slow build over first half to boom in 2011

Ben Aris in Moscow



Russia was undoubtedly far more affected by the international crisis that started in September 2008 than anyone expected – especially the Kremlin. It also stands out as the only one of the BRIC countries (Brazil, Russia, India, China) to show negative growth, leading to calls from the likes of analyst Anders Aslund to remove the “R” from BRIC.

"This is rubbish," Jim O'Neill, the man who coined the term in the first place, told *bne* at the 2009 International Monetary Fund (IMF) conference. "The only reason that Russia was hurt so badly was unlike the others, it borrowed heavily on the international capital markets and, of course, it is dependent on the price of oil."

The Russian economy contracted by a bit less than 9% in 2009, but as the year came to a close it was already starting to recover – six months later than analysts were predicting at the start of the year. However, despite the pain of the crisis, the prospects for 2010 are looking much better than many dared hope.

*bne's* annual survey of investment bank outlooks suggests that growth will return to at least 4% and possibly go as high as 6% by the end of 2010. Inflation will remain low at about 5%, while overnight rates at the Central Bank of Russia (CBR) will become real for the first time, finally giving the central bank a second tool to manage the economy and so be able to tackle Russia's twin perennial headaches of inflation and ruble appreciation more effectively.

Fixed investment will recover and could bounce back strongly (depending on what happens to oil prices), while FDI will continue to recover, not to the 2008 levels, but it will remain a constant addition to growth.

The oft-discussed problems of the reappearance of a budget deficit will be much milder than appears now, coming in at something under 5% of GDP. This means the Kremlin

will drastically reduce its international borrowing and has already cut the amount it needs to raise from \$18bn to \$10bn, but this could fall to \$5bn or even nothing at all if oil prices rise back to around \$80 per barrel, which most of the banks believe will be the average price for 2010. Indeed, the state will be able to raise all the money it needs to plug the deficit at home and pave the way for a return of private issuers to the international capital markets.

Finally, the RTS had a spectacular performance, rising over 120% in 2009 from its spring lows to end the year at about 1400. Unlike last year, the investment banks all agree that the index will end 2010 at around 1900-1950 and some say that it will reach and pass its all-time high of 2600 by 2011.

The themes for 2010 include: a turning inwards to growth driven by domestic demand, a push to introduce some real bottom-up economic reforms, a new focus on improving

"It is not just the economists and bankers that are feeling more confident about the future: the Russian people too have cheered up"

Russia's productivity, increased inter-regional crediting, a shift towards closer ties with China, consolidation within many sectors and most important a gradual reassessment of Russia's risk.

The collapse of the Russian economy in 2009 was dramatic, but emerging market crises are intrinsically less "sticky" than those in the West, largely because of the shallow penetration

of debt in all its forms into the economy. As Liam Halligan, chief economist at Prosperity Capital Management, points out, Russia's fundamentals remain extremely strong and stand out from the rest of emerging Europe. And despite spending \$200bn on rescue packages, the Kremlin still has \$400bn in the bank, which was increasing again towards the end of the year, and remains the third richest country in the world after China and Japan, against the US and UK, which are 18th and 19th with a bit more than \$80bn each. As the story going forward for the next several years will be all about the credit worthiness of countries, Russia finds itself, along with its newest buddy, China, in an enviable position.

## Economic optimism

As the Christmas holidays approached in 2009, there was a notable increase in optimism and even some talk of a "boom"

## Expected Optimism

### Changes to the Official 2010 Macroeconomic Forecast

	Revised version (Dec-09)	Budget version (Sep-09)	URALSIB forecast
GDP, YoY %	3.1	1.6	5.5
Industrial production, YoY %	2.8	1.4	8.2
Fixed investment, YoY %	2.9	1.0	6.1
Retail sales	3.3	1.5	5.3
RUB/\$ (average)	28.3	33.9	27.4
Exports, \$ bln	350.0	308.0	370.8
Imports, \$ bln	226.0	197.8	232.6
Urals crude oil, \$/bbl	65.0	58.0	71.5

Source: Economy Ministry, URALSIB estimates

or "equity market bubble" in 2010.

The government officially admitted the increasingly bright prospects for 2010 in the middle of December by significantly revising upwards many of the main indicators shortly after the 2010 budget was approved. The budget numbers have not been revised, which means – like every year – the government has built a healthy comfort margin into the budget that should leave it plenty of cash for discretionary spending.

The latest official expectation for 2010 GDP growth has been raised to 3.1% in response to higher oil prices and a stronger ruble. The average oil price was increased to \$65/bbl from \$58/bbl (which remains the official budget estimate), and the forecast of a capital outflow was revised to an expectation of a flat capital account. This resulted in a change to the government's ruble exchange-rate forecast for 2010 from RUB33.9/\$ to RUB28.3/\$.

And it is not just the economists and bankers that are feeling more confident about the future: the Russian people too have cheered up in the last months of 2009. After worrying that they would once again be the victims of a governmental screw-up, the number of Russians who believed that Russia

was doing well economically increased by November with 57% believing that Russia was doing well, or average compared to the rest of the world, while the number of people think it was doing badly fell from 43% in March to 39% in November, according to pollsters VTsIOM.

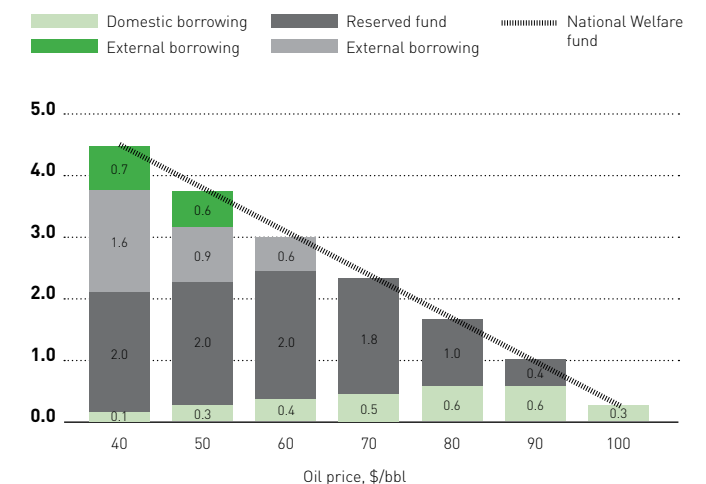
Liam Halligan with Prosperity Capital Management, one of the biggest portfolio investors into Russia, argues that Russia stands alone in comparison to the other CIS countries as its macro fundamentals are completely different from other countries in the region.

The one group that is not optimistic is the government. The Russian finance minister, Alexei Kudrin, said in December that Russia's economy would grow by 1.6% in 2010 and that it would take until the fourth quarter of 2012 for the economy to win back all the ground lost in the crisis.

Kudrin's estimates are clearly extremely pessimistic and he is erring on the side of caution. He set \$58 for a barrel of oil for the 2010 budget -- at least \$20 less than practically everyone else in the game (with the notable exception of Capital Economics). And Kudrin has been forced by events to upgrade several of his forecasts as 2009 came to end – not that the budget numbers were changed. Clearly the government forecasts are designed not to give their best guess at what is going to happen, but to build in a very comfortable margin of error so that there can be no nasty surprises in 2010. Likewise the IMF and its ilk are following a similar policy when it comes to forecasts as they also clash dramatically with the forecast private bankers are giving for the economic performance in 2010.

Kudrin was actually quoting the most pessimistic of the three scenarios developed by the Ministry of Economic Development and Trade, all of which are more pessimistic than the independent forecasts. ●

## Financing of the federal budget deficit



Source: Renaissance Capital

# UKRAINE 2010: The only way is up

bne

The crisis year was horrible for Ukraine, which was harder hit than nearly any other country in the Commonwealth of Independent States. The combination of collapsing steel prices, devaluation of the national currency, bank sector woes, political instability and, worst of all, mismanagement of public finances all contributed to the tumbling GDP.

In 2010, much depends on the outcome of presidential elections slated to begin in January, but that could take until April to come to a definitive conclusion. Much has already been written about how the various presidential hopefuls could affect the country's prospects, however, the conclusion of the elections itself is probably the most significant event, as all of the prospective candidates are pro-business. An end to the infighting would have the biggest impact on the country's prospects.

Ukraine's analysts are all in agreement that the economy will return to growth in 2010, albeit at a slower pace, and the stock market, which has recovered most of its losses, still has another 25% of upside over the year, driven largely by improving earnings that come on the back of economic recovery. Some are even more optimistic, as despite all its problems, Ukraine remains one of the most attractive investment destinations in the CIS. "We believe that Ukraine could well be the surprise performer in the first quarter. Elections in January will more than likely restore a government better able to manage the balance between the West and Russia. This in turn will ease tension over gas pipelines, and provide a government to which the IMF can reasonably lend. In this scenario, debt in particular looks attractive, with equity likely to follow the trend of declining spreads. We forecast 25% upside potential in the PFTS Index in 2010," say analysts with Renaissance Capital.

## Stock market

The PFTS Index was the worst performing index in 2008,

losing more than 50% of its value (against Russia's 46% fall). But it had a very strong run in 2009, up over 100%. "This is remarkable considering the degree to which the country has been buffeted by the crosswinds of default fears, gas disputes, a severe GDP contraction and uncertainty about the upcoming presidential election," says Renaissance Capital.

Like the other countries in the region, the PFTS had stabilised at the end of 2009, but share prices will track the economy upwards over 2010, with a possible sharp uptick following the elections, but smaller movements before hand.

## GDP and global recovery

Ukraine's economy was the hardest hit of any country in the region by the crisis, but it was already bouncing by the end of 2009. The recovery will continue in 2010, but at a slower pace than with the other countries in the region. The *bne* consensus growth is for 3.8% growth in 2010.

The vertiginous fall of the GDP in Ukraine was truly horrific: down 20.3% in the first quarter, 17.8% in the second, and 15.9% in the third quarter of 2009. Analysts estimate that the total decline for 2009 will come in at about 12-13%. "While the economic contraction continues to ease, there are few signs of a fully fledged recovery any time soon. Producer confidence remains low and private consumption is subdued due to falling income and uncertainty over the exchange rate," says Elina Ribakova of Citigroup.

UkrSibbank agrees and says that Ukraine will depend on an export-led recovery, as consumers are too shell shocked to deliver much in the way of economic stimuli and the main source of support for the consumer sector has become government largesse. "Earlier in the decade, against the backdrop of rising exports, Ukraine became an attractive market, absorbing billions in debt and direct investment. This triggered a skyrocketing growth in domestic incomes and significant increase in wages. Since 2005, a large chunk



of growth was generated by domestic demand, accelerated by rapid increases in consumer credit. Since financial flows to the country collapsed last year, the growth pattern has turned upside down. Nominal wage has stumbled recently, pulled down both by sharp fall in corporate earnings and rising unemployment. Double-digit inflation gnaws real incomes," says UkrSibbank.

Clearly the fall was slowing as 2009 came to an end and the economy may return to growth, but most analysts assume it will take at least two years for the economy to regain all the ground lost in 2009.

Ukraine has also been plugged into the global demand recovery story more than most. With 50% of its GDP reliant on exports (especially steel), equity revaluation has been far more a function of global trends than domestic drivers. The official position is that the economy will grow between 3.0% and 3.7% regardless of what happens outside of Ukraine. "There will be a figure of 3% or a figure of 3.7%, and compared to the fall that we have in 2009, this figure is really achievable no matter how the situation develops," Economy Minister Bohdan Danylyshyn said in December.

## Retail and consumers

Retail has also risen a little over the year from first-quarter lows, but the increases are in line with the small rises in income over the same period so no momentum is being built in this sector and growth remains a function of state largesse. "The retail trade has shown stable month-on-month growth since May (with September the only exception), but the year-on-year decline, at -20.7%, is still very large. In our view, the population is not ready to spend its accumulated savings (outside the banking system) in light of uncertainty about further income, mainly, in turn, reflecting uncertainty surrounding the upcoming presidential elections in January," says Renaissance Capital.

Analysts estimate that the population is holding some €55bn in cash outside the banking system and remain reluctant to spend this money until some clarity about the future appears.

Ukraine's consumers are in a much more difficult position than their Russian counterparts as about half of the mortgage borrowing was done in dollars. The devaluation of the national currency has significantly increased the cost of repaying those loans as well as putting extra pressure on the banks and exacerbating the non-performing loans problems. Together these problems will hold back the recovery of both consumption and consumer lending.

## Industrial production

Industrial production recovery remains tied to the recovery of commodity prices – and especially steel. However, while steel prices are up, analysts are unsure about the sustainability of the increase.

Industrial production recorded contraction of just 6.2% in October 2009 comparing to nearly 30% decline earlier this year. There are two fundamental factors driving the industrial recovery – an improvement in global demand and weakness of Ukrainian currency, which allows domestic companies to reap more benefits from global growth.

Metallurgy, currently representing about 20% of Ukrainian industrial production, has been the key recovery driver so far, creating demand for coke, ore and electricity. It will remain the backbone of the local economy in the mid-term, but it's also the most dependent on global trends.

The food industry is a bright spot both from the perspective of export capacities and strong local demand. The sector offers prospects provided that necessary capital and technology would arrive there on time. Local currencies of Ukraine's neighbours appreciated versus the hryvnia, creating exports opportunities to the EU and Russia, a large market with population over 150m. Food industry key problems are painful de-leveraging, which froze investment projects across the industry, and some delays with certification of Ukrainian foodstuffs resulting from insufficient quality of inputs.

## Investment

The contraction in capital investments is even greater than those of the sectors and the lack of investment will remain a drag on recovery. Capital investment was halved over 2009 and until the political uncertainty is resolved there is little prospect for its recovery.

Investment is well positioned to increase in 2010-2011, but this is subject to structural reforms that Ukraine has yet to begin. Currently investment is very modest, representing only UAH22bn, or close to 11% of country's GDP. It is well

"We believe that Ukraine could well be the surprise performer in the first quarter"

below the emerging market average of 30-40% GDP. "Fixed capital investment contracted sharply, by over 57% on year in the first half of 2009, and we expect it will remain squeezed owing to the lack of credit and overall economic uncertainty. In turn, the government ability to stimulate the economy is limited by the considerable deterioration of budget revenues," says Citi's Ribakova.

## Inflation

In 2008, Ukraine was reporting the highest inflation rates in the region and amongst the highest rates in the world as inflation topped 31% in May 2008. The result of the crisis has been to depress demand and bring the rates down, but inflation remains high at an estimated 13-14% for 2009.

The central bank forecasts the rate will come down to 10% in 2010, but the government has promised several measures that could send the rate up again.

A social spending bill is in the Rada that would increase wages. Tymoshenko has also said that she will restart the payouts of defaulted deposits in Oschadny Bank. And the government has promised the International Monetary Fund (IMF) to hike domestic gas tariffs, which are half that the government pays Russia for the gas. "While delays in gas tariffs for households and heating companies should help to limit consumer inflation this year, we believe domestic gas prices will eventually be adjusted in accordance with IMF recommendations after the presidential elections, set for January. Combined with the expected expansion of social spending and wage indexation, as well as the high level of monetisation of the fiscal deficit, this should prevent consumer price inflation from dropping significantly," says Citi.

#### Budget

The budget has been whacked by the crisis and the government has done little to tackle the issue. Initially agreeing to pass a zero deficit budget for 2009 as part of the IMF deal to tap \$16.4bn of stand-by loans, the pressure of looming elections meant the government under PM Tymoshenko continues to spend freely. The IMF has proven to be incredibly soft on Kyiv (unlike its attitude towards the equally troubled Latvia) and finally the fund caved in to allow a 3% deficit.

"The IMF has proven to be incredibly soft on Kyiv"

However, the government overshot even this target and Citi analysts estimate that the deficit ended 2009 closer to 6%, but will fall to 4% in 2010. In fact, considerable confusion surrounds exactly what the government is spending and how the picture will look next year. Several investment houses in Kyiv have reported that the official reports on state spending are clearly wrong and it appears the government has been cooking the books in an effort to keep the IMF money flowing while it muddles through to the elections in early 2010. "While analysis of public finances is complicated by the lack of reliable data on budget execution, available information provides some grounds for concern. The economic crisis has resulted in a considerable deterioration of budget revenues. Given this trend, the revenue target could be a major challenge. While the state budget deficit reached UAH24bn during the first nine months of 2009 and is below the UAH31.2bn level budgeted for this year, data published by Ministry of Finance in compliance with cash accounting do not show growing volumes of VAT arrears and tax pay-

ments made by Ukrainian companies in advance," says Citi's Ribakova, in one of the more restrained comments.

This confusion is highlighted in *bne's* consensus prediction for the level of the deficit in 2010, which is 4.9%, but estimates range from 4% to 6%. Whatever it ends up at, it is clear the deficit is too high.

However, Ukraine's companies are not helping, as many are sitting on their tax money and tax payment discipline has broken down while the government is distracted with elections. While the state budget deficit reached UAH24bn during the first nine months of 2009 and is below the UAH31.2bn level budgeted for this year, the amount of VAT arrears had reached UAH20bn by October.

And even Citi analysts, who estimate the 2010 deficit to come in at 4%, say this is unlikely and the deficit will go much higher. One of the main unknowns is if the wage and social payments law that was passed at the end of 2009 is implemented, then the minimum wage will be increased by some 40% over 2010, adding UAH71bn to the budget spending bill, which would massively drive up the deficit unless some new sources of financing it can be found.

#### Balance of payments

Ukraine's current account has registered a deficit for the past three years, reaching a peak of \$11.9bn in 2008. This reflected significant growth in consumption of goods other than commodities, while imports of oil and gas comprised only 10-15% of total imports. Exports of ferrous metals amounted to about 40% of total exports. The trade balance in commodities was in surplus in 2008. 2009 saw a sharp drop in non-commodity imports thanks to a collapse in demand that has brought the balance of payments into balance and the country was even showing a small surplus in the last months of 2009, says Renaissance Capital.

#### External debt

Ukraine has built up significant amounts of external debt in 2009 as it cast about for ways to pay its gas bill. In all, it has to repay some \$40bn in 2009 – equivalent to the country's hard currency reserves and then some. However, the state did manage to restructure some \$19bn of debt repayments and the fears of an impending default receded in the last months of 2009 – a trend analysts expect to continue through 2010.

The Eurobonds redemptions schedule in 2010 will be tight for the corporate and banking sectors, while the sovereign area has a year-long pause till December 2010. Total volume of redemptions in 2010 will be approximately a third less than in 2009 that would result in -\$6.3bn of net repayments. According to "Fundamentals of monetary policy for 2010" published by the central bank, total payments on external debts in 2010 are estimated at \$20.3bn, more than \$18bn would make payments on corporate debts, around \$2.3bn payments on state and state guaranteed debts, says UkrSibbank.

Concorde Capital thinks that the level of total external debt will fall slightly in 2010 from 93% of GDP at the end of 2009 to 90% of GDP by the end of 2010. Renaissance Capital believes that the amount of external debt will fall faster in 2010 to about \$30bn, with the same high level of rollovers as in 2009. At the same time the pressure will be taken off by the resumption of FDI, of which \$4.5bn is expected to arrive and should pick up as the year wears on and investment sentiment improves.

#### Bank sector

The Ukrainian banking system has escaped the horror scenario for now. One important achievement is that it has survived a bank run and de facto collapse of three large banks, one of which was the leading financial institution in transactions and cash management. The consequences of this have been moderate, compared to what one could've expected, perhaps due to the low level of financial system development.

UkrSibbank says that the majority of top-tier Ukrainian banks had excessive liquidity as of the end of 2009 as deposit runs stopped in the summer and the willingness of domestic banks to generate new loans was very limited.

Money market rates have been low for the most of this year, reflecting strong cash preference by domestic banks. To some extent, this preference can be explained by a) unwillingness to lend to the real economy; b) strict conditions of NBU's refinancing loans (the central bank often demands additional restrictions); and c) there is no wide interbank market. New lending barely exists, and commercial loans are rare and expensive – the interest rates on new six-month to one-year loans are typically ranging from 25% to 30% and there is still very limited number of banks offering lending products as of the end of 2009.

Non-performing loans (NPLs) are a big problem and will get worse. As of the third quarter, total credit portfolio of local banks was at UAH747.8bn, while amount of provisions stood at UAH92.7 bn. UkrSibbank expects NPLs to reach 20% of the total loan portfolio which means full provisioning would require an additional UAH56.7 bn.

As of the third quarter, the capital of Ukrainian banks was at UAH118.0 bn. Subtracting additional provisioning would leave UAH61.1bn of net equity, which would be an equivalent of around 6.9% CAR. This compares to the healthy 15.6% reported in the beginning of October 2008. Given that some of the banks are extremely well capitalized (eg. state giant Oschadbank), the capitalization of selected banks could be significantly below the industry average. "Ukrainian banks should be able to clean the mess of troubled assets over the course of 2010, but some serious handicaps are there, including weak local legal system which allows borrowers to delay or even avoid cession of the collateral in some cases. Tier III and Tier IV banks are well positioned to be the first to restart lending as they are better capitalized than Tier I and Tier II financial institutions," says UkrSibbank. ●

"Non-performing loans are a big problem and will only get worse."

# CENTRAL & SOUTHEAST EUROPE 2010: Fragile – handle with care

Nicholas Watson



The consensus is that emerging Europe will recover in 2010, albeit at a slower pace than certainly other emerging markets, but also perhaps even than the US and Western Europe. However, this view encapsulates what has become a growing problem in looking at the region since the crisis exposed its many vulnerabilities – that it's now simply too diverse to regard as a single entity.

In its top 10 economic predictions for 2010, the consultancy IHS Global Insight says growth in all the emerging regions will recover in 2010 and, with the possible exception of emerging Europe, will outpace the US, Europe and Japan. "Non-Japan Asia will be at the forefront, with GDP growth of 7.1%. Latin America, the Middle East, and Africa will see gains in the 3-4% range. The laggard will be emerging Europe, which will expand only 1.7%."

The CEE region's generally high dependency on foreign credit made the effects of the global economic crisis, when it eventually arrived, that much worse. The forecasted decline in GDP for the ex-communist region as a whole – including the former Soviet Union – is more than 6% for this year, compared with 4% for the Eurozone. However, the European Bank for Reconstruction and Development (EBRD) notes that this regional average hides a multitude of variations.

Neil Shearing, emerging markets economist at Capital Economics, agrees with Global Insight's overall contention that Asia is best placed to prosper, followed by Latin America and Brazil in particular, with CEE continuing to lag behind. He also notes there will be some bright spots in emerging Europe, generally speaking those economies that have received a competitive boost from weaker exchange rates and have comparatively low levels of foreign currency debt. The losers will be those with fixed exchange rates and high external imbalances. Thus Central Europe, bolstered by Poland, will see its GDP contract by only around 3.5% in 2009, while Southeast Europe, where all the economies (except for Albania) entered recession, will likely decline 6.5%.

Danske Bank expects a contraction in CEE in 2009 of 7.5%, while most economies should grow in 2010 – the Baltics notably not until 2011 – though at just 0.8%, it will only be a fragile recovery. "There are large differences between the countries in the region, but in general the recovery will be fragile for most countries due to years of excessive spending and unsustainable credit growth rates," says senior analyst Lars Tranberg Rasmussen.

Those imbalances make countries particularly vulnerable to the kind of shocks delivered from Dubai World and Greece. Those two events might have been absorbed fairly well by the markets, but what will happen when the next shock arrives? And few doubt another will come – in mid-December,

"In case of another shock, the Baltics, Bulgaria and Hungary all remain worryingly exposed"

ber, the nationalisation of Austria's sixth-largest bank Hypo Group Alpe Adria put the focus firmly back on EU banks with large exposure to CEE. Capital Economics says it has long argued that the pressures facing CEE banks are likely to persist for some time. "While the rebound in global risk appetite over the past six months or so has helped to stem the outflow of capital from the region and ease tensions in interbank lending markets, it is still far too soon to sound the all clear," it says.

In case of another shock, the Baltics, Bulgaria and Hungary all remain worryingly exposed, with foreign debt levels that exceed 100% of GDP. Newsweek talks of a "quiet crisis brewing in Eastern Europe, where Bulgaria, Hungary and the Baltic states face staggering foreign debts in excess of their GDP." Capital Economic's Shearing says the rising sovereign

debt concerns on the back of recent events in Greece and Dubai even posed the question of whether investors should be worried about a government default in emerging Europe. However, "while recent developments suggest that it would be complacent to rule out such an event altogether, we think the prospect of an outright default remains fairly low down the list of challenges facing the region."

The crisis was a terrible blow for the region just as it was celebrating 20 years after throwing off the yoke of communism. However, that blow has been felt and absorbed differently by the regions within the all-encompassing CEE, and differently by states within those regions. As renowned investor Warren Buffett noted back in 2001, "You only find out who is swimming naked when the tide goes out."

Finally, East Capital, the CEE-focused investment firm, highlights a developing trend in the region where countries are not only recovering, but are about to enter a period of what it calls "more normal" development after the years of boom and now bust. "The main feature of this new 'normal' is growth in line with potential – rather than over potential – that is not based on low base effect or cheap credit, but rather on low

inflation, low positive real interest rates and political stability," East Capital says. "Most countries in the region are still in recovery mode and will remain so during the first half of 2010, before entering this new normal in the second half of the year." It adds that for some of the worst-hit economies in the region, such as the Baltic states, the recovery period will be longer.

East Capital identifies this normalisation trend in Russia, Turkey and Poland. "That these countries are normalising from a macro perspective does not mean that they are fully-fledged market economies, but it should send a message to investors that emerging Europe is moving in the right direction," it says.

### Poles apart

The country that has proved itself most during the crisis is Poland, which will be the only EU member state to record growth in 2009 and, indeed, will be one of the best performers in the world. Polish GDP grew by a stronger-than-expected 1.7% on year in the third quarter, putting the economy on course to grow by around 1.75% for the whole year.

**Selected Emerging European Economies: Real GDP, Consumer Prices, and Current Account Balance** (Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices <sup>1</sup>				Current Account Balance <sup>2</sup>			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
<b>Emerging Europe</b>	<b>5.5</b>	<b>2.9</b>	<b>-5.2</b>	<b>1.8</b>	<b>6.2</b>	<b>8.0</b>	<b>4.7</b>	<b>4.2</b>	<b>-7.6</b>	<b>-7.6</b>	<b>-2.7</b>	<b>-3.6</b>
Turkey	4.7	0.9	-6.5	3.7	8.8	10.4	6.2	6.8	-5.8	-5.7	-1.9	-3.7
Excluding Turkey	6.0	4.1	-4.3	0.5	4.5	6.5	3.8	2.5	-8.9	-8.9	-3.2	-3.5
<b>Baltics</b>	<b>8.9</b>	<b>-0.7</b>	<b>-17.4</b>	<b>-3.7</b>	<b>7.3</b>	<b>12.2</b>	<b>2.6</b>	<b>-2.5</b>	<b>-17.7</b>	<b>-11.4</b>	<b>2.3</b>	<b>2.6</b>
Estonia	7.2	-3.6	-14.0	-2.6	6.6	10.4	0.0	-0.2	-17.8	-9.3	1.9	2.0
Latvia	10.0	-4.6	-18.0	-4.0	10.1	15.3	3.1	-3.5	-21.6	-12.6	4.5	6.4
Lithuania	8.9	3.0	-18.5	-4.0	5.8	11.1	3.5	-2.9	-14.6	-11.6	1.0	0.5
<b>Central Europe</b>	<b>5.5</b>	<b>3.9</b>	<b>-0.7</b>	<b>1.5</b>	<b>3.7</b>	<b>4.6</b>	<b>3.6</b>	<b>2.9</b>	<b>-5.2</b>	<b>-6.1</b>	<b>-2.4</b>	<b>-3.1</b>
Hungary	1.2	0.6	-6.7	-0.9	7.9	6.1	4.5	4.1	-6.5	-8.4	-2.9	-3.3
Poland	6.8	4.9	1.0	2.2	2.5	4.2	3.4	2.6	-4.7	-5.5	-2.2	-3.1
<b>Southern &amp; Southeastern Europe</b>	<b>6.1</b>	<b>6.1</b>	<b>-7.5</b>	<b>-0.1</b>	<b>5.1</b>	<b>8.4</b>	<b>4.5</b>	<b>3.0</b>	<b>-13.9</b>	<b>-13.8</b>	<b>-6.6</b>	<b>-6.0</b>
Bulgaria	6.2	6.0	-6.5	-2.5	7.6	12.0	2.7	1.6	-25.2	-25.5	-11.4	-8.3
Croatia	5.5	2.4	-5.2	0.4	2.9	6.1	2.8	2.8	-7.6	-9.4	-6.1	-5.4
Romania	6.2	7.1	-8.5	0.5	4.8	7.8	5.5	3.6	-13.5	-12.4	-5.5	-5.6
<u>Memorandum</u>												
Slovak Republic	10.4	6.4	-4.7	3.7	2.7	4.6	1.5	2.3	-5.3	-6.5	-8.0	-7.8
Czech Republic	6.1	2.7	-4.3	1.3	2.9	6.3	1.0	1.1	-3.1	-3.1	-2.1	-2.2

<sup>1</sup> Movements in consumer prices are shown as annual averages. December–December changes can be found in Table A7 in the Statistical Appendix.

<sup>2</sup> Percent of GDP.

Analysts say Poland ended up with Europe's strongest economy through a series of unrelated coincidences, rather than any particularly skilled crisis strategy.

The first piece of luck was the structure of Poland's economy, which is heavily oriented toward its large domestic market of 38m people, unlike its export-oriented neighbours the Czech Republic and Slovakia. Crucially, Polish consumers did not slam their wallets shut when the crisis hit the region a year ago. Poles have become significantly richer over the last two decades of economic transformation; GDP per capita came to about \$6,000 in 1989 and now is above \$17,000, and Poles enjoyed double-digit wage increases during the final years of the boom. That made them flush enough to continue spending. Spending and investment were also maintained thanks to continued inflows of EU funds into Poland, particularly for infrastructure projects like highway construction. Another factor helping the economy was the steep depreciation of the zloty last year.

All this led the authors of a report that accompanied the Deloitte Business Sentiment Index, a survey of the views of leading corporate executives from the largest organisations across Central Europe and some of Southeast Europe, to note that the huge differences between Poland's upbeat answers compared to its more pessimistic partners in the index suggests a new era in the business dynamics of Central Europe, with Poland pulling away for good from its neighbours. "Polish executives gave every indication that the country will emerge not just as the most important player in Central Europe, but also as a significant force in the global markets," says Deloitte.

"Poland ended up with Europe's strongest economy through a series of unrelated coincidences, rather than any particularly skilled crisis strategy"

That said, there are a number of reasons to think that Polish growth will remain sluggish over the coming years. The first is that the government is in serious danger of public debt breaching the 55% level of GDP (it is currently just below 50%). At that level, Polish law mandates painful steps to put the budget back in balance, steps which would be unlikely to enhance the electoral prospects of Donald Tusk, the prime minister, in next year's presidential elections. As such, Capital Economics believes Tusk is likely to find ways around the constitutional limits on public debt, meaning that GDP could expand by 2.5% in 2010. Although helping growth in the short term, this will only delay much-needed fiscal consolidation, which will keep GDP growth firmly below its

potential rate for at least three years. "As one of the region's least open and capital dependent economies, Poland's near-term prospects are brighter than that of its peers. Nonetheless, medium-term headwinds are building, and we expect growth to remain below its potential rate of around 4% for at least three years," says Capital Economics.

The fiscal problems will also hold back Poland's euro-adoption plans. The government made a surprise announcement in 2008 that Poland would join the euro by 2012. But in December, PM Tusk admitted that only by 2015 would the country have fulfilled all the Maastricht criteria required to join the euro.

#### Not a Turkey at all

In Southeast Europe, Turkey has come out this global economic crisis particularly well, ironically because it has been so prone to crises in the past that it undertook many reforms to prevent another happening again, including major changes to its banking industry.

This time around, Turkish banks rode out the crisis without any financial help from the government, unlike the massive bailout of lenders and tougher regulations that occurred during the last recession in 2001. "The banking sector is well capitalized and could tackle the downturn in the economy without recapitalisations, and massive interest rate cuts also benefited the banks," says East Capital partner Jacob Grapengesser, whose East Capital Turkish Fund was the clear winner in bne's equity fund ranking in 2009, managing to post a hefty 9.9% return in the year to June 31. Three of the top holdings in the fund at that time were banks.

The strength of the banking system was a major factor behind Fitch Ratings' belated decision in December to raise Turkey's credit rating by two notches to 'BB+' – a move that Moody's Investors Service followed in January with a lift to 'Ba2'. Tim Ash of Royal Bank of Scotland – who last year wrote a piece entitled, "Ratings agencies need to wake up and smell the Turkish coffee" – has been particularly strident in his criticism of the ratings agencies' attitude toward Turkey. "It was clear to me six months or so ago that Turkey's performance through the current crisis meant that it had done its 'tour of duty' and was deserving of a much better credit rating," he says. "Turkey has funded itself both externally and from a public finance perspective under its own resources, and has managed to avoid going cap in hand to the International Monetary Fund. This stood it in contrast to a bevy of investment grade emerging European credits which have been forced to seek emergency IMF funding, including Latvia, Hungary and Romania."

The contrast with regional neighbour Romania is instructive. Whereas the big story in Romania is about how the IMF has suspended loan payments until a new government is in place to make sure the country abides by the promises the loan was predicated on, a rather tedious story in Turkey has been the ongoing saga about whether the government feels it necessary to sign a new stand-by agreement with the IMF to replace the

expired one. The two countries may occupy the same regional space, but their problems couldn't be further apart.

The latest GDP figures released in December support the idea that Turkey will be amongst the best performing economies in the region over the next year or so. In the third quarter, Turkey's economy contracted by 3.3% on year, slowing from a revised 7.9% contraction in the second quarter. No official quarterly growth data were available. Sertan Kargin of TEB Investment notes that the financial sector maintained its solid performance in the third quarter, with the sector continuing to provide strong added value to economic activity with 7.8% year-on-year growth coming on top of the 7.5% growth posted in the second quarter, the 10.8% increase in the first quarter and 9.1% increase in 2008. "This was mainly because of the continual solid fee-income and operational productivity," he says.

The 2009 contraction in GDP is put at 5.5-6.0%, while there will be a return to growth in 2010. "The risks to our current 3% growth forecast for next year now lie on the upside," says Shearing. "Reforms undertaken earlier this decade and a relatively low share of foreign currency debt mean that the banking sector is in good shape. Indeed, in contrast to most of the region, credit conditions are showing tentative signs of easing." TEB's Kargin has raised his 2010 GDP growth forecast to 3.7% for 2010 from 3.0% previously.

The weaker lira should continue to give a boost to exporters as external demand recovers, and October's strong industrial production and better export data suggest this might already be happening. October's balance of payments data showed Turkey's exports rose by 4.5% year on year, against weak import demand, which was down 17.5%. This helped the current account post a surprising \$671m surplus in October, which compares with the \$2.5bn deficit a year earlier. "The silver lining of the global financial crisis is a smaller current account deficit," says Galatia Phoka, emerging markets analyst at Eurobank EFG.

However, the lack of that IMF deal, while a sign of the country's strength, could also hold back growth. "In the absence of an IMF programme, it could take at least three years for growth to return to its potential rate around 5%," says Shearing.

The big concern is how, absent an IMF deal, the government will continue to finance its fiscal deficit, especially given the risk of a pre-election splurge in the run-up to the elections in 2011 (the reason, incidentally, why the government is so loath to accept money from the IMF, since it comes with stringent spending conditions attached). With local banks, which have so far funded the deficit, looking increasingly to lend to the private sector, the government will have to look to foreign investors for the money. Given foreign demand for Turkish debt has dried-up as yields have fallen, yields and interest rates would have to rise to attract the foreign capital back. ●

"In the absence of an IMF programme for Turkey, it could take at least three years for growth to return to its potential rate around 5%"

# KAZAKHSTAN 2010: A transition year

Clare Nuttall in Almaty



**K**azakhstan's economic performance in 2010 will be closely correlated to international macroeconomic developments and trends in world commodity markets.

After a slowdown in 2009, the country is expected to resume economic growth in 2010, provided oil prices remain above \$50. However, with the completion of the massive Kashagan oilfield still some years off, and banks remaining reluctant to make new loans, an immediate return to rapid GDP growth is not expected. Visor Capital expects 2010 to be a transition year for Kazakhstan, before the economy starts to rebound more strongly in 2011. The firm forecasts that GDP will increase by a modest 0.4% in 2010 after a 2.5% decline in 2009.

Kazakhstan's recovery is largely linked to the rise in global commodities prices in the second half of 2009. As of late 2009, Kazakhstan had already overtaken Australia and Canada to become the world's largest producer of uranium. Investment in oil and gas extraction continued through the crisis. Investors made some cuts, but oil companies were reluctant to risk losing their licences on major fields by cutting back too much.

The massive offshore Kashagan field is expected to become operational in 2012 or 2013. In addition to allowing investors to recoup their development costs, Kazakhstan stands to benefit financially. "This will probably be the start of a 10- to 15-year 'Golden Age' for Kazakhstan," according to Visor Capital's head of research, Jean-Christophe Lermusiaux.

"Kazakhstan's future in the long term will depend on how the Kazakh authorities decide to develop the country, as a significant part of the GDP growth will depend on how they decide to invest profits from the oil and gas production," he says. "The country needs significant investments – probably in excess of \$100bn – in infrastructure."

2009 saw increased investments into roads and to a lesser extent to electricity infrastructure. There are also plans to

build nuclear power plants in Kazakhstan, and corporate deals signed with France, Russia and several other countries are helping state nuclear company Kazatomprom to increase its technical capabilities.

Kazakhstan is also expected to benefit from the continuing strong growth in China. China is already one of the largest consumers of Kazakhstan's natural resources, and the completion of the Kenkiyak–Kumkol oil pipeline and the Central Asia-China gas pipeline in 2009 will allow Kazakhstan to ramp up hydrocarbons exports in the future.

## Banking sector

Two of Kazakhstan's top four banks, BTA Bank and Alliance Bank, were taken under government control in February. As of the end of 2009, the restructuring process for both was finally close to completion. After months of uncertainty, this at last gives a much clearer direction for the banking sector and the wider economy for 2010.

BTA Bank, Kazakhstan's largest bank by assets at the time of the state takeover, signed a term sheet with its creditors' committee in December. Both sides agreed on the restructuring of BTA's \$11.6bn debt. The deal is more favourable to creditors than had been previously expected, and is expected to gain the approval it needs from 75% of creditors, points out Milena Ivanova-Venturini, director of equity research, banking and finance, Central Asia at Renaissance Capital.

National Bank Governor Grigoriy Marchenko has since indicated that a deal with creditors is likely to be signed by March 2010. The restructuring process at Alliance Bank is also at an advanced stage and is likely to be wrapped up in 2010. Kazakhstan enters 2010 with a very different banking sector from the one it had a year earlier. Two of the top four banks, plus Astana Finance and BTA subsidiary TemirBank, are undergoing debt restructuring. While the sector was largely privately owned in January 2009, the government through the Samruk Kazyna national welfare fund is now

the major stakeholder in BTA and Alliance, and also holds minority stakes in the other two top-four banks, Halyk Bank and Kazkommertsbank. In addition to its direct shareholdings, the government also accounts for the lion's share of the sector's liquidity indirectly – both through state programmes to support SMEs and the real estate sector, for example, and through deposits from Samruk-Kazyna companies.

Foreign ownership is set to increase if Russia's Sberbank takes over BTA. However, the government and central bank have indicated that they may step in to prevent foreign ownership from increasing beyond 50% of the sector's total assets. This is believed to be mainly a signal that Halyk and Kazkommertsbank are not for sale.

Among the other big banks, Halyk, Bank CenterCredit and ATF Bank have all survived the crisis, as have smaller banks such as Eurasian Bank. They are now entering 2010 with plans to grow their businesses, taking advantage of the disarray in the sector and the flight to quality for deposits.

Lermusiaux notes that the banking sector's recovery has not yet got to a stage where it can boost the economy. "Today, Halyk and the other 'survivors' have a liquidity excess, but the number of new loans is decreasing. Kazakh state organisations and to a lesser extent the international financial institutions are the main source of financing at present as it is so tough to get loans. Typically, in a transition period in a healthy economy, you would expect a much higher proportion of private financing," he says. "The government has succeeded in stabilising the economy, but more efforts are needed to rapidly boost GDP. While large companies can access funding, many mid-sized companies are struggling. There is now stricter control of the financial sector in Kazakhstan than in Europe, so banks will need clear sign from the authorities to start lending again."

## Inflation

Investment banks agree that inflation is under control in Kazakhstan. Visor's forecast is for 6.5% inflation for year-end 2009, 7.1% for 2010 and 7.5% for 2011.

Renaissance Capital expects that consumer inflation will stay below official estimates of 8.3%, which will give the government scope to keep fiscal and monetary policies loose for some time. "The benefits will filter down to the equity space though a lower cost of capital, more investment, and fewer non-performing loans," a Renaissance Capital report says.

## Forex

The tenge was devalued by 25% against the dollar in early 2009. However, fears of a further devaluation later in the year were not realised. Kazakhstan strengthened its foreign reserves to \$48bn as of December 2009. "The risks on the tenge are more on the upside. If the current position with oil and commodities continues, there are real prospects for tenge appreciation in 2010," says Renaissance Capital's Ivanova-Venturini.

Visor Capital forecasts a sustained growth in inflows to the National Fund, and a moderate appreciation of the tenge in 2010. "The authorities have made it very clear that they will not let the tenge appreciate easily," says Lermusiaux. "It will probably be flattish for a few months, but it is likely that the National Bank is likely to let it strengthen to around KZT145/USD by the end of the year. If oil prices continue to increase, the National Bank is likely to come under pressure to allow the tenge to appreciate because this will make it easier for Kazakhstani banks and other borrowers to repay foreign currency loans."

Renaissance Capital's report points out that Kazakh exports have become increasingly competitive as the Russian rouble and Brazilian real appreciated in the second half of 2009. "We expect Kazakhstan's relative competitiveness as an exporter to bring focus to its investment case in 2010," says the report.

## Equities

As investors return to emerging markets, the risk premium assigned to Kazakhstan has fallen.

The main index of the Kazakhstan stock exchange, the KASE index, has rallied 81% as of December 2009. Renaissance Capital's RENCASIA index, which tracks mainly Kazakhstan-focused equities, increased by 88%. "We forecast 35% on the RENCASIA index for 2010," says Ivanova-Venturini.

Kazakhstan's rally is still more modest than those in Russia, where the RTS Index climbed by over 110%, and Ukraine's, where the PFTS Index was up by 100%. "We expect to see a return to the stock picking approach next year," says Visor Capital's Lermusiaux. "Fluctuations in stock prices will, however, still be mainly influenced by international macro signals. Since the markets tend to anticipate events by one

"This will probably be the start of a 10- to 15-year 'Golden Age' for Kazakhstan"

year, stock prices will be looking forward to 2011, which we believe will be a year of faster growth in Kazakhstan, so there is still some room for upside for companies that will deliver earnings in line with expectations."

Among Kazakh equities, Renaissance Capital forecasts the greatest upside for banks, which underperformed their Russian peers in 2009. "We think a normalisation in the banking system will provide one of the most attractive access points to the Kazakhstan equity space in 2010," it says. It notes in particular Halyk and CenterCredit. ●

# EURASIA 2010: The good, the bad and the ugly

Clare Nuttall in Almaty

In 2009, Armenia was the worst affected by the economic crisis of all the CIS countries, with a GDP decrease of more than 15%. In 2010, the International Monetary Fund (IMF) forecasts a return to modest growth of 1.2%. The draft national budget for 2010 stipulates a deficit equivalent to 5.7% of GDP, as the country seeks to maintain social spending. Yerevan already raised a \$500m stabilisation loan from Russia in 2009, and hopes to secure more funds from international donors to support it through 2010. On a more positive note, Armenia's banking system remained relatively resilient to the crisis due to its low integration with international capital markets. Meanwhile, Russia's RosAtomStroyExport has been selected to work with Armenia to build a new nuclear power unit, between 2012 and 2016. This will lessen Armenia's dependence on energy imports. Construction of the Russia-Armenia-Iran oil pipeline may start in 2010.

Azerbaijan is expected to be the world's fastest growing economy in 2009, according to a report from the EIU. GDP was up by 8.3% year on year in January-October - considerably lower than its growth in recent years; 34.5% in 2006, 25.0% in 2007 and 10.8% in 2008. However, the majority of this growth was centred on the oil industry. According to the Azeri government, the oil sector is expected to grow by 20.3% in 2009, while the non-oil economy will grow by just 3.2%. The government has set diversifying the economy as its priority. Azerbaijan's 2010 budget will focus on social spending, investment and defence. It is based on a conservative forecast of \$45 per barrel. The government forecasts economic growth of 8.3% in the oil sector and non-oil sector growth of 4.94% in 2010.

Georgia's economy remains fragile. The rapid growth of the first part of this decade stalled after the August 2008 war with Russia over South Ossetia. Although the post-war economy was initially shored up with donor funds, 2009 saw a decline of 4% in GDP. In the first half of 2009, foreign

direct investment plummeted by 80% to \$226m, with the largest investments coming from the UAE, the UK and Turkey. The government forecasts 2% growth in 2010, although Prime Minister Nika Gilauri is trying to boost this figure by attracting more foreign investment. Zurab Pololikashvili was appointed as Georgia's new economic development minister in August 2009, and has said he aims to increase investment

"Kyrgyzstan was one of the top reformers on the World Bank's 'Doing Business' survey in 2009"

from new sources including Spain, Germany, France, India, South Korea and Japan. Pololikashvili also plans to restart Georgia's privatisation programme in 2010.

Kyrgyzstan was one of the top reformers on the World Bank's "Doing Business" survey in 2009. However, it still saw an abrupt slowdown in GDP growth from 7.6% in 2008 to an expected 1.5% in 2009, due to the knock-on effects of the crisis on its main trading partners - Russia and Kazakhstan. The IMF forecasts growth of 3% in 2010. The government has announced wide-reaching reforms that it says will further improve the business climate, but it is too early to say how effective these will be. Major reforms are also planned in the energy sector in 2010, with price hikes for heat and electricity coming into force from the start of the year. These are intended to bring utilities pricing into line with costs, and help to fund a large-scale investment programme into generation and transmission infrastructure. A key element of this is the construction of the Kambarata-2 hydroelectric power plant, which will help to ensure Kyrgyzstan's energy security. However, these reforms are deeply unpopular among much



of the population, which is used to cheap power, and there have been warnings this could lead to social unrest.

Tajikistan is expected to maintain real GDP growth of 2% in 2009, increasing to 3% in 2010, according to the IMF. Demand and prices for its two main exports - aluminium and cotton - fell in 2009, increasing the balance of payments gap. Tajikistan is also indirectly affected by international commodities prices due to its dependence on remittances from migrant workers mainly in Russia and Kazakhstan. The country's priority for 2010 is to raise money for construction of the Rogun hydropower plant. This became more urgent in December after Uzbekistan quit the Central Asian unified energy system and cut gas supplies to Tajikistan. The cash-strapped Tajik government is trying to tap both international investors and the local population to raise the \$600m needed for the first phase of the project. Foreign investment remains at a low level. However, Rosatom is currently in talks with the government over the development of uranium deposits, and tenders of two major assets - the Bolshoi Konimansur silver deposit and Shakhbas gold field - are on the agenda.

Turkmenistan is set to be the biggest beneficiary of the Central Asia-China gas pipeline, which opened in December. In addition to closer relations with China - which lent it \$3bn loan to fund the commercial development of the massive South Yolotan gasfield - Ashgabat is also aiming to build relations with the EU, as it seeks to lessen its dependence on Russia as its main gas export route. According to the IMF, Turkmenistan's GDP growth will drop to 4% in 2009, but is set to resume its rapid upward trajectory in 2010, when growth of 15.4% is forecast. In 2010, the country is also planning a major investment and construction programme. Money allocated to the construction sector through the state budget will be increased by 54.6% from the 2009 budget. Turkmenistan is to spend almost \$12bn of state money to build 240 major new facilities in 2010. Approved projects include the north-south railway, facilities at the Avaza tourist zone, new residential and commercial real estate, shopping centres, factories and education facilities.

Largely isolated from international markets, Uzbekistan has maintained growth throughout the crisis and this is set to continue in 2010. In an attempt to encourage investment, the 2010 budget includes cuts to the base income tax rate and the single tax for micro firms and small enterprises. The government had already reduced the profit tax rate for commercial banks depending on the share of long-term investment financing in their loan portfolios in October. Several large-scale foreign investments by companies such as Gazprom, Lukoil and Petronas are also going ahead, and in November, Uzbekneftegas signed a \$2.5bn agreement with Petronas and South Africa's Sasol to build a synthetic liquid fuel production plant. However, the overall business climate remains difficult, with the issue of currency convertibility a particular problem for foreign investors. According to reports from investors, since the start of the crisis it has become even more difficult to realise revenues from Uzbekistan. ●

"Largely isolated from international markets, Uzbekistan has maintained growth throughout the crisis and this is set to continue in 2010"