

## Banking sector in Central Eastern Europe: Pace to slow down slightly on indirect sub-prime crisis effects

- Economic growth to remain above major market levels for many years
- Indirect effects from the sub-prime crisis: slowing growth, higher funding costs
- Key markets in 1Q 2008 have not yet lost their strong pace set in 2007
- Raiffeisen International and OTP are the top picks in the region

### Economic development

A period of above-potential growth lies behind most CEE countries. First and foremost, growth needs to come down, as the pace of recent years was unsustainable, which would lead in the medium term to overheating economies. The second factor is that important export markets (particularly the EU) are also set to slowdown, as the financial crisis and the slowdown in the US will be felt. Overall, though, we do not expect a strong impact on the Euroland economy. *"In total, we only expect a moderate slowdown of economic growth, as the slowdown in Euroland should be relatively modest and we think that domestic demand has gained enough of a dynamic to compensate at least partially for any slowdown of foreign trade, especially as the competitive advantage of EU members is still significant. These countries offer a unique mixture of a stable political/legal framework and (labour) cost advantages, which will remain for many years and continue to attract foreign investments. This will support further productivity and wage convergence towards Western peers. Thus, economic growth should remain above major market levels for many years to come"*, analyzes Günter Hohberger, banking sector equity analysts at Erste Bank and co-author of the report.

### Sector overview

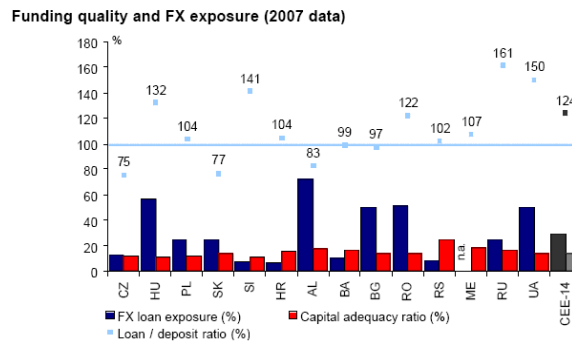
Unlike many US and Western European players, our CEE bank coverage<sup>1</sup> is not at all involved in any sub-prime or sub-prime related investments and therefore needs no writing-off of their assets. With the end of the 1Q08 reporting season, however, investors' focus has changed from the direct effects (e.g. write-offs, capital needs) to the indirect effects of slowing economic growth and increasing funding costs. On the funding side, however, the crisis has squeezed liquidity. The 3M Euribor (for instance) increased by 125bp to 4.97%, from 3.725% at the beginning of 2007. Therefore, the funding ability and funding quality have become an issue in the last couple of months, in order to secure asset growth at a reasonable price.

*"We looked at the loan to deposit ratios of the different banking markets to divide the markets, which are more securely funded, from those that are more stretched"* says Günter Hohberger, banking sector equity analysts at Erste Bank and co-author of the report. *"The most stretched banking systems we found in Russia (161% loan / deposit ratio) and Ukraine (150%), followed by Slovenia (141%), Hungary (132%) and Romania (122%)."* In particular, in Russia (with more than 1,200 banks and a low market concentration), the smaller and mid-sized banks are currently running into trouble funding the strong asset growth. Players with good regional branch networks could therefore become increasingly interesting for bigger players, which need to grow their retail networks in this heavily under-banked country (1 bank branch covers 41,000 inhabitants, vs. about 1,900 in mature markets!).

With the higher interest rate levels in most CEE countries compared to the Eurozone, the demand for FX loans has risen heavily in recent years. In 2007, the strongest FX loan growth was seen in Bulgaria (+86% y/y), Romania (+84% y/y) and Ukraine (+75% y/y), resulting in FX exposure (FX loans in terms of total loans to the non-financial sector) of more than 50%. The strongly FX-exposed countries face higher default risk than markets relying on local currency loans in the case of a depreciating local currency, which increases credit instalments. The Erste Bank analysts therefore have also looked at the

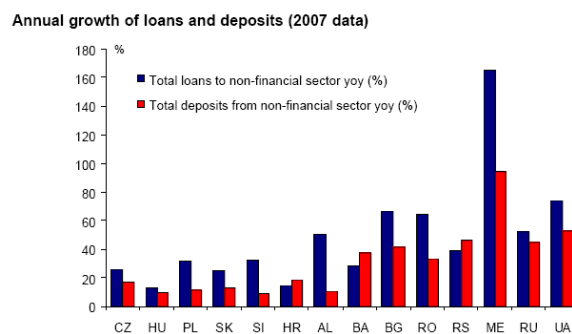
<sup>1</sup> CEE here includes Albania, Bosnia & Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia and Ukraine.

equity coverage of the FX loan exposure to demonstrate the different sizes of the banking sector's cushions. "As shown in the graph below, the Czech Republic (low interest rate level), Slovenia (euro implemented as of 1.1.2007), Croatia and Serbia can be seen as safe havens in terms of FX exposure", states Günter Hohberger.



Source: National banks, Erste Bank Research

"The strongest loan growth in 2007 was seen in the new EU members Bulgaria and Romania, as well as the CIS region, i.e. Ukraine and Russia, with more than 50% annual growth. The main driver in the CEE region was again retail loans, growing above 50% levels in Ukraine, Romania, Russia, Bulgaria and Serbia. Corporate loan growth was very strong in Bulgaria (+77% y/y) and Ukraine (+62% y/y)", says Hohberger. "In general, deposit growth has been slower than loan growth, lifting loan/deposit ratios above the 100% barrier in some countries. In many CEE countries, the low penetration of loans provides a basis for strong lending growth rates in the coming years. The main drivers for the loan growth in most of the countries are mortgage<sup>2</sup> and consumer loans - a consequence of decreasing unemployment rates, rising GDP per capita and subsequently growing demand for consumer goods and housing."



Source: National banks, Erste Bank Research

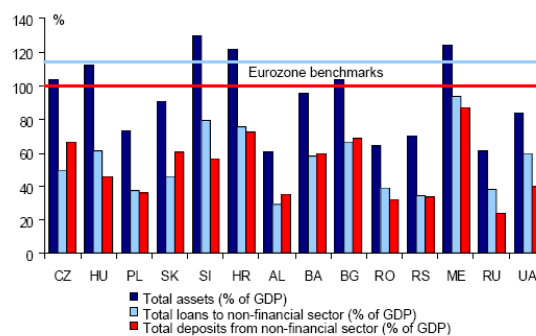
Since summer 2007, Romania has been facing periods of strong sell-offs, driven by fears about the vulnerability of the Romanian economy and the impact of its weaker currency on the economy (especially in the financial sector). "We believe that the weakened currency is supportive of the Romanian economy and the adjustment process of the high C/A deficit. Since the beginning of this year, we have seen a sharp deceleration of the current account widening, suggesting that the C/A deficit to GDP might remain flat this year (compared to the general market consensus of minor growth). The C/A deficit will be partially financed by FDI inflows (estimated at 6% of GDP) and further growth of external borrowing, mainly by the private sector. We expect that strong growth of domestic demand will also lead to a widening of the current account deficit in Ukraine. Fortunately, Ukraine has been attracting large FDI inflows, which have sufficiently covered the current account deficit. A large-scale privatization plan scheduled by the Ukrainian government for 2008 makes the economy less dependent on issuing new external debt", comment the Erste Bank analysts.

<sup>2</sup> Mortgage loans were the main growth contributor in CEE, with +127% y/y in Ukraine, +116% in Russia and +77% y/y in Romania.

### Banking penetration rates CEE

The expected economic slowdown in the CEE region is not yet reflected in the banking sector data we have for 1Q08. Key markets like Poland, Romania and Ukraine have not yet lost their strong pace set in 2007. In Romania and Ukraine, the loan growth in 1Q08 even accelerated to 66% y/y and 76% y/y, respectively. *“The new EU members Bulgaria and Romania, as well as Ukraine and Russia, will offer the highest growth rates in the coming years, converging to mature market levels. Overall, we expect all CEE countries to use the catch-up potential they have, resulting in above-average growth rates for more than ten years”*, says Gernot Jany, banking sector equity analysts at Erste Bank and co-author of the report.

Penetration rates (2007 data)



Source: National banks, Erste Bank Research

*“While the deposits are already at a relatively high level in countries like the Czech Republic and Croatia, in the emerging banking markets, a lot of money is still stored in piggy banks. We expect the commercial banks to continue to replace piggy banks as confidence in the banking market rises. The entrance of foreign players usually has a very positive effect on confidence in the banking market, which can already be seen in Ukraine, Bulgaria and Bosnia & Herzegovina”*, summarizes Jany.

Following conclusions from the dividend discount model, peer group valuation and regression analysis the analysts of Erste Bank point out the following banks in CEE:

- **Raiffeisen International** with the ongoing growth story and the value play **OTP** provide the strongest upside potential based on current share prices and therefore again receive a Buy recommendation
- **BRD GSG** as one of the most profitable banks in CEE and the Romanian growth play **Banca Transilvania** have performed well in the past months and due to limited upside potential we arrived at an Accumulate rating
- **PKO BP**, which is the Polish big play with a strong bottom line growth and **Komercni banka** providing comfortable funding quality are our preferred stocks rated at Accumulate
- **AIK Banka** is the Serbian high growth and profitability play which includes a bet on improving politics receiving an Accumulate rating

Erste Group, Press department

1010 Vienna, Graben 21, Fax: 0043-50100-19849

Hana Cygonková, Tel: 0043-50100-11675, e-mail: [hana.cygonkova@erstebank.at](mailto:hana.cygonkova@erstebank.at)

Ionut Stanimir, Tel: 0043-50100-11676, e-mail: [ionut.stanimir@erstebank.at](mailto:ionut.stanimir@erstebank.at)

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