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Prospects depend on western support

The region relies on older members of the EU to buy its exports and provide capital, says **Neil Buckley**

These are deeply uncertain days for central and eastern Europe. Despite the region's extraordinary post-communist transformation in the past two decades, it depends heavily on western Europe to buy its exports and provide capital. For now, that is its Achilles heel rather than a source of strength.

Much of 2010 and early 2011 saw recovery in the region, apart from in the Balkans. But after the eurozone debt crisis intensified last summer, the outlook worsened again.

Confidence in western Europe's ability to contain the eurozone crisis has been further eroded this month after French and – in particular – Greek voters rejected "austerity" policies. Greece's political troubles have increased investor concerns that the country might exit the eurozone, and made some revise upwards their estimates of how bad the impact might be.

EU officials say preparations already made mean that a Greek exit need not produce a shock on the scale of the collapse of Lehman Brothers in 2008. Then, central and eastern Europe, which had sucked in cheap credit in the good years of 2003 to 2008 and become heavily reliant on short-term capital flows, saw the money dry up, landing it in a deep recession.

But, notes Thomas Mirow, president of the European Bank for Reconstruction and Development, much will depend on how investors react.

"As we have seen with Lehman, these kinds of events are very difficult to forecast, because they have a material aspect, a hard, physical element, but they also have a psychological element," he says.

"For many major investors in Asia, or the Pacific, or the Americas, this is all about 'Europe' and they probably would not exactly differentiate between . . . smaller countries. So nobody knows whether international investors would still trust that Greece is as singular [an event] as the Europeans, up to now, have described it to be."

EU officials say preparations mean a Greek exit from the euro need not produce a regional shock on the scale of Lehman Brothers Reuters

Differentiation by investors is important because CEE countries are arguably in better shape now to cope severe shocks, says Herbert Stepic, chief executive of Raiffeisen International Bank, one of the biggest lenders to the region.

"Current account deficits are lower than before, labour cost growth has slowed, competitiveness has increased, taxes have come down, and [sovereign] debt levels are half what they are in the rest of the EU, with the exception of Hungary."

So far in this crisis, east-west contagion has been mainly through trade and banking channels. Vital export markets have slowed sharply, while domestic demand often remains feeble. Governments struggling to curb budget deficits also have little scope for fiscal stimulus.

Moreover, strains on the western European banks that dominate the region, coupled with regulatory pressure to bolster their balance sheets, are squeezing credit growth, while foreign direct investment is also being constrained.

These factors already made the EBRD bring down its 2012 growth forecasts for central Europe and the Baltic states from 3.4 per cent last July to 1.4 per cent by January this year. For the Balkan states forecast growth shrank from 3.7 per cent to 1 per cent.

Further east in the former Soviet republics, particularly in central Asia, which are more affected by commodity prices than what is happening in the EU, the outlook is more robust.

But first-quarter growth figures for CEE countries this week were, notes Mr Mirow, "not good at all". The Czech Republic notched up a third quarter of contraction, Romania fell back into recession, and Hungary had its first year-on-year contraction since 2009.

Slovakia, however, looked brighter, and Poland, the only EU member state to avoid recession in 2009, again looks resilient, insulated by its large domestic market.

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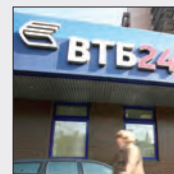

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Poles, Czechs and Slovaks form regional super-sector

Banking

The three core countries have profitable and well capitalised institutions, writes **Jan Cienski**

More than two decades after the fall of communism, central and eastern Europe has become such a diverse region that it is increasingly difficult to treat it as a single unit. This is especially evident in the banking sector.

While Hungary, Romania, Bulgaria and the Baltic states struggle with substantial foreign currency denominated debt and sluggish lending growth, the three countries at the core of the region – Poland, the Czech Republic and Slovakia – have well-capitalised and profitable banks.

The biggest risk the three face is from the outside, that the foreign groups that own 65 per cent of Polish banks and more than 90 per cent of those in Slovakia and the Czech Republic will cause a credit crunch if they reduce lending by their subsidiaries to bring their core tier one capital ratio – a key measure of balance sheet strength – to the 9 per cent minimum stipulated by the European Banking Authority.

"If there are problems for west European banks, there could also be a problem for Polish banks," said Marek Belka, the governor of the National Bank of Poland, at a recent conference. "If there is a change in sentiment, we could see a withdrawal of capital."

Credit growth in emerging Europe appears to have markedly weakened, though countries that are stronger domestically and have a growing deposit base – such as Poland, Slovakia and the Czech Republic – appear more insulated.

The Bank for International Settlements, which monitors funding flows, has found that assets of international banks in emerging Europe dropped $33bn in the third quarter of last year and the outflows appear to be continuing, according to a study by the European Bank for Reconstruction and Development.

In Poland, credit is still expanding – by an annual 16 per cent for corporations and about 10 per cent for households – but new lending is expected to slow sharply this year.

However, fears that foreign banks would be forced to get rid of emerging markets assets in order to beef up their capital ratios have not yet been realised.

Some have changed hands because of their parents' troubles at home, notably Poland's Bank Zachodni WBK, sold by Ireland's AIB in late 2010 for €3.1bn to Santander. The Spanish group this year spent a further €1bn buying Poland's Kredyt Bank from KBC, its Belgian owner.

Polbank, the Polish subsidiary of Greece's Eurobank EFG, was sold this month for €460m to Austria's Raiffeisen Bank International.

But few analysts expect many more big changes in the near future. One reason is that some subsidiaries in the Czech Republic, Poland and Slovakia are making solid profits, which makes them valuable assets.

In recognition of this, Germany's Commerzbank late last year said it would refuse loans that do not help Germany and Poland – indicating the importance of its Polish affiliate BRE Bank, which last year reported a record €275m net profit, a 77 per cent increase on 2010.

Overall, the Polish banking sector made a record profit of 15.7bn zlotys (€3.7bn) last year. Krzysztof Pietraszkiewicz, head of the Polish Banking Association, estimates the figure for this year will not be much less.

> 'We are living in times of large uncertainty. Capital is the best buffer'

Czech banks also turned a decent profit of Kc53.4bn (€2.1bn), down slightly from 2010, because several banks had to write down their holdings of Greek bonds. Slovak banks saw their profits leap by 34 per cent to €674m last year.

All three countries also easily meet the new capital requirements for the sector. Poland's banks have a tier one capital ratio of 12 per cent, while Slovakia's have 11.9 and the Czech Republic 13.9 per cent.

The Czech and Slovak sectors are relatively well insulated from shocks, with loan to deposit ratios of 80 and 90 per cent respectively. Poland still depends on external financing with a ratio of 110 per cent.

"The Czech banking system is self-sustaining. Banks are unable to reach their lending targets because of a lack of demand," says Miroslav Singer, head of the Czech National Bank.

Regulators are also moving to limit outflows. In Slovakia, the central bank has issued a recommendation restricting dividend payments if a bank's core tier one ratio is below 11.5 per cent. In Poland, the regulator does not want banks to pay more than 50 per cent of earnings in dividends.

"We are living in times of quite large uncertainty," says Andrzej Jakubiak, the head of Poland's financial regulator. "Capital is the best buffer."

Mr Jakubiak says his agency will be careful about letting any foreign bank leave the market rapidly.

Unlike the Czechs and Slovaks, who made negligible loans in foreign currencies during the real estate rush that preceded the crisis of 2008, Polish banks enthusiastically lent to households in Swiss francs and euros, a practice that has all now all but ended.

Although about a third of outstanding loans are denominated in foreign currencies, Poland's non-performing loans are 8.4 per cent, significantly lower than most of the rest of the region except for Slovakia and the Czech Republic. This is, in large part, because economic growth in Poland has been faster.

A recent report by Capital Economics, a consultancy, looked at potential banking sector problems across central Europe and found all three countries had below-average non-performing loans, forex debt, and short-term external debt.

"I see very few risks to the banking system," says Mr Singer, who adds that recent stress tests on Czech banks show the system surviving even very large shocks.

Spanish savvy: Santander bought Poland's Bank Zachodni WBK in 2010 for €3.1bn Bloomberg

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Vienna and Warsaw vie for pre-eminence

Financial centres

Other capitals have tried to compete but have proved too small and poorly regulated, writes **Jan Cienski**

Prague, considered one of the most attractive cities in Europe, was initially a magnet for the regional headquarters of international companies Dreamstime

For centuries, Vienna was the political, cultural and economic hub of central Europe.

When its neighbours sloughed off communism more than two decades ago, the Austrian capital quickly tried to recapture this role.

However, it has been strongly challenged, in particular by the financial industry that has grown up in Warsaw.

Vienna seemed to have many advantages over the Polish capital.

After the Soviets pulled out of their occupation zone in 1955, Austria was free to resume its development into an advanced western economy, while the rest of central Europe languished under state socialism.

That allowed the country to build up the modern banks, stock exchange, laws and regulations that gave it an enormous head start over its neighbours.

Austrian banks were among the first to seize the opportunities of doing business in central European countries that had been starved of capital. They have become dominant almost everywhere except for Poland, where German, Italian and Spanish banks predominate.

Some of the other regional capitals tried to build up their financial industries, but proved too small and too badly regulated to put up much competition.

Prague, one of the most attractive cities in Europe, was initially a magnet for the regional headquarters of international companies.

However, the Prague Stock Exchange played a leading role in an ill-fated voucher privatisation scheme, which was supposed to move state assets into the hands of Czech citizens.

At the scheme's peak, in the mid-1990s, about 1,700 listings clogged the exchange. It withdrew 1,301 in 1997 to try to reassert control over the market, but never won credibility.

At the end of last year, it had a capitalisation of €29bn, an average monthly turnover of €1.2bn and had seen one new listing in 2011. It is owned by the Vienna exchange.

In the mid to late 1990s, Hungary's financial sector was developing strongly. The Bux, the Budapest stock market index, spurred by a series of privatisation offerings, had soared from 1,500 at the end of 1995 to more than 9,000 in the spring of 1998, making it one of the best performers in the world.

The banking sector, largely privatised and free from the shackles of state ownership, was profitable and busy investing in systems and branches.

Such was the optimism that the Hungarian capital talked of being the regional banking hub for central and eastern Europe.

Richard Lock, a partner at Lakatos Köves, a Budapest law firm, says: "At that time, the idea that Vienna or Warsaw would be leaders in the region 15 years later would not have seemed credible."

But political and economic turmoil over the past decade have turned Hungary into a regional laggard and the Budapest Stock Exchange, now also owned by Vienna, has a market capitalisation of €14.6bn and average monthly turnover of €1.1bn.

The Vienna exchange – with a market capitalisation of €64bn and monthly turnover of €2.5bn – has either bought or allied itself with most of central Europe's stock markets.

But with only two IPOs itself last year, the exchange has not proved a great magnet.

> 'We had a Serbian company that considered listing in Warsaw or London. Vienna was not mentioned'

"We had a Serbian company that was considering between listing in Warsaw and London's Aim – Vienna was not mentioned," says Rodrigo Carvalho, director of the Warsaw operations of Portugal's Espirito Santo investment bank.

Warsaw started much later than Vienna. But Poland's larger population, 37m compared with 8m inhabitants in Austria, and a much faster growing economy – it expanded by 15.7 per cent from 2008-2011, far faster than any other EU country – turned the stock exchange into one of the country's capitalist successes.

Business was also helped by a stream of large privatisations, and by local pension funds limited by law to investing most of their assets in Poland.

Market capitalisation last year was €153bn, and average monthly volume is about €3bn. One of Warsaw's biggest achievements has been in attracting listings. Last year, the main and alternative markets together saw 203 IPOs worth a total of €2.2bn.

It has also worked to attract non-Polish listings. Ludwik Sobolewski, the bourse's chief executive, is often on the road, looking for IPOs in Prague, Kiev, the Baltic states and even Israel.

However, the IPO figures suggest Warsaw is gaining in numbers but less in depth. In the first quarter of this year, it had 47 per cent of Europe's IPOs, but only 4 per cent of their offering value. London had 61 per cent.

Mr Sobolewski pledges to push for fewer and higher quality listings, and is now setting his sights on overtaking exchanges at the level of Istanbul and Moscow.

"Let's stop celebrating our conquest of Prague, Budapest and Vienna," he says. "The new combined Moscow exchange is seven times larger than Warsaw; they could soon be a real competitive threat."

Although the WSE is now very much larger than its Vienna equivalent, the Austrian capital comes much higher in the annual rankings of financial centres prepared by the Z/Yen Group, a think-tank.

Vienna still has a denser network of banks, head offices and other financial sector trappings than the Polish capital, although Warsaw is catching up.

Additional reporting: Kester Eddy in Budapest and Haig Simonian in Vienna

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Prospects depend on west

Continued from Page 1

More uncertainty surrounds contagion through the banking channel. As the sovereign debt crisis intensified last autumn, fears resurfaced that western European banks might start pulling out of the region, in order to meet regulators' capital adequacy targets.

The EBRD and other international financial institutions, banks and regulators in January launched the "Vienna 2.0" plan – a successor to the 2009 Vienna Initiative that ensured banks maintained their investment in the region during the last crisis.

Concerns about widespread deleveraging receded a little after the European Central Bank eased the sector's funding troubles by launching its longer-term refinancing operation in December.

But bank operations in the region are being reordered – partly because of altered strategies, and partly by necessity.

Several banks that received government bailouts are trimming eastern European operations to meet their terms or EU state aid rules. They include Belgium's KBC, Germany's Commerzbank, Ireland's Allied Irish Banks, Portugal's Millennium BCP and Austria's Volksbank and Hypo Alpe Adria.

The process has prompted several big entrants – with Russia's biggest bank, state-controlled Sberbank, last year acquiring most of Volksbank's CEE operations apart from a Romanian subsidiary.

Analysts suggest Sberbank's entry could presage a wider move by cash-rich emerging market banks into a system until now dominated by western European institutions.

The shake-up is also providing an opportunity for western European banks that still have resources to expand. In Poland, Santander of Spain this year took control of KBC's 80 per cent stake in Kredyt Bank. Santander is merging Kredyt Bank with its Bank Zachodni WBK business – acquired from Allied Irish Banks in 2010 – to create what will be Poland's number three bank by deposits.

The biggest lenders, including Italy's UniCredit, Austria's Raiffeisen and Erste Group, as well as Italy's Intesa Sanpaolo and France's Société Générale, say they are committed to the region. But UniCredit is shifting its strategy to focus on its most profitable markets, including Poland, Turkey, Russia and Croatia.

Pressure on bank balance sheets is producing a credit "crunch" in certain countries, particularly Hungary.

Hungary's problems have been exacerbated by what the sector sees as unfriendly government policies, and another hangover from better times: a heavy burden of loans in euros and Swiss francs that consumers are struggling to pay in weakened forints.

Foreign banks clashed with the government last year over its aggressive measures to reduce the burden of outstanding mortgages, which forced them to take the currency losses.

Banks complained the plan contravened EU law, but Budapest insisted it was justified by their previously reckless lending behaviour.

Much tighter restrictions on foreign-currency loans since the crisis in Hungary and elsewhere are part of broader changes in the business models of western financial institutions.

Where many previously relied heavily on wholesale and parent bank funding of regional subsidiaries, now the focus is on funding through local deposits, and reducing excessively high loan-to-deposit ratios in countries such as Hungary and the Balkan states.

Another hangover from before the crisis is a large legacy of non-performing loans in various countries. A report for the Vienna Initiative found these averaged 11 per cent across central, eastern and south-east Europe – but were much worse in some countries that had particularly pronounced boom-bust cycles.

It warned that a "festering" bad loan problem could be a drag on growth, by creating uncertainty and limiting lending. The report called for more co-ordinated action by banks and supervisory authorities.

Yet for all the difficulties, the region's supporters are still confident. Assuming the eurozone crisis can be resolved, they say, central and eastern Europe will bounce back to growth. While slower than in the best years, it will still outpace that further west.

"If you look at the Baltics, going through Poland, the Czech Republic, down through Croatia," says Andreas Treichl, chief executive of Erste Bank, "I am absolutely convinced that in the next few years, this is the region that will fuel growth for Europe."

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State-run 'elephants' are developing agility

Russia

VTB and Sberbank have become much more client-friendly and their access to funding is vastly superior to private competitors, writes **Courtney Weaver**

Local and foreign investors are eagerly awaiting the estimated $6bn share sale of Sberbank, Russia's biggest state-controlled banking group, a deal that will highlight the institution's transformation in the past five years.

Under the leadership of German Gref, a former economy minister, who took the helm in 2007, Sberbank has cemented its position at the top of the Russian banking sector, moving into areas previously dominated by niche or foreign organisations, and modernising its operations so as to combine size with efficiency.

While Mr Gref appears to have succeeded at teaching "an elephant to dance" – one of his initial promises as chairman – the successes of Sberbank and its state-controlled peer VTB have made conditions harder for private market participants.

These banks lack the access to funding that the government banks have and are also losing their edge in certain services, such as consumer lending and investment banking, where their state competitors have only recently made inroads.

Analysts and industry executives expect that stronger private companies able to withstand the increased state competition will pull away from peers that cannot, paving the way for consolidation.

"The largest state owned banks are taking share and the smaller banks are growing more slowly," says Simon Nellis, a sectoral analyst at Citibank.

"[Smaller, private banks] are more nimble in certain areas, but still you have to fund the growth and that's where the challenge is. It was a lot easier five years ago, when markets were open and people were happy to fund Russia's small banks."

"Times have changed. Both VTB and Sberbank have better management. They are much more responsive to clients' needs than they used to be, and they are being much more aggressive in their access to funding so they can compete."

Funding can certainly be an issue for VTB and Sberbank's private peers. Yet some have managed to squeeze money from capital markets despite tough conditions.

> 'It was a lot easier five years ago, when markets were open and people were happy to fund small banks in Russia'

Nomos Bank, Russia's second largest private lender by assets, raised more than $700m in a London initial public offering last year, and an additional $500m this year through a seven-year eurobond issue in April.

Jean-Pascal Duvieusart, the bank's head of strategy, is frank about the competition from Sberbank and VTB, but adds that Nomos's recent fundraising success shows that certain institutions should be more than able to keep their heads above water.

"Sberbank and VTB both have huge market shares. That's a fact. Anyone who tells you differently is out of touch with reality," he says.

"The trend in the market is consolidation around people who have meaningful leadership positions. The size of the bank doesn't matter. What matters is profitability. What matters is your ability to generate capital and grow further."

Nomos's loan book, he notes, grew at 30 per cent last year – faster than the rate at which the sector grew – while retail and small business loans grew more than 50 per cent.

Retail lending is one area where smaller private banks have been able to remain competitive, because of the more "personalised" service they can offer, compared with the sometimes lumbering Sberbank and VTB.

The market is relatively under-developed: retail lending made up just 10 per cent of Russia's gross domestic product in 2011, versus 29 per cent in the Czech Republic and 36 per cent in Poland.

Growth in this are of the market has paid off for smaller businesses, such as Home Credit Finance Bank, which remained in point-of-sale lending, cash loans and credit cards during the international financial crisis and has kept a stable place in the sector despite advances by Sberbank and VTB.

Nonetheless, Citibank's Mr Nellis says the agility and more personal service that smaller banks provide may soon no longer be enough.

"Sberbank is more aggressive in retail lending. VTB has [its retail banking subsidiary] VTB24. They are giving the smaller banks a run for their money. I think there are still opportunities to provide faster, more nimble service but over time that advantage will probably be eroded."

As Sberbank maintains a strong grip on its number-one market position – with control over nearly a third of the country's banking assets – it is beginning to look more widely.

Last year, it acquired Volksbank International, the eastern European arm of Austria's Österreichische Volksbanken, giving it a platform to expand outside its home market.

The bank has expressed interest in building a presence in Poland and Turkey and has the balance sheet to do so.

Last year, it recorded a 74 per cent increase in net profit, while its loan book grew by 35 per cent.

Despite the strong results, it will not rush into acquisitions, according to Anton Karamzin, Sberbank's chief financial officer.

"It doesn't mean that because we have the money that we are going to come and buy," he says. "We want to be part of those banking sectors that offer growth and profitability opportunities on the longer term horizon of five, 10, 15 years."

Circling the competition: Sberbank controls a third of Russia's banking assets and is starting to look abroad Bloomberg

MBAs evolve from exotic flower status

Business education

A homegrown sector has emerged, says **Kester Eddy**

New generation: Stefan Petkov is a graduate of the one-year MBA at CEU Business School in Budapest

Stefan Petkov well remembers his decision to take up an MBA in 2004, when the Central and eastern European (CEE) countries were not only joining the EU, but eager to take on European best business practice.

"Back then, MBAs were still 'exotic flowers' in this region. I was very motivated to develop my professional career here.

"The best way to do it? Get an academic degree in CEE," says Mr Petkov, whose first degree was in finance and banking in his native Bulgaria.

He opted for a one-year MBA at the Central European University (CEU) Business School in Budapest, largely because of its good standing in the region.

"The school was recommended to me by a few friends, and I had little hesitation about enrolling," he says.

Like Mr Petkov, each year hundreds of young professionals from CEE countries sign up for MBA programmes at a score or more of management schools across the region; many others opt to do an MSc in Business at university.

Hardly any of these schools, and certainly none of the current programmes on offer, existed before 1989 – when in some countries the word "management" itself was politically taboo.

Management education's short history in the region raises question about these institutions' quality – especially given the abrupt return of capitalism to economies dominated for decades by central planning.

But Mr Petkov, 31 and based in Sofia as a project manager for UniCredit Group, has no doubts.

"That MBA programme has helped me so much in my career. My technical skills – I specialise in corporate finance – were very much enhanced and, dealing with cross-country, cross-functional, change-management projects across UniCredit Group, I have to say every day feels like my Action Learning courses at CEU," he says.

Surprisingly – given that an outsider may associate MBA graduates with grasping young men in striped suits stamping on rivals in a frenzied bid to make their first of many millions – Mr Petkov stresses that his 11-month programme, rather than "overheating" his ambitions to rise quickly to senior executive level, made him more thoughtful about business life.

"The programme shaped me to be both an insightful subordinate and a performing manager, to understand the whole cycle of business management," he says.

Almost inevitably, given the number of institutions that sprung up across the region after 1989 to offer business education, some were of dubious quality.

But so, too, was some of the supposed help from western institutions aimed at improving the newly-founded business sector.

> Hardly any of the schools – and none of the programmes on offer now – existed before 1989

Danica Purg, president of the IEDC Bled School of Management in Slovenia, says: "Sometimes, we were sent second-rate, even third-rate professors; some were really not very good."

As a result of those experiences, Prof Purg has been pivotal in raising standards across the region, founding Ceeman – the central and eastern European Management development association – in 1993 to help schools address quality.

Ceeman has created a range of courses and workshops, with experienced local and visiting professors, that attract participants not only from the furthest domains of its target region, including Russia and the CIS, but increasingly from south Asia, western Europe and even the Americas.

The annual three-day Programme Management Seminar (PMS) is designed to develop the often neglected role of school administrator. It regularly attracts students from western Europe, where the skills taught are typically – and often erroneously – assumed to be capable of being picked up "along the way".

Marina Gordeichuk, senior administrative manager at Skolkovo Moscow School of Management attended PMS in 2009. "It is a unique opportunity for programme managers to meet colleagues from a variety of business schools and to share ideas and experience.

She says: "It gives you a great chance to step back and view your day-to-day work from a different perspective, and gives you an opportunity to benchmark [yourself]."

For all such striving, the highly ranked (and highly expensive) western schools look set to attract the best professors for the foreseeable future, and will lure many from central and eastern Europe who seek a global career.

Yet, Mr Petkov argues, for those seeking a professional life in the region, a local MBA programme makes sense: "In my class, there were 60 MBA candidates from 22 nationalities. The majority originate from CEE, and are still doing business here, which is very positive; [it provides] a geographically close, professional network."

An MBA programme in the US would be so different culturally, and, while one in western Europe – especially with a scholarship – would be "a bit more tempting", he insists he "wouldn't trade my CEU MBA experience for any western degree".

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Economic fears curtail market resurgence

Real estate

Rents in euros have made investment in retail property more popular, says **Jan Cienski**

As risk-aversion eased last year, there was a big impact on emerging European real estate markets, as investors began to snap up properties across the region.

Now, the return of worries about the eurozone and lacklustre economic growth look likely to reverse sentiment.

According to a survey of the region by Colliers, the property services group, 2011 was the best year for real estate investment in the region since 2007, before the crisis began, with €13.2bn in transactions.

Colin Dyer, chief executive of Jones Lang LaSalle, another property services group, says: "Initially, money flows into deep liquid markets such as London, New York and Paris. Then, as prices go up, it starts to flow into cities such as Manchester, Stuttgart and Warsaw." He notes that with yields in Paris of about 4 per cent, Warsaw's yield of 6 per cent makes for attractive investments.

Russia accounted for 40 per cent of last year's investment total, while Poland was the overall leader in central Europe with €2.6bn in transactions – a 37 per cent increase on a year earlier. It was followed closely by the Czech Republic with €2.2bn, about four times higher than in 2010.

The depth and liquidity of the Polish and Czech Republic markets made them much more attractive to investors, who tended to steer clear of less developed ones such as Romania – with only €150m in transactions last year – or politically and economically troubled Hungary, which has fallen out of the region's top league and registered only €650m in commercial property sales in 2011.

"There is a differentiation among the various parts of central and eastern Europe," says Rachel Lavine, head of Atrium European Real Estate, a fund with €2.1bn in CEE retail assets, mostly in the Czech Republic and Poland. "We see a big difference between Poland, the Czech Republic and Slovakia on the one hand and Hungary, Romania and Bulgaria on the other"

Atrium, which last year bought three large shopping centres, one in Prague, one in the western Polish city of Szczecin, and one in Warsaw is an example of the trend for investors to buy fully leased low-risk properties in functioning cities.

John Duckworth, regional managing director for Jones Lang LaSalle says: "There are classic financial product buyers who are focused on Poland and the Czech Republic and want a steady cash flow [investment] in Warsaw or Prague."

Other big buyers included German and Austrian property funds, which had largely withdrawn from the region in the depths of the crisis.

There were also newer entrants such as Blackstone, the private equity group whose property arm is building up retail assets around Poland, including the €110m purchase of a shopping centre in the western city of Wroclaw.

Retail rents across the region tend to be in euros,

Euro winner: local currency risk is transferred from owners to lessees

which lowers the risk associated with the currency fluctuations experienced by CEE countries since 2008.

In effect, the currency risk is transferred to the lessees, as they earn zlotys, koruna or forints, but have to pay rent in euros.

That has made retail investing more popular than office or industrial properties, which languished last year – especially those located outside Warsaw's business district – and are unlikely to be much more active this year.

"Buying Warsaw retail is difficult," says Ben Habib of First Property Group, a UK investor that specialises in properties outside the centre of Warsaw and in secondary Polish cities. "This is because there is a lot of money chasing it. We have been unable to justify the prices for some of the shopping centres."

This year is unlikely to be as vibrant as 2011. Economic growth is slowing across Europe, making investors pause before buying retail properties, and banks are restricting lending as they and their western European parents have to meet tougher capital requirements.

Buyers with a good record can still find financing to buy income producing properties, but developers are facing much more difficult times, which means that few speculative retail and office projects will be built.

Before the crisis, banks would be happy to lend 75 per cent of the cost of a project. Now they are reluctant to go much above 50, and are demanding high levels of pre-leasing.

While that may slow the flow of completions, investors are hoping there could be more secondary properties on the market if banks foreclose on struggling projects that have been kept on the books for the past few years.

"We're hoping there will be some distressed asset sales," says Piotr Krawczynski of Kulczyk Silverstein Properties.

"Until now, banks have been reluctant to take over projects, but that may change, as five-year loans issued in 2007, during the peak of the boom, are now coming due."

But even if distressed deal flow improves, wider worries that the fragility of the eurozone will slow regional growth mean that 2012 is unlikely to be much better than 2011.

Tough battle to keep cash flowing in

Financial support

Vienna Initiative prevented a 'rush to the exit', writes **Neil Buckley**

Three years ago, in the darkest days of the financial crisis following the collapse of Lehman Brothers, the investment bank, regulators and international financial institutions (IFIs) met in Vienna and launched an important project.

The Vienna Initiative aimed to prevent western European banks from pulling out of central and eastern Europe (CEE) markets.

The meeting included the IMF, World Bank, the European Bank for Reconstruction and Development, and the European Investment Bank and lenders pledged €24.5bn – and ultimately disbursed €33bn – to CEE countries, provided commercial banks maintained exposure. There was also financial support for individual banks.

In return for recipient countries' commitment to meet conditions attached to this support, many banks signed letters pledging to stay invested and continue providing credit.

The initiative did its job: banks did not withdraw, and the crisis in CEE, the emerging market region worst hit by the 2008-2009 downturn, was contained.

A recent report by the EBRD found that: "Complementing public funds with a co-ordinated bail-in of private-sector lenders may not only have helped countries to close external funding gaps, but also to soften the inevitable deleveraging process in eastern Europe and prevent an uncoordinated 'rush to the exit'."

But as the eurozone crisis worsened last year, fears re-emerged about a new rush to the exit by western banks. If anything the concerns were greater.

Western European governments, battling to reduce deficits and debt, were this time less able to support their home banks.

The banks, meanwhile, faced heavy pressure from the European Banking Authority's capital requirements and, later, Basel III standards to strengthen their balance sheets at home. The risks of unilateral actions to protect banks without regard to their foreign subsidiaries seemed even higher than three years earlier.

Worries intensified last November when the Austrian National Bank introduced rules limiting its banks' lending in eastern Europe to what they could fund from deposits.

It also accelerated the timeframe for them to comply with Basel III, though the measures were later partly watered down.

The EBRD, one of the main participants in the original initiative, led calls for a renewed effort to keep banks invested in CEE – which was launched in January, again in the Austrian capital, called "Vienna 2.0".

Its goals and resources are more modest – promoting some critics, perhaps unfairly, to call the new initiative "toothless". IFIs did not this time pledge specific sums, saying only they "stand ready" to support bank subsidiaries in eastern Europe if necessary.

"Vienna 2.0 is probably not going to be the headline maker Vienna 1 was," says Erik Berglof, the EBRD's chief economist. "It is more about the long term, and making sure deleveraging is orderly."

The aim is to foster more permanent and organised co-ordination between regulators in "home" countries, where parent banks are based, and the "host" countries of subsidiaries – and between these and cross-border regulatory bodies.

This is something banks have been pressing for.

Herbert Stepic, chief executive of Raiffeisen Bank International, says one lesson of the 2008-09 crisis for regulators was to pursue oversight more stringently.

"However, an overly hasty approach to this challenge raises the prospect of excessive regulatory demands that could undermine banks' productive role in financing the real economy – and thus threaten to damp recovery and growth," he says.

This year's Vienna meetings agreed on eight "basic principles", including ensuring free allocation of liquidity and capital across borders, while preserving

> 'Excessive regulatory demands could undermine banks' role'
>
> **Herbert Stepic, Chief executive, Raiffeisen Bank International**

financial stability; matching the supervisory framework to the cross-border integration of financial markets; and taking account of "spillovers" from national actions by regulators.

Meanwhile, the risks of deleveraging have eased, in part thanks to the European Central Bank's longer-term refinancing operation begun in December.

But the EBRD says deleveraging has been observed since the third quarter of last year, when the Bank for International Settlements saw assets of international banks in "emerging" Europe fall by $33bn, after a net increase of $47bn in the first half of 2011.

Credit growth turned negative in almost all the new, eastern members of the EU by late 2011 and early 2012, the bank adds.

Mr Berglof says: "There are some hotspots at present, but not the massive deleveraging we were worried about late last year. Certainly, in the countries involved, it is affecting the availability of credit."

Some banks have curtailed eastern European operations. But the biggest insist they are committed.

Andreas Treichl, chief executive of Austria's Erste Group Bank, says: "Those banks that don't have a strong local presence will withdraw.

"Those banks that do have strong local operations will definitely not retreat."

Institutions complain of 'brutal' treatment

Hungary

The economic crisis coupled with policies of the centre-right government have had a severe impact, says **Kester Eddy**

When István Karagich advertised for a financial assistant in March, he was overwhelmed with applications.

"We got 400. We used to get about a 100 for a job like this. It just shows how many have been laid off in [the] financial sector," says Mr Karagich, chief executive of Blochamps Capital, a finance consultancy in Budapest.

The global economic crisis, coupled with the policies of Hungary's centre-right Fidesz government, led by Viktor Orbán, have had a severe impact on the country's banking sector.

Precise figures for job losses are hard to come by, but, as an example, the Hungarian unit of Raiffeisen, the Austrian bank group, has shed 800 – more than one in five – of the 3,800 employees it had in 2008, when the crisis began. MKB, the Hungarian subsidiary of Bayerische Landesbank, announced another 165 redundancies this month.

The financial data are also depressing.

"We estimate the entire loss in the banking sector [for 2011] at about Ft300bn (€1bn)," says László Bencsik, deputy chief executive of OTP Bank.

The financial crisis has affected all central and eastern Europe's banking sectors, but, having survived the immediate crisis and its aftermath in 2009, Hungary's banks have been increasingly under the cosh since Mr Orbán's government took power in 2010.

That summer, desperate for revenues and seeking to avoid the political backlash from putting up personal taxes, the regime imposed an "extraordinary" banking levy – making it retroactive for the whole of 2010 to boot.

Tamás Bernáth, head of financial services advisory at PwC, the consultancy, says: "I blame the banks for making some of their problems through reckless lending. But this was brutal. Sure, there are other banking taxes in the world, but at 0.5 per cent of total assets, it's about six times larger than in Austria."

Hungary had another problem. In order to access credit but avoid the high interest rates on forint-denominated loans, from about 2000, households began taking out mortgages in foreign currencies – mostly Swiss francs.

While this seemed like a good idea at the time – when the franc was worth Ft150 – from late 2010 it began a sharp appreciation, peaking within a whisker of Ft270 in summer 2011.

With tens of thousands of homeowners struggling to make monthly repayments, the government pushed through legislation, forcing banks to accept lump-sum loan repayments at the artificially depressed rate of Ft180 to the Swiss franc – with the banks taking the exchange rate loss.

As a result, 170,000 loans, worth some Ft1,300bn (€4.5bn) – or 25 per cent of the total portfolio of Ft5,200bn in foreign denominated mortgages – were repaid in late 2011 and this year.

"This was huge," János Müller, chief adviser of the Hungarian Banking Association, told a Budapest conference last month. "The total loss for the banking sector was Ft370bn; it means the sector showed a negative result in 2011 for the first time since 1992."

Notable exception: OTP was one of the few banks that reported a profit in 2011 Bloomberg

OTP was one of the few banks that reported a profit in 2011, but it was a struggle.

"Including the one-off measures, the return on equity for OTP in Hungary was 4.5 per cent: now, by buying 10-year government bonds, you can get between 8 and 9 per cent," says Mr Bencsik.

> 'The banking sector is the engine of the economy. With no loans, there'll be no economic growth and no new jobs'

While the government thought it had done a good job, critics said the move had mainly benefited the well-off, rather than those unable to cope with their bloated monthly payments.

The banks, meanwhile, quietly seethed. Heinz Wiedner, chief executive of Raiffeisen Bank in Hungary, says "I'm still upset every time I think about the [mortgage] repayment act, because it solved neither the government's nor the country's problems. It helped those people who primarily either had the money somewhere, or who were able to get very good refinancing.

"These were the best clients, who would have been able to repay their loans anyway."

The move also contributed to the weakening of the forint, Mr Wiedner says, adding to the burden for those stuck with their original foreign currency loans.

In addition, Mr Müller points out, banks have cut lending – in particular, credit to small businesses – also hampering growth.

Meanwhile, government measures continue to evolve.

In an effort to ease the mortgage burden further, the government has negotiated a new scheme of deferred repayments, whereby losses are shared between the state and banks. And, while it has promised to halve the bank tax next year, and phase it out altogether in 2014, last week it announced a levy of 0.1 per cent on financial transactions.

This move was criticised by the banking association, which said it broke an agreement that precluded new taxes on the sector that it had signed with the government in December 2011.

Others said it would be costly to implement and encourage yet more businesses to migrate to the grey economy.

For all its problems, Mr Müller insists the sector is solid, with an average capital adequacy ratio of 13.4 per cent, although non-performing corporate loans had climbed to a worrying 15.4 per cent at the end of 2011.

Mr Müller thinks the risk of a credit crunch is the greater threat. "The banking sector is the engine of the economy. With no loans, there'll be no economic growth and no new jobs."

Private equity now focuses on safety of Polish havens

Regional investors

Broader interest is in commercial property, says **Jan Cienski**

Central and eastern Europe may stretch from the Baltic to the Balkans, but for the private equity industry it is much smaller – consisting really only of Poland.

Jacek Siwicki, president of Enterprise Investors, a Warsaw-based private equity fund, has been involved in the region for many years.

During a recent industry breakfast, he said that before the international economic crisis, his investors used to push him to diversify away from Poland, keen not to lose out on other opportunities in a fast growing region.

"Now they are saying, 'Don't tell us about CEE – we just want to know about Poland.' Poland has by far the best reputation among private equity investors," he said.

For those who want to invest in the region, the choice is usually between Poland or Turkey – other countries are barely on the radar, he said

Mr Siwicki's view was seconded by Jiri Zrust, a managing director at Macquarie, the financial services group whose main investment in the region is DCT, a container port in Gdansk.

"In the region, it is only really Poland that is discussed," he said.

The main reason is its size – with 37m people it accounts for about half the region's population – and economic resilience as one of the EU's fastest growing economies.

Analysis by CMS, the law firm, and DealWatch, examining mergers and acquisitions in "emerging Europe" – CEE, Ukraine and Russia – found that there were 3,792 deals last year with a total value of €150bn, about the same level as in 2010.

Russia accounted for 65 per cent of deal value in 2011, while Poland made up 12 per cent.

However, the bulk of the big deals were in Russian mining. The largest non-Russian transaction was the €4.8bn acquisition of Polkomtel, a mobile telephone operator, by Zygmunt Solorz-Zak, a broadcasting tycoon aiming to build Poland's first multimedia company.

The CMS report said: "We expect investors to stay away from small deals in countries such as the Czech Republic, Romania and Hungary. But at the same time, the largest countries [Russia and Poland] are likely to witness growth in deal activity."

One result of this lack of interest from outsiders is that in countries such as Bulgaria local investors have become more active.

Across the rest of the region, where there has been interest from bigger investors this has often focused on commercial property.

Meanwhile, in Poland, local private equity funds on the hunt for deals have increasingly had to compete with industry buyers and big funds swooping

> 'The region has become less homogeneous since the crisis'

in from western Europe to try for some of the biggest deals.

All in all, the country has had a very strong year.

Last year, private equity deal value was €1.2bn, about 18 per cent of all emerging Europe activity, according to a report on deal flow prepared by Exen, Bastion Group and Gide Loyrette Nouel.

Although the industry was not involved in the biggest deal, the sale of Polkomtel, other sizeable transactions included Poland's largest private equity buyout, the €425m purchase of TP EmiTel, a telecommunications company, by Montagu Private Equity.

Other significant deals included the €400m purchase of Zabka, a convenience store chain, by Mid Europa Partners, a UK-based firm, from Penta, a Czech and Slovak investment fund – an example of a "second-generation" private equity investment.

While 2011 was a good year, the outlook for 2012 is more uncertain.

One factor is slowing growth across the region.

Hungary is experiencing political and economic turmoil, Romania and Bulgaria have yet to emerge from post-crisis doldrums, and the Czech Republic recently slipped back into recession. Poland is likely to grow only about 2.5 per cent this year.

Because local banks tend to be owned by west European parent groups, who are battling economic difficulties at home, deals are difficult to finance.

"At the moment, you can get at most 3 to 3.5 times ebitda, or about €200m-€300m," says Thierry Bandon of Mid Europa. "This creates a flight to quality, as only the best deals can be funded."

Recent research by Deloitte, the consultancy, captures the sourer mood.

A private equity confidence index covering 17 countries in central Europe saw its biggest drop in expected market activity since the survey began in 2003.

Almost two-thirds of those questioned in the October 2011 report worried about the availability of financing. However, Poland looked relatively positive compared with the rest of CEE.

"The region has become less homogeneous since the crisis, and Poland really shines," says Robert Manz, managing partner at Enterprise Investors.