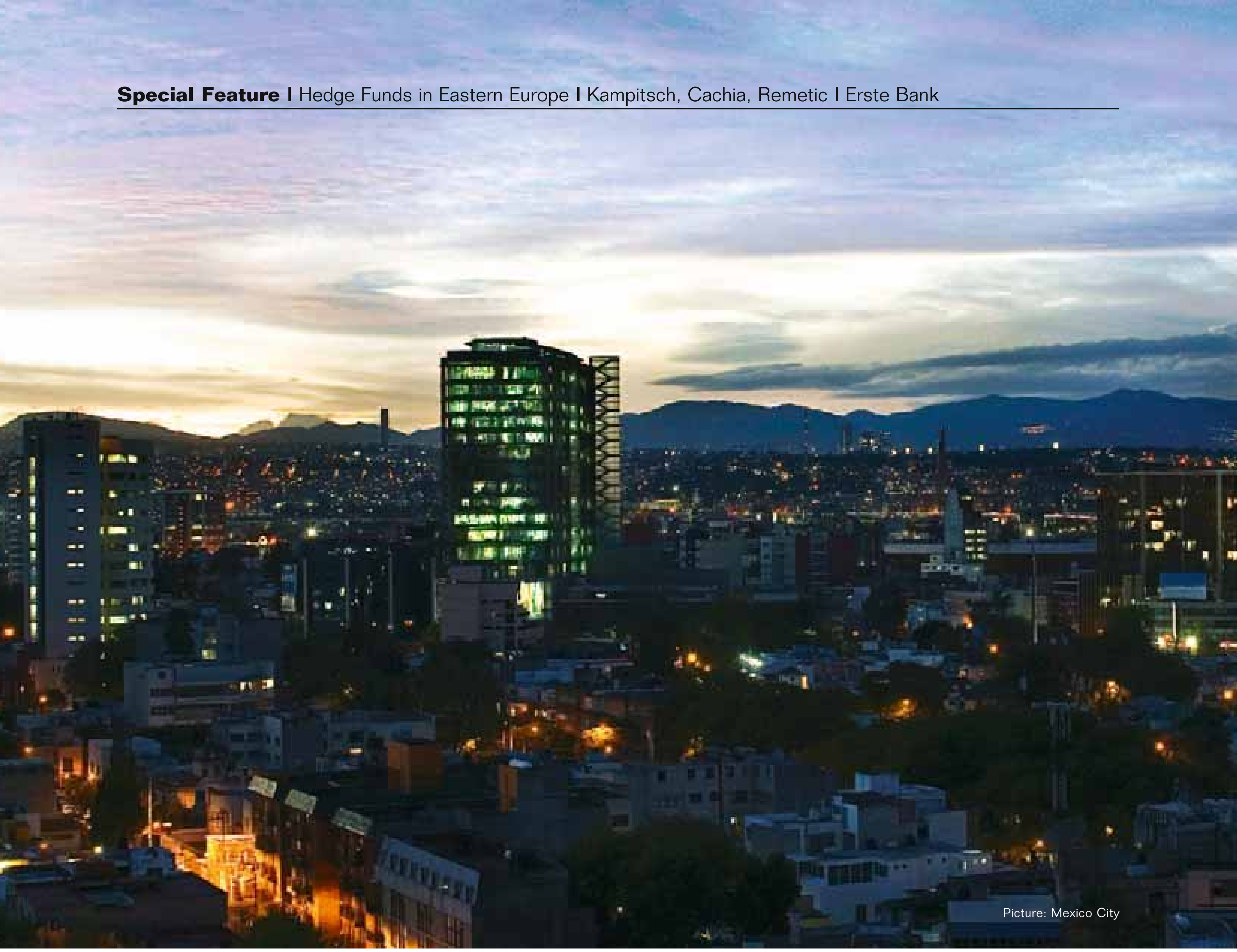


Hedge Funds in Eastern Europe: A case study

By: Christoph Kampitsch, Mark Cachia, Sonja Remetic | Erste Bank

Globalization has unleashed fast track economic convergence of the developed world and the countries which are considered to be in a transitional phase between developing and developed status. We have seen dramatically improved macro fundamentals, surging domestic spending, investor-friendly climate characterized by diversity, volatility, rapid economic growth and immature institutions. Being a key player in the Eastern European financial industry, we highlight the emerging regional hedge fund industry.

In the past 10 years, Eastern European Equities as measured by MSCI have increased over 800% in local currencies (roughly 25% pa). It is worth noting that this includes the Russia crisis of 1998 and the collapse of global equities in 2000. Just in case you might think this 10 year period was chosen out of convenience: looking further back to its launch (in January 1988) the index still shows annualised returns of 25%

Of course, this kind of retrospective investment deserves little applause. No doubt one can find any number of similar success stories; especially if one drills down to the individual markets or securities. However it does provide a context for us to understand valuations and hence the opportunities going forward.

Convergence or converged?

The principal theme for Eastern Europe over the past decade has been one of convergence, much in the same way that Italy and Spain converged in the nineties. We see this trend continuing, but moving further East. Countries like the Czech Republic and Poland approach developed Europe in terms of Equity and Fixed Income valuations. Asset managers therefore have had to look further to find the sort of opportunities that were previously available. We are recently seeing funds concentrating on regions as far as the Baltic States or Central Asia where there is arguably greater economic optionality than in central Europe albeit within the constraints of barely traded equity markets.
To understand the opportunities within the wider region, one has to appreciate that central and Eastern Europe is highly heterogeneous. Although some ideas cross boundaries, many are expressed within individual countries.
The following sections hopefully shed some light on both the macro economic make-up of each, but also some of the more popular themes being captured by managers in each region.

Focus: Eastern Europe

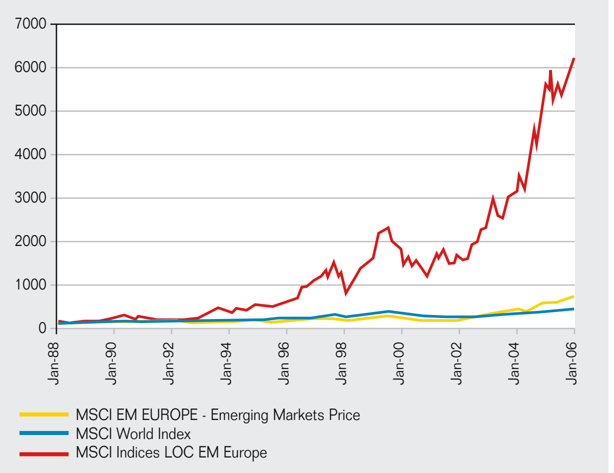
Eastern Europe, ranging from the Baltic to the Balkans, has been on fast reform track since the rise of the Iron Curtain. The countries under the Emerging Europe Umbrella benefited from their exclusive status as a play on joining the European Union and often outperformed the MSCI emerging markets index. Countries whose currencies are converging with the Euro are favoured – with Poland being on top of that list due to its tight ties to Germany and being one of the few foreign countries whose stocks trade on major exchanges in the US.
Being a direct link and a significant exporter to Western Europe and the Middle East, Turkey has been of major interest to many investors, especially those active in the banking and financials sectors. Kazakhstan has also received some attention this year due to the surging importance of oil.
Investors have seen a shift in buying attitude from initially purchasing Dollar- and Euro - denominated Eurobonds to allocating to local-currency government bonds by 2004. This change has been driven to a certain extent by the lack of sovereign external debt, which raised prices and pushed out the spreads that emerging market bonds offer over developed markets to multi-year lows. In 2006, the JPMorgan Emerging Market Bond Index has seen the lowest returns since 2001 (9.9% in 2006 vs. 9.7% in 2001). Central Europe continued to perform well, attracting mostly service industries, setting up regional centres on existent telecom infrastructure, transportation network, European Union Membership and cheap yet skilled labour force. Quite a few emerging economies hope to become not only the extended workbench of companies from high-wage countries but also their back-office. Surveys have showed that German companies are particularly interested in locating facilities in Central and Eastern Europe (CEE). The region is closer to the importers in time zone, physical distance and customer culture.

Editors note: The Special Feature is designed to analyse a subject not directly related, but still relevant, to the rest of the magazine. We have chosen a leader in the Eastern European financial industry, and a seasoned investor in the hedge funds of the area, to provide an overview and short history of the eastern regional hedge fund landscape. The goal is twofold: First, to highlight the rapid changes and traits inherent to emerging markets. Second, Eastern Europe is particularly interesting as a case study, and perhaps roadmap, for Latin American hedge funds.

Hedge Funds and CEE

Russia and the CIS. Russia is the most populous country in the CEE and has the most hedge funds dedicated to it, with over 25 Russian hedge funds with offices in Moscow alone. Scores more are based in London and New York. While many of the larger funds are essentially long-only, or significantly long-biased, many of the smaller funds have more balanced portfolios and are traded opportunistically. Over the last several years, the Russian markets have been driven by booming energy and metals prices, and hedge

Figure 1 I EM Europe Performance



Source: MSCI

funds have benefited greatly from investing in that theme. Natural resource companies dominate the Russian Traded Index (52% Energy Sources, 12% Metals). As a result, long-only, buy-and-hold investors will continue to be at the mercy of energy prices when investing in Russia.

Hedge funds, on the other hand, have diversified their portfolios away from the energy complex. They are investing in themes such as the re-organization of the telecom and utilities industries and the rise of the middle class.

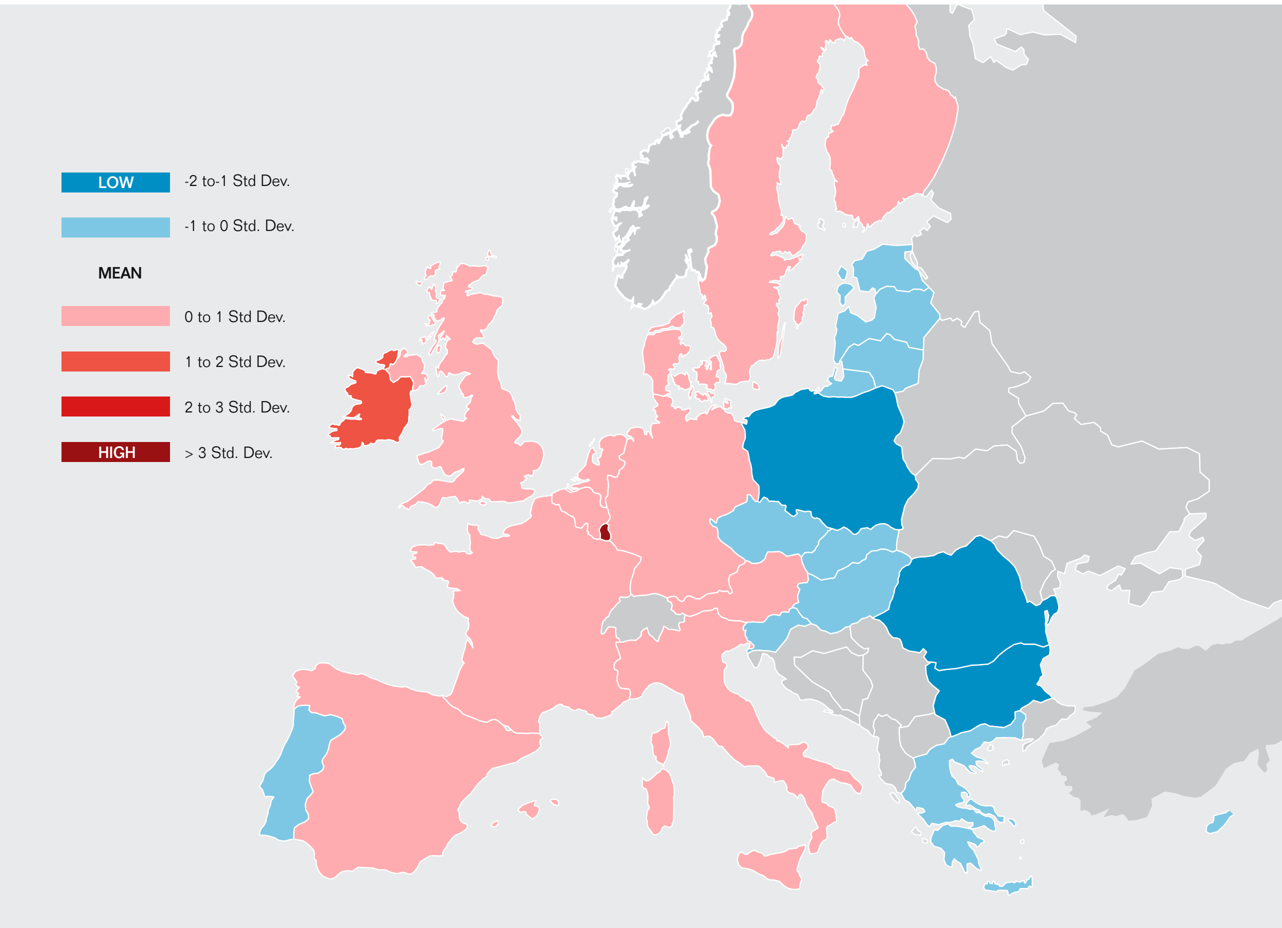
The rise of the middle class theme is popular throughout the CEE, and is expressed in several different strategies, from banking, real estate and construction, to retail. Hedge funds also are generally long the Russian Rouble, and expect continued appreciation over 2007. Managers expect significant volatility in the Russian markets as 2007 progresses due to uncertainty surrounding the elections and the question of succession of President Putin. Therefore, most plan to opportunistically trade around positions, mitigating risk and augmenting returns, an option that is not available to the behemoth long-only players and most mutual funds.

Hedge funds have also expanded out of Russia and into the CIS. Funds dedicated to the Ukraine and Kazakhstan have started in order to benefit from specific themes in those countries. As mentioned earlier, Kazakhstan has rapidly increased its production of oil and other natural resources, and will continue to do so. The financial sector and the capital markets are quickly expanding. Hedge funds are taking advantage of these events, aiding and abetting the emergence of Kazakhstan by providing capital, such as pre-IPO funding.

CE4 – Poland, Czech Republic,

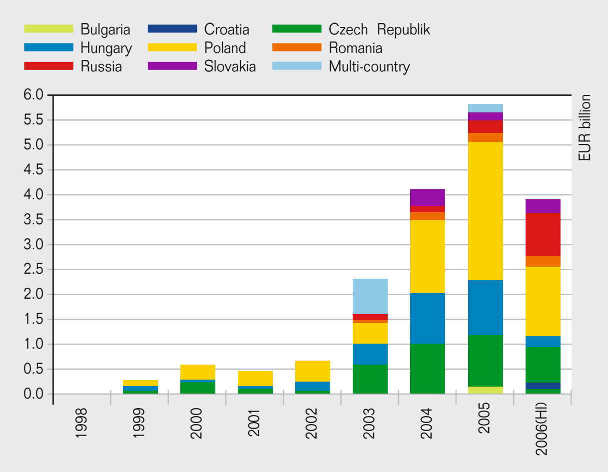
Hungary, Slovakia. The CE4 is the most mature region of the CEE. These countries are all part of the European Union and are at various stages of joining the EMU. Most of the convergence has played out, although some coun-

Figure 2 I European Union GDP (PPP) per capita



Source: IMF, 2007

Figure 3 I Anual CEE investment volume by country



Source: CB Richard Ellis, Noble Gibbons, Elta Consult

tries of the region (i.e. Hungary) have experienced more volatility than others. Hedge funds have benefited greatly from participating in the privatisation of formerly state-owned industries. Favourite positions have been companies such as CEZ, OTP Bank, and MOL, which were fabulously profitable (556%, 224%, and 239% respective 3 year performance), although not without risk (CEZ was down 35%, OTP was down 38%, and MOL was down 28% from their highs in April/May to their lows in June 2006, before rebounding and showing gains at the end of the year). Now that these companies are more fully valued, hedge funds have reduced long exposure to the region and are seeking to trade more opportunistically in the area. Fortunately, the Polish, Czech, and Hungarian markets offer index futures that are quite liquid that managers can utilize to gain short exposure to these markets. Managers also have expressed scepticism on the short term macro fundamentals of Hungary and the Czech Republic and have been incrementally adding short exposure to their currencies.

Turkey. After Russia, Turkey is the next most populous country under the classification of CEE. Not coincidentally, Turkey also has the second highest number of dedicated funds. Long-only investors were not rewarded in Turkey as they were in the other parts of the CEE, with the Istanbul ISE 100 Index declining nearly 3% for 2006 and closing the year down nearly 18% from the February highs. However, the greater flexibility of hedge funds has allowed them to avoid a portion of the downside in Turkish equities, fixed income and currency. While Turkey unquestionably has strong long-term fundamentals, the short term is likely to be fraught with volatility concerning the local political landscape, the EU question, budget deficits, inflation, and the current account deficit. Hedge funds enjoy the luxury of being able to trade both sides of a market that is very well known for its sudden, precipitous drops and its just as sudden, meteoric comebacks.

South-Eastern Europe. South-Eastern Europe, also known as the Balkans, has finally come into its own. The privatization process continues at various stages in the region. Even Slovenia, a member of the EU which adopted the Euro in January 2007, continues to privatize companies. These stock markets have performed tremendously well in 2006, with little participation in the May-June weakness that plagued others in the CEE. It is more difficult to short in this area, and the markets are also far less liquid than others in the CEE. Hedge funds have demonstrated their value by targeting companies that are likely to be acquired, thereby generating better than market average performance and participating in liquidity events.

The Baltic States. The Baltic States are the least populous and smallest geographically. As a result, they present the fewest investment opportunities for hedge funds. Many of the larger companies merged with international companies, leaving relatively few publicly traded opportunities. Consequently, hedge funds have been working in conjunction with private equity funds when investing in the market. While fewer opportunities exist in the Baltic States, the level of risk is also lower than the rest of the CEE.

Real Estate and the CEE

A fast-growing…In the first half-year 2006, CEE property markets continued their swift growth, driven mainly by high GDP growth and low penetration rates. The volume of property transactions in 1H06 reached EUR 3.9bn (+26% y/y). In 1H06, the majority of funds were invested in the core CEE markets of the Czech Republic, Hungary and Poland (79% of the total volume), but Russia is winning ground, accounting for 7% of overall investments. CB Richard Ellis expects a full-year 2006 property transaction volume of around EUR 7.0bn, not counting own development projects. With 65%, most of the current investments are still occurring in the capital cities. In terms of sectors, offices (43% of total volume) and retail assets (40% of total volume) are still dominant.

…and still attractive market. In addition to their high growth rates, CEE property markets also attract with decreasing yield levels, low vacancy rates and increasing rent levels. The convergence seen in recent years between the CEE markets and Western Europe in terms of yield level is continuing. In the core CEE markets, convergence is losing speed, although emerging markets still show room for further compression. Despite a strong increase of available office stock, vacancy rates in the CEE region are stabilizing after declines in the last few years. Aside from the yield level, the rent itself is the second factor contributing to the value of a property. As a consequence of the rather stable development in vacancy levels, rents have also remained nearly unchanged. Moscow is the exception, as we have seen consistent rental growth over the last few quarters there. According to Jones Lang LaSalle's European Office Property Clock (which shows the expected change of absolute rent levels in prime locations within each market), most CEE cities are either in the phase of bottoming out (Prague, Vienna), or have already entered a phase of rental growth (Budapest, Warsaw). Moscow

Figure 4 I Local statistics

	Population	GDP (PPP) millions of int.dollars	GDP (PPP) per capital int.	GDP (nominal) per capital int.dollars	Percentage of EU average GDP (PPP) per capital
European Union	485.703.094	13,840,833	27,894	30,937	100%
Luxembourg	448.569	35,194	76,025	91,927	273%
Ireland	3.883.159	191,694	45,135	57,163	162%
Denmark	5.368.854	203,502	37,399	54,474	134%
Austria	8.169.929	298,683	36,189	41,266	130%
Finland	5.157.537	179,141	34,162	41,542	122%
Belgium	10.274.595	353,326	33,908	39,331	122%
Netherlands	16.318.199	549,674	33,079	42,763	119%
United Kingdom	60.201.000	2,004,461	32,949	41,960	118%
Germany	83.251.851	2,698,694	32,684	36,779	117%
Sweden	9.090.113	296,715	32,548	44,454	117%
France	59.765.983	1,988,171	31,377	37,417	112%
Italy	58.751.711	1,791,006	30,383	33,078	109%
Spain	40.007.100	1,203,404	28,810	31,727	103%
Greece	10.645.343	274,493	24,733	24,030	89%
Slovenia	1.932.917	49,062	24,459	18,346	88%
Cyprus	802.000	19,692	23,419	22,046	84%
Malta	397.499	8,447	21,081	14,598	76%
Portugal	10.084.245	217,892	20,673	19,000	74%
Czech Republic	10.256.760	210,418	20,539	15,186	74%
Estonia	1.415.681	25,796	19,243	12,933	69%
Hungary	10.075.034	190,343	18,922	10,914	68%
Slovakia	5.422.366	101,220	18,705	11,307	67%
Lithuania	3.601.138	56,985	16,756	9,620	60%
Latvia	2.366.515	34,426	15,061	10,074	54%
Poland	38.625.478	556,933	14,609	9,214	52%
Bulgaria	7.621.337	82,533	10,844	4,075	39%
Romania	21.698.181	218,926	10,152	6,338	36%
Candidate countries					
Croatia	5.654.200	61,804	13,923	10,559	50%
Turkey	72.600.000	653,298	8,839	5,417	32%
Republic of Macedonia	2.054.800	17.902	8,738	3,040	31%
Potential Candidate Countries					
Bosnia and Herzegovina	3.964.388	25,505	6,884	2,774	25%
Albania	3.544.841	18,329	6,259	3,175	22%
Serbia	9.663.742	51,162	6,112	3,700	22%
Montenegro	616.258	2,412	3,800	1,784	14%

should see rental growth slowing down - after significant growth in the last few quarters.

Conclusion

The best way to understand any asset class, a market or a region is by studying it intensively, have some "real" exposure there (not just on paper) and people with long expertise in the local market. In case of investing in hedge funds in Central and Eastern Europe (the same is of course true for Latin America or any other emerging market) one must travel within the region extensively, talk to the right people (speaking their language helps a lot) and find the local investment talent. One cannot just search databases to find the right managers or open a specialised magazine to read about the local hedge funds.
On top of what is outlined in the editors note we want to highlight two more things: Firstly, share some of our insights in this region with the readers and secondly, show the advantage of finding the right managers, in this case someone has who is as anchored there as the Alternative Investment Team of Erste Bank.

Picture: Buenos Aires