Emerging Europe investment

Why screen for qualitative risks?

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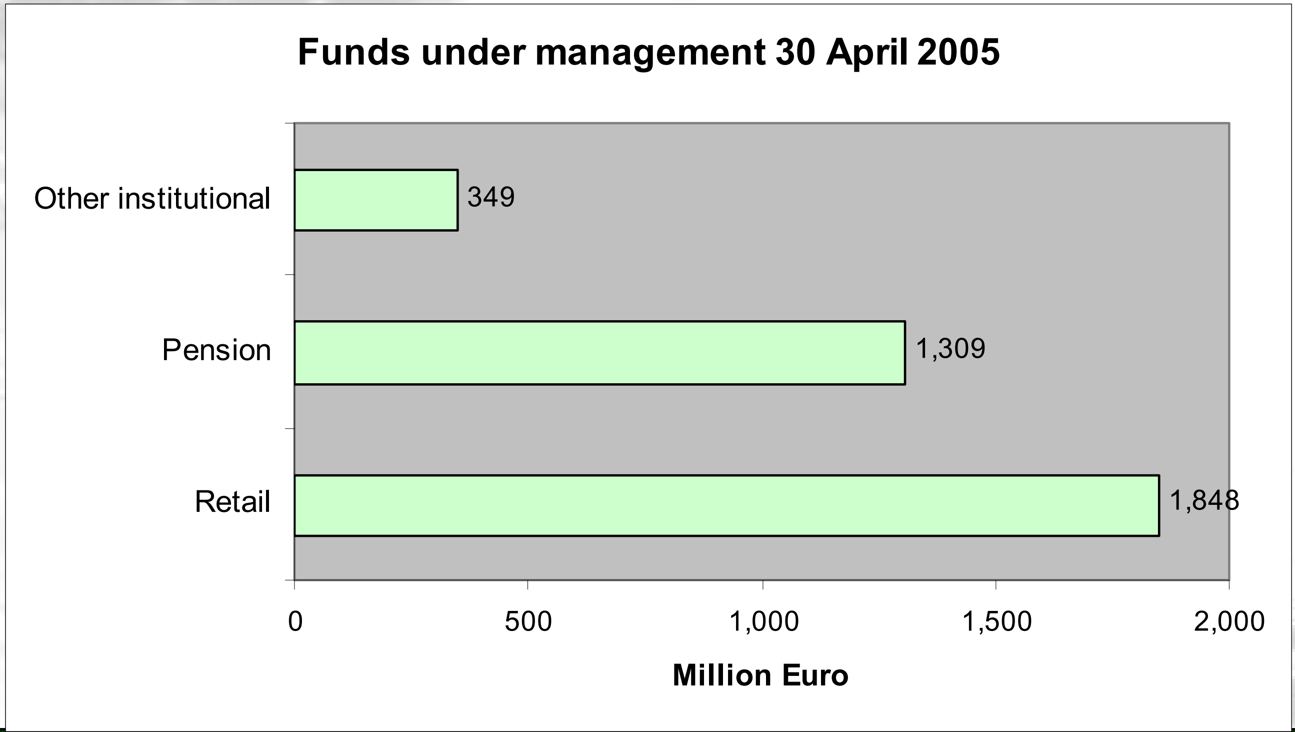
OTP Fund Management

Market leader in Hungary

- **> 25% AUM – Euro 3.5 billion**
- **> 42% retail fund market – Euro 1,8 billion**
- **> 20% pension funds market – Euro 1.3 billion**

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

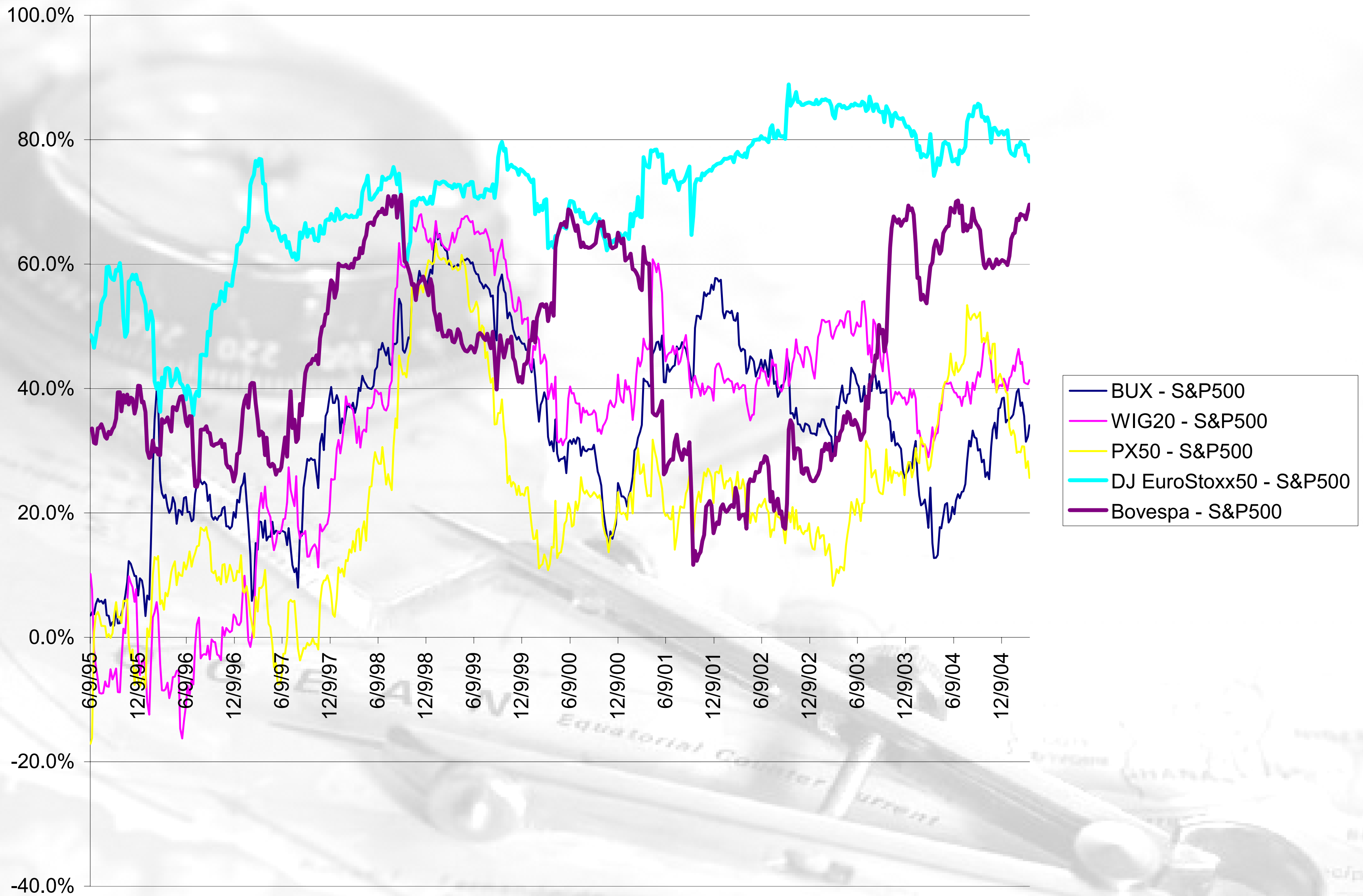


Emerging Europe investment - context

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

- *⇒Yet CEE perceived to be a riskier investment*

Correlation between movements in CEE indices and the S&P500



Why screen for qualitative risks?

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

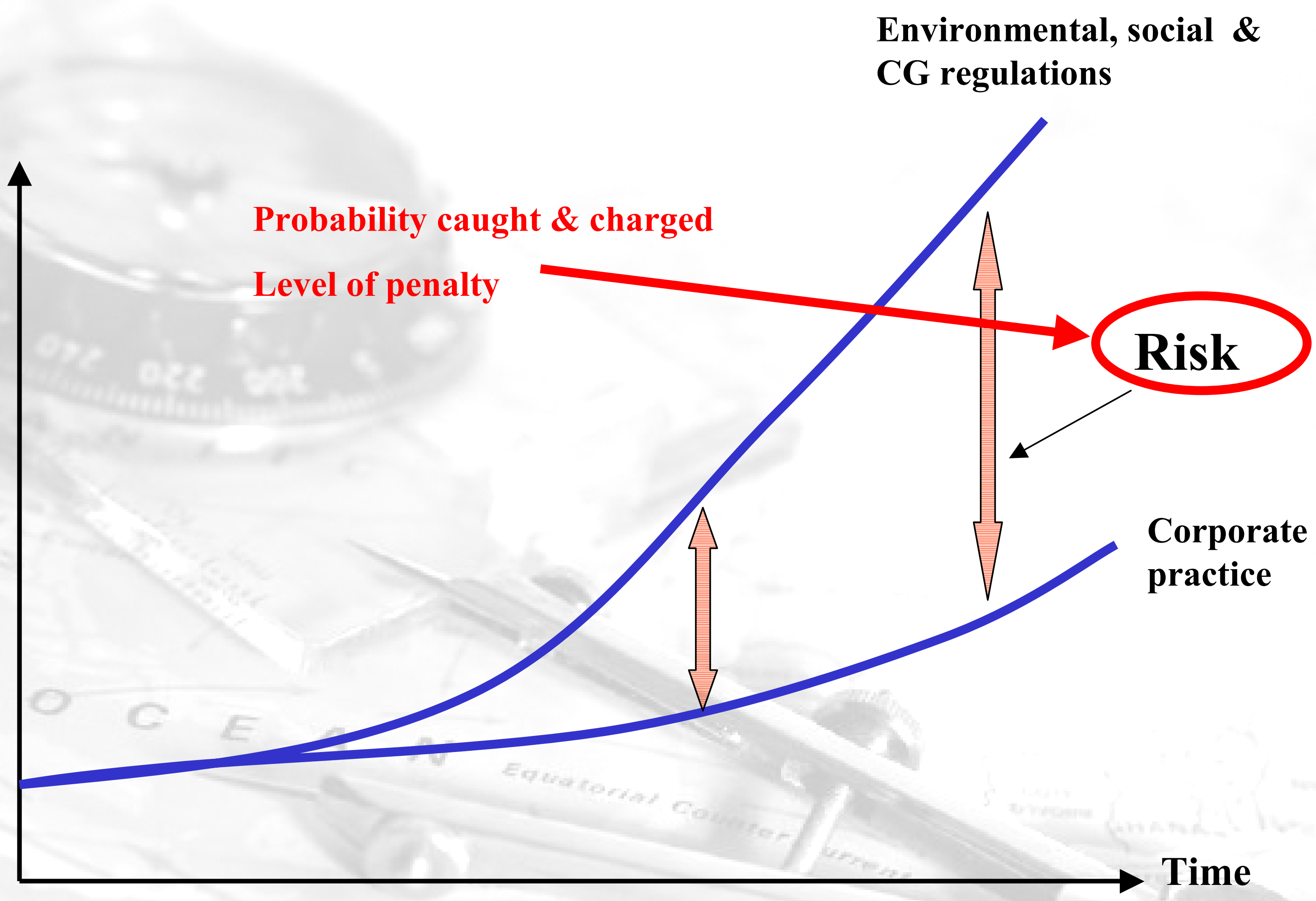
Target: identify quality management

- **McKinsey (2002):** *investors willing to pay a 30% premium for equity in well-run companies in emerging markets*
    - No fund systematically examines “next generation” social & environmental risks
    - ….and corporate governance analysis often superficial
- **Why?**
    - Not important? **(x)**
    - Low awareness? √
- Not so different from the majority opinion in Western Europe right now…

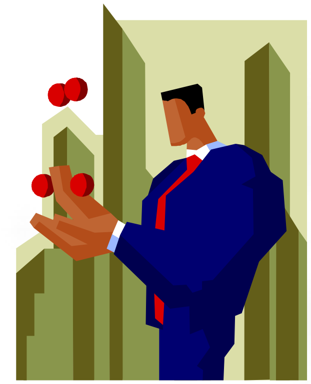
Why screen for qualitative risks in CEE?

- **EU *aquis communitaire* -** the most significant legislative & institutional change relating to environmental, social & CG issues since communist rule
- **Customer demand** – high education & increasing awareness – April 05 Eurobaramoter poll:
  - 7 of top 10 countries where respondents weighed environment most highly in CEE
  - In CEE, air and water pollution, man-made disasters (e.g. oil spills & industrial accidents) and waste management top the list
  - Only 2% trust companies on environmental matters
  - 40% would be willing to pay a bit more for eco-friendly products (vs. 29% in W Europe)

Gap analysis



What are the key corporate governance risks?



History of shareholder abuse

- Excessive power of controlling stakeholders – including through “shadow” directors
- Inadequate Board independence
- Board advisory committees – lack professionalism and power
- Insider trading
- Poor remuneration disclosure
- The use of poison pills to deter takeovers
- Non-transparent intra-group relationships, especially auditors

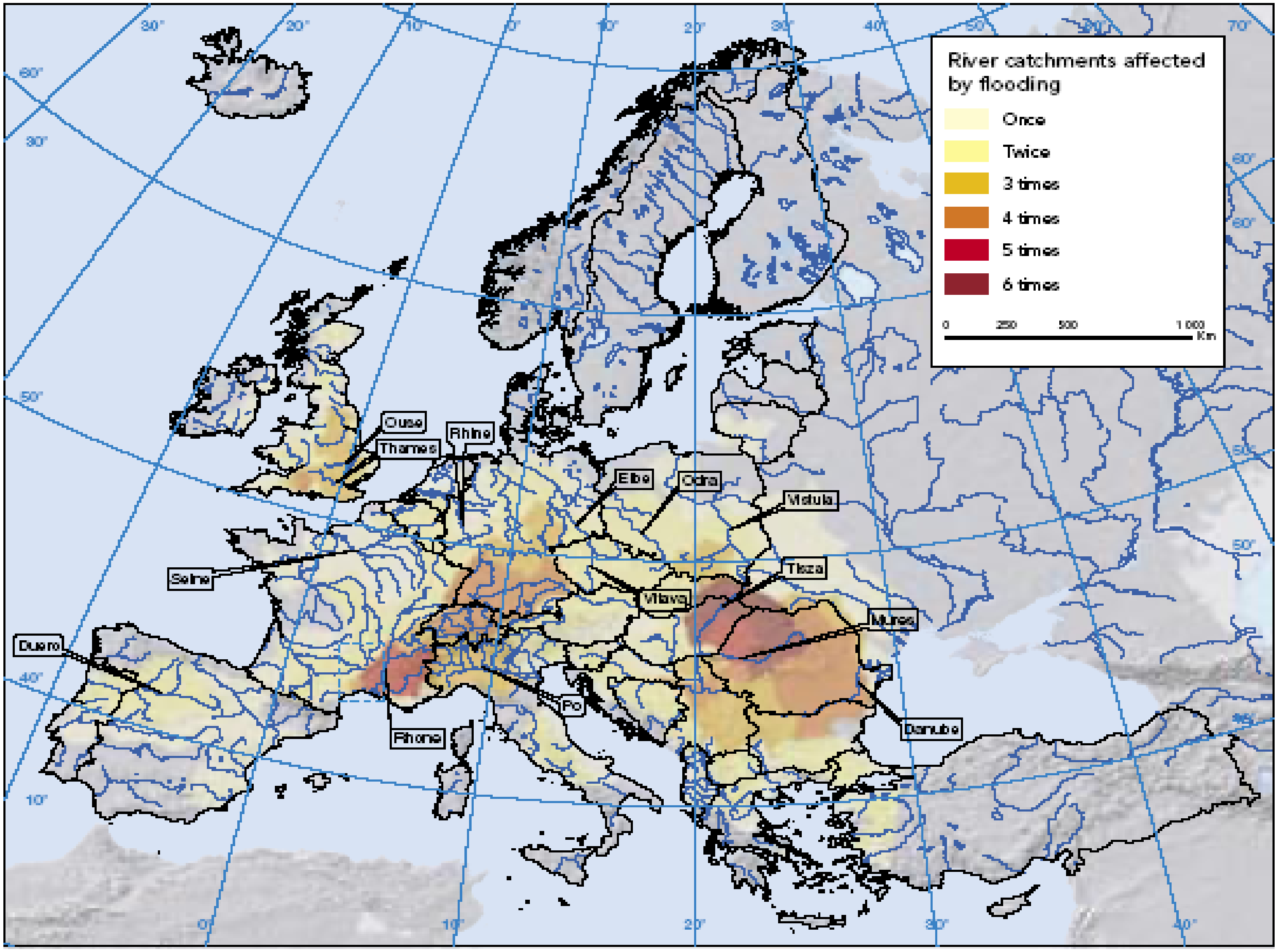
What are the key corporate governance risks?

- Deutsche Bank (2003) - premium higher in CEE than Western Europe
  - Top 10% of companies with respect to CG in the MSCI Emerging Europe and Middle East index outperformed the worst performers by 156% (price to BV).
  - Similar out-performance with price to earnings, price to cash flow, enterprise value to EBITDA, and return on equity.
- Out-performance stronger than in Latin America or South Africa
- Other supporting evidence: Credit Lyonaise Securities Asia (2001), Gompers *et al* (2003), Klapper and Love (2002), Black *et al* (2003), and Brown and Caylor (2004).

What are the environmental risks?

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

Map 1 Recurrence of flood events in Europe 1998–2002



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

What are the social risks?

- Size of informal economy: pension and social security problems
- Lack of formal labour relations
- Health & safety at work: longer and less flexible working hours; exposure to stress
- Discrimination: Roma, age, disability and gender – internal & supply chains
- Underdeveloped customer responsibility
- Bribery, corruption and nontransparent political contributions
- Low awareness of broader stakeholder community

The case of Biedronka - Poland

- In 2004 a middle manager for the discount grocery chain, Biedronka, sued her employer for unpaid overtime
- First ever such suit in Poland
- Case went to appeal, and in May 2005 awaiting final verdict
- Case worth Euro 8,500, but other staff suits against Biedronka total Euro 24 million
- Senior management face criminal investigations
- The aftermath:
  - Carrefour (70 cases), Auchan (30), Geant (30), Tesco (around 20), Real (10), Leclerc (2)
  - Sharp increase in sexual-harassment cases

What about the opportunities?

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

A growth area

Recycling is big business…

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

Our vision

Product: Emerging Europe SRI product

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

Style: Alpha-enhancing &/or ethical

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

Market: International – Western Europe and CEE