

# EME-Report

Danske Capital • September 2007



## Eastern European Seminar

On 26 September 2007 Danske Capital invites you to our Eastern European Seminar in Copenhagen.

The topics are:

- A presentation of the EME-Report
- Expansion of retail banking and fund management in Eastern Europe
- Investment opportunities in Eastern Europe

Among the speakers are Researcher Ville Kaitila from ETLA, Head of Investor Relations Gabriele Semmelrock-Werzer from Erste Bank and Portfolio Managers Kustaa Äima and Ole Gotthardt from Danske Capital.

Please contact your respective contact person in Danske Capital for further information.

## Investor trips

Danske Capital arranges two investor trips to the Balkans during the autumn:

8-11 October 2007

25-28 November 2007

The investor trips will give you a close first-hand insight into the Southeastern European region with several interesting company visits and meetings with local macro analysts.

Please contact your respective contact person in Danske Capital for further information.

## How fast will Eastern European countries catch up with the EU?

A new study commissioned by Danske Capital analyses the growth prospects of Emerging Markets economies in Europe<sup>1</sup>. The study is carried out by the independent research institution ETLA, The Research Institute of the Finnish Economy. The main findings from an investor's perspective are listed below.

- The convergence towards EU-15 means that Eastern European countries enjoy a higher level of investment growth and faster productivity growth thereby rendering high economic growth sustainable and creating attractive equity investment opportunities.
- Convergence is not an automatic process, however. Political stability, education and growth-oriented policies can positively influence the process. EU will provide most countries with this stability and encourage a growth-oriented environment through increased foreign direct investments (FDI).
- By 2030 Eastern Europe is estimated to account for 41% of total European GDP compared to 27% today and to further increase to 44% in 2050. The potential EU-members are forecasted to increase their percentage of EU-15 GDP from 19% today to 41% in 2050. A share of 41% exceeds Great Britain and Germany's contributions to EU-15 GDP today.
- With the EU serving as an anchor for political stability, Eastern Europe does not have the same risk characteristics as those of the Emerging Markets in Latin America and Asia, where the convergence process is less obvious than in the EMEs.
- The report shows that return on capital will be higher in the EMEs than in the EU-15 countries. The EMEs' higher return on capital and appreciating currencies will constitute attractive investment opportunities.

View the full EME-report at [www.danskecapital.com](http://www.danskecapital.com)

<sup>1</sup>ETLA, Ville Kaitila - Kari Alho - Nuutti Nikula (2007): "Growth Prospects of Emerging Market Economies in Europe - How fast will they catch up with the old west?". Study commissioned by Danske Capital.

## New study highlights the convergence process

For over a decade, the majority of Eastern European countries have been growing faster than the wealthier EU-15 countries<sup>2</sup>. Faster growth has enabled the economic well-being of these countries to approach that of Western Europe. The present study concerns the economic growth of 21 Central and Eastern European Countries (Emerging Market economies, hereinafter "EMEs") since the beginning of the 1990s

and in particular the growth prospects of these countries up to 2050 compared to the EU-15 countries. This white paper summarizes the most important aspects of the original study done by ETLA and commissioned by Danske Capital. It furthermore highlights some interesting points with respect to the investment case for this asset class.

### Projected PPP-adjusted GDP per capita in the EMEs, EU15= 100

Country	2000	2030	2050	Country	2000	2030	2050
Lithuania	34	84	94	Croatia	37	71	84
Estonia	38	87	93	Turkey	26	66	84
Hungary	47	82	92	Slovakia	42	74	83
Slovenia	67	88	92	Bulgaria	24	69	82
Russia	27	76	91	Ukraine	16	63	82
Latvia	31	82	91	Romania	25	67	81
Czech Republic	59	83	87	Macedonia	24	58	80
Kazakhstan	17	69	87	Bosnia-Herzegovina	23	61	79
Poland	41	74	87	Albania	13	52	79
EME average	28	71	87	Armenia	10	60	79
Azerbaijan	10	67	86	Georgia	8	45	71

### Convergence means growth

The report documents that Emerging Markets economies in Eastern Europe enjoy a higher level of investment growth and faster productivity growth than the rest of Europe. This makes high, long-term economic growth sustainable. EU-15 countries are expected to continue to grow at an average annual rate of 1.9% for the period 2006-2050, while the EMEs will grow at 3.7% per annum. Based upon a conventional macroeconomic growth model the EMEs' combined GDP is forecasted to reach 87% of that of the EU-15 by 2050 (PPP adjusted GDP/Capita).

### EU provides the EME-countries with a stable environment for growth

"Convergence is not an automatic process as global economic history very clearly demonstrates<sup>3</sup>." The speed of convergence is influenced by factors such as political stability, education and population growth. The report argues that in so far as the EMEs reform their economic structures and allow for working markets and economic integration with the rest of the world, convergence is likely to continue. EU can in this sense be seen as an anchor providing support for countries likely to join the EU and encourage the EME-countries to support a growth-oriented economic development. Those EMEs that are or will become members are better sheltered from national policies that could interrupt this development.

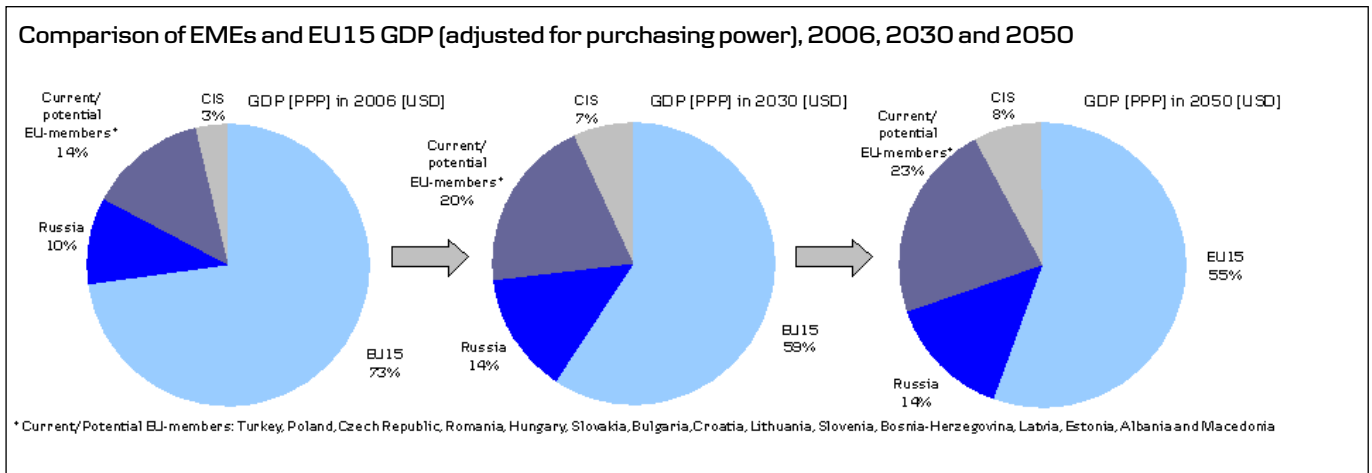
<sup>2</sup> The EU-15 countries include the Netherlands, Belgium, Spain, the United Kingdom, Italy, Austria, Ireland, Greece, Luxembourg, Portugal, France, Sweden, Germany, Finland and Denmark.

<sup>3</sup> ETLA, Ville Kaitila - Kari Alho - Nuutti Nikula (2007): "Growth Prospects of Emerging Market Economies in Europe - How fast will they catch up with the old west?". Study commissioned by Danske Capital.

## The economic balance will change

With growth rates in the EMEs in excess of those in EU-15, the economic balance between East and West is likely to change significantly over the coming decades. The EMEs' total PPP adjusted GDP is estimated to reach almost half of European GDP by 2050. Combined with appreciating local currencies this development will increase the purchasing power of EME consumers. Such increase in wealth is likely to benefit European companies as well. Convergence is thus expected to benefit both the East and West.

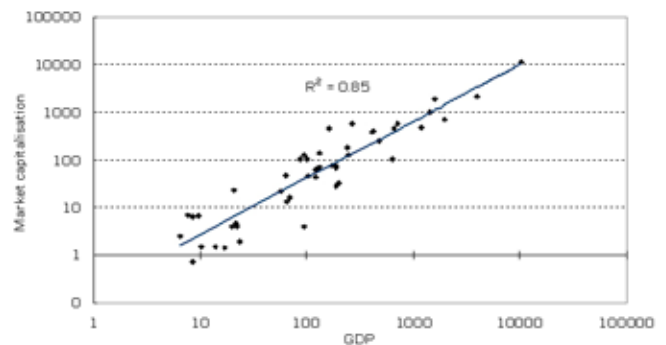
The figure below clearly shows how the balance is going to change in the decades ahead. Today current and potential EU-members' GDP is currently 19% of EU-15, which is just below Germany's current level of EU-15 GDP. This level is estimated to increase to 33% in 2030 and 41% in 2050. In 2050 the Eastern European countries likely to join the EU are going to constitute as large a percentage of EU-15 GDP as that of Germany and Great Britain today, making it difficult to justify today's very modest exposure to the region.



## Higher rates of return on capital in EMEs

The study also projects the return on physical capital, i.e. the return in relation to invested capital (before taxes). The report shows that return on capital will be higher in the EMEs than in the EU-15 countries. However, as convergence progresses, this spread will diminish. The EMEs' higher return on capital and appreciating currencies will present attractive investment opportunities. Convergence is also expected to lead to the growth of EMEs' financial markets, and stock market capitalisation is expected to rise closer to that of the EU-15 countries. The figure to the right shows a clear relationship between GDP/capita and market capitalisation.

Relationship of GDP and stock market capitalisation (USD (log) billion, 47 countries included)



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Danske Capital is an international asset management company and part of the Danske Bank Group. Located in Northern and Eastern Europe we manage more than EUR 85bn in assets for both home market retail clients and institutional clients from around the world.

Headquartered in Denmark, Danske Capital has more than 120 investment professionals providing investment management, client services and sales from offices in Luxembourg, Sweden, Norway, Finland, Estonia and Lithuania. We also have analysts and managers in Sofia and Sarajevo. All offices operate from one global platform, enabling us to deliver high quality, uniform service and reporting to all clients.

Danske Capital focuses in-house resources on the management of Nordic, European and Eastern European assets, where we have the knowledge, resources and systems to deliver excellent performance.

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## Convergence leads to attractive investment opportunities

Danske Capital has been investing in Eastern European equities since the early nineties. The convergence process has for a number of years been an integral part of our investment philosophy and process. The ETLA study supports our view that convergence is likely to continue with EU-15. It is our opinion that Eastern Europe will become a bigger part of the total European economy leading to a shift of financial assets from West to East.

Today most life & pension companies in Europe and the Nordic region obtain exposure towards convergence through global Emerging Markets. This will only provide a small allocation to Eastern European equities. Therefore we recommend an increased exposure to this very attractive asset class.

Danske Capital's product range covers the entire region with an interesting mixture of funds covering the entire region as well as specific country and sector funds. Identifying companies that are likely to benefit the most from the convergence process is a key driver of performance. All funds are actively managed and have one common approach towards a fundamental research of the underlying companies.

We thus have a team of dedicated research analysts based locally in the region to identify the companies benefiting most from the convergence.

Convergence is our primary guide to investing in Eastern European equities.