HOLD ASSET MANAGEMENT

QUARTERLY **INSIGHTS**

HOLD ASSET MANAGEMENT — THE CENTRAL-EUROPEAN VALUE-BASED EQUITY SPECIALIST

CEE EQUITY MARKETS: WHY INCENTIVES MATTER

Under-recognition of the power of what psychologists call 'reinforcement' and economists call 'incentives.'

Excerpt from the speech of Charlie Munger on the psychology of human misjudgment (Harvard, 1995 June)

Under-recognition of the power of what psychologists call 'reinforcement' and economists call 'incentives.'

Well you can say, "Everybody knows that." Well I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it.
And never a year passes but I get some surprise that pushes my limit a little farther.

Being value investors, in-depth analysis of fundamental data is at the core of our research process. However, during our journey of gaining investing experience and expertise we realized that analyzing the incentives of the decision makers is of paramount importance, also a key tool in our risk management. It is especially true in our core universe Central-Eastern Europe, where incentives are quite skewed compared to those in developed markets.

Incentives are a natural historical consequence of the economic and political developments of these countries. Having been part of the Soviet bloc until 1989 every major company was state owned. Private ownership or stock exchanges did not exist. Although since the democratization of the CEE countries led to fast privatizations in the following two decades, populistic political backlash reversed this process recently. A notable case is Poland, which is the largest CEE economy.

As a consequence, around 45% of the regional Index (MSCI CEEC ex Russia) consists of companies, in which the state has great influence by way of being the majority or a strong minority shareholder. Any passive investor in CEE markets should be aware of this fact.

To understand the incentives of the decision makers, we should analyze the shareholder structure of the companies. Hence we created three categories: state owned, publicly owned and owner operated companies. The latter needs further explanation. We split public companies into two brackets: do they have a major individual shareholder, who has skin in the game by investing his personal wealth in the company or not. This helps us to tackle the principal-agent problem.

In the world of passive investing, more and more public companies do not have an active large principal shareholder. These companies are run by managements, who are incentivized to run the show with a short term focus, satisfying investors' short-term expectations. However there is no gain without pain. Long term shareholder value creation often requires sacrifices in the short term (upfront development costs hurting profits, underutilized assets, etc) and contrarian, anti-cyclical decision making such as allocating capital into segments out of favor.

The management of most public companies has no strong backing from fragmented shareholders to pursue a strategy optimized for the long term. Finally, these managements are often incentivized to grow the business even without value creation, as larger size can justify higher salary. We have met numerous cases when the management's bonus was dependent upon revenue, earnings and investment growth without focusing on the Return on Invested Capital.
We truly believe that companies where the interests are properly aligned the chances for long term shareholder value creation is significantly higher. Therefore we think that in the long run, owner operated companies should outperform. This is also confirmed by the global experience shown on the chart below.

STOCK PERFORMANCE OF FAMILY-OWNED COMPANIES COMPARED TO THE MARKET

SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT

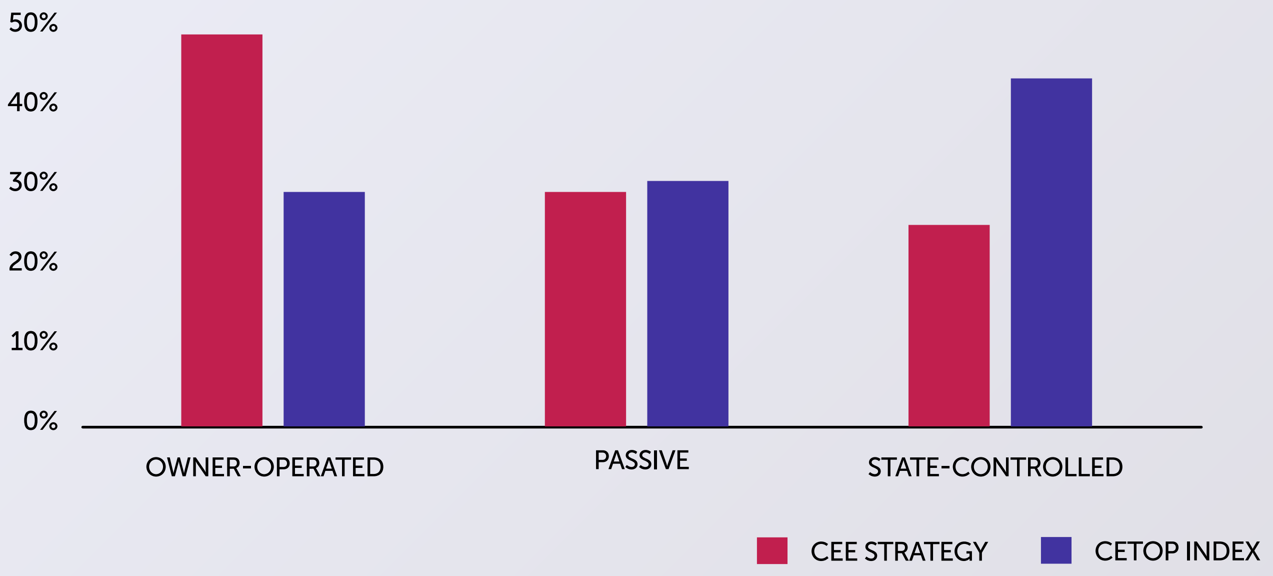
From the incentives point of view, ceteris paribus owner operated companies are the best potential investments whilst state owned companies are destined to be the worst. Why? Because states have other topics on the top of their agendas rather than maximizing returns for minority shareholders.They concentrate on stakeholder value instead of shareholder value and often the most important stake is the political existence of the incumbent political leadership.

For value investors to find undervalued assets is challenging as the market usually assigns valuation premium to most of the well run owner operated companies. But we monitor every owner operated company in our region with particular interest in those that have ongoing problems dragging down their shares. Temporary difficulties enlarged by the investors' psyche from time to time creates appealing entry points.

On the flip side of the coin, as value investors we don't rule out investing in state owned companies as their valuations are often depressed, especially when value destruction is in the forefront. We are willing to invest in state owned enterprises if they are attractively valued and investors are preoccupied with the risks.

The following chart shows the distribution of the CEE regional CETOP Index (calculated by the Budapest Stock Exchange) and Hold CEE Convergence Fund's holdings by their ownership. It illustrates well the dominance of state ownership and a low number of owner operated entities in the regional benchmark. On the other hand by looking at our current holdings the opposite is true, an overweight in owner operated and underweight in state controlled entities. However we must add that recently we tactically increased our exposure to state owned entities as in some cases markets start to price in more value destruction than realistically possible.

COMPOSITION BY OWNER



SOURCE: MSCI, HOLD ASSET MANAGEMENT

This topic is highly relevant in Poland recently, with PiS (Law and Justice party) gaining majority in 2015 and confirming its rule in 2019. PiS has since significantly influenced the Polish stock market in a detrimental way in at least three sectors: banking, utilities and energy.

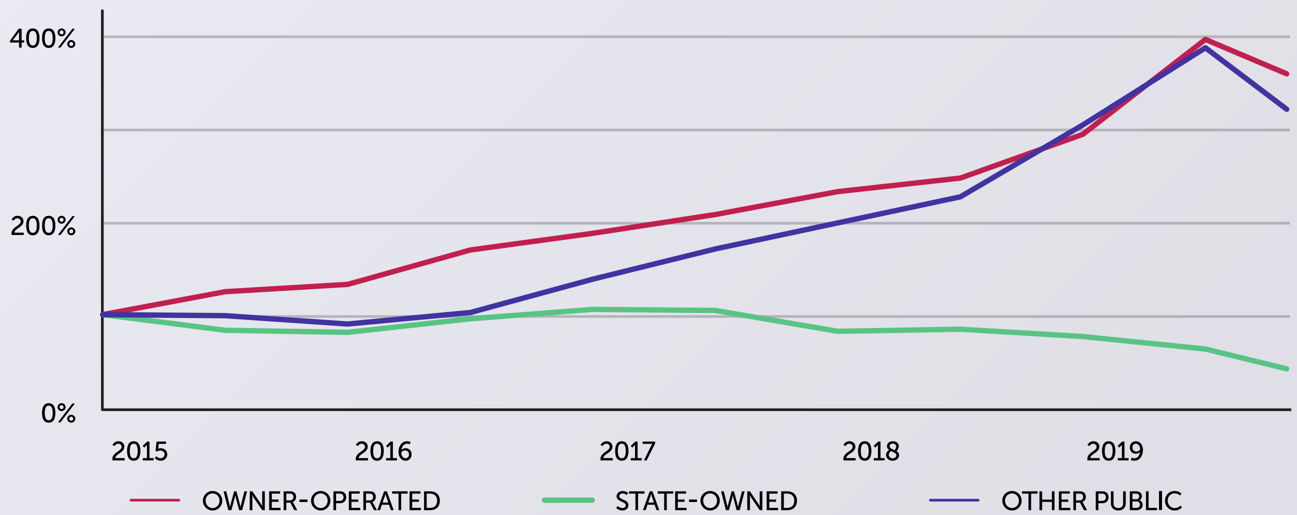
In the banking sector PiS decided that the state should gain market share via acquisitions. First, they took the opportunity that Unicredit (due to capital problems) wanted to exit the 2nd largest Polish bank, Pekao, and utilized state insurer PZU and Polish Development Fund to acquire a 30% stake. Pekao was historically trading at a significant premium to state owned largest bank PKO. This premium has disappeared since. PZU also bought control in Alior, a greenfield bank, which has lost seventy percent its market value since the initial investment. The Polish government plans to initiate further bank acquisitions, which makes the minority shareholders of both Pekao and PKO quite concerned.

In the utility sector, the largest problem is a social one: large number of Poles are employed by the local inefficient and very pollutant coal mines. Instead of gradually closing them, Polish government decided that utility companies should support them by raising capital and building new, value destructive coal power plants. More recently, Poland froze retail electricity prices to shield people from increasing electricity bills fueled by the jump of CO_2 certificate prices. Utilities paid the bill again – although they have been compensated partially. Finally, for national energy security reasons Poland plans to build nuclear plants to offset the retirement of its old coal fueled power plants. Nuclear investment is extremely value destructive under current terms without a guaranteed offtake price that is twice as high as the market price of electricity. Poland also plans to deliver the nuclear projects through the listed utility companies. As a consequence of state influence all Polish listed utilities cancelled dividends in the last few years and lost 60-70% of their market value in last 5 years.

Currently Poland has been one of the worst performing capital markets globally in the last five years, depressing the return of passive investment strategies and those active ones for whom the CEE region is rather small to engage in stock selection.

We are highly convinced that investors have to put great emphasis on the incentives of the owners in order to achieve superior returns. This is especially true in the CEE markets where passive investors are highly exposed to the risks of state ownership. Throughout the years our experience and performance have shown that significant alpha can be generated by overweighting owner operated companies. Currently our top three holdings in our Emerging Europe long only equity mandates - namely Mayer-Melnhof Karton, Digi and a Hungarian REIT - are all owner-operated companies.

TOTAL RETURN PERFORMANCE OF CETOP INDEX COMPANIES SINCE PIS IN POWER



SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT