# QUARTERLY **INSIGHTS**

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

## 2020 CEE INDEX CHANGES

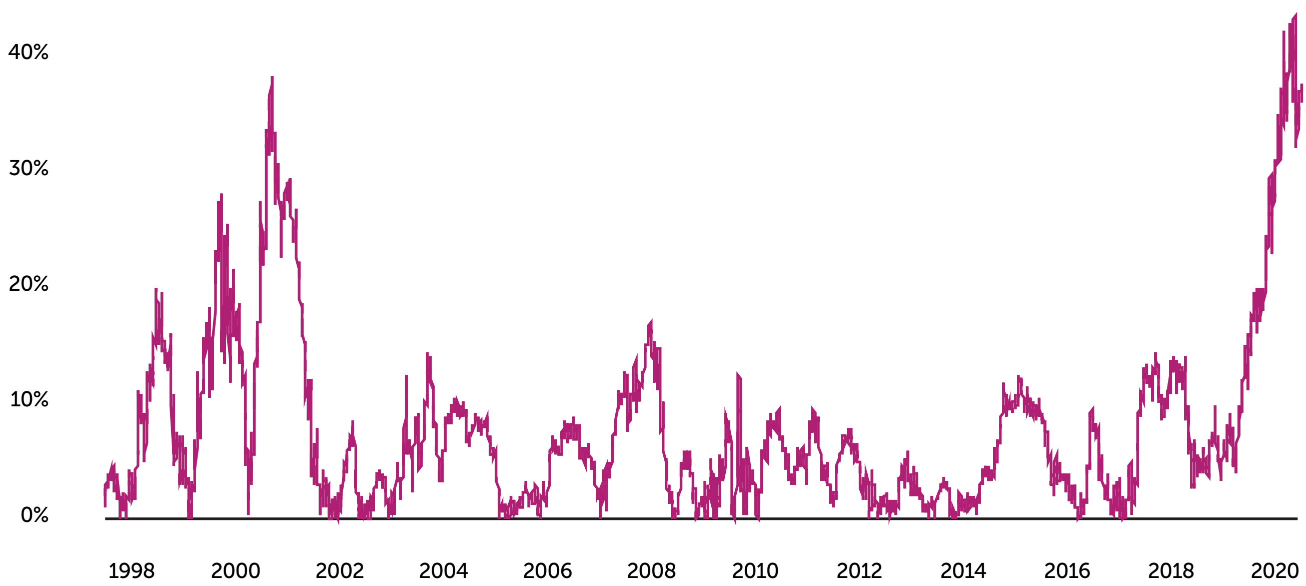
### COULD BE DETRIMENTAL FOR THE FUTURE RETURNS OF PASSIVE PORTFOLIOS

**2020 was an extraordinary year to say the least. An unforeseeable pandemic development shook both our personal lives and the investment world. Volatility was extreme and so was the performance difference between winners and losers. Indexing strategies amplify this effect, which was also the case for our focus area, the CEE equity universe.**

COVID devastated industries in which personal contact is necessary such as travel, retail and also cyclicals like banking and energy. Whereas the virus greatly helped sectors which benefited from lockdowns like e-commerce and software. An indicator of the magnitude of this effect is the performance difference between MSCI Value and Growth indices (seen below), which was the largest since at least 1997.

1 MSCI WORLD VALUE VS GROWTH

absolute performance difference annually since 1997




SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT

Global stock indices usually use free-float adjusted market capitalization weightings and periodically rebalance to always contain the largest constituents. This behavior amplifies the effect of the economic cyclicality as recently best performing names (COVID winners) might reach such high capitalization that results in inclusion in the index thereby forcing out recent underperformers (COVID losers).

A similar effect comes from the IPO market, where in the sectors of the COVID winners, the buoyant public market sentiment entice private companies from the favored sectors (especially if they are backed by shorter term focused private equity) to IPO themselves. If these companies are large enough, they can almost immediately enter their regional stock index creating significant passive demand for their shares.

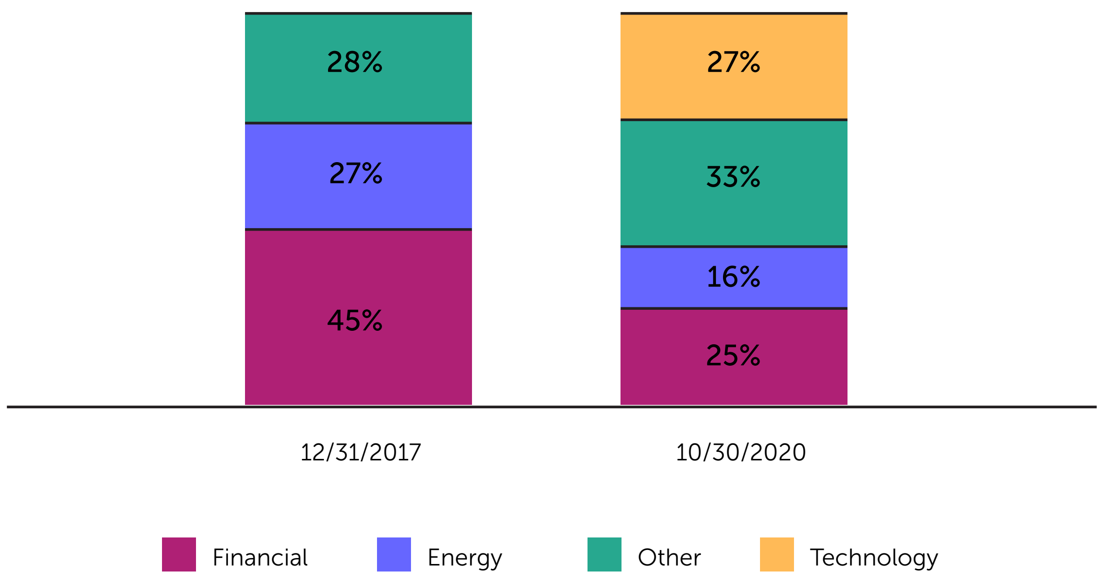
## LET US FOCUS NOW ON THE CEE REGION

The CEE markets are traditionally over-represented by cyclical sectors, namely banking and energy. It is the major reason why these markets have underperformed their global peers during the COVID crisis. However, things started to change on the composition front. First by the outstanding share performance of the Polish game developer CD Projekt, which – propelled by the lockdown trade – became the largest constituent of the Polish index WIG20. Secondly after its IPO in October, the largest Polish e-commerce company Allegro, immediately became the largest constituent in the local index.

As a consequence, in less than 3 years up to October 2020 the Tech sector went from zero to being the largest constituent in the WIG20 index. Meanwhile, the cyclical financial and energy sectors' combined weight dropped from 72% to 41%.

2 WIG20

change in the composition




SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT

## MEET ALLEGRO

For Allegro the timing was perfect. The private equity owners managed to take the company to market in early October (bookbuilding in September) during a time when share of e-commerce in retail sales was on the rise and the second wave of COVID in Europe further reinforced that trend. The shares were several times oversubscribed and quickly doubled in price in a few weeks' time, propelled by passive index buyers entering local and regional markets towards the end of October. Its capitalization reached close to 21 billion EUR and its valuation was around 60-65x EV/EBITDA ('20F), roughly double the valuation of the global e-commerce leaders such as Amazon and Alibaba. Also interesting to mention that Allegro was bought from its previous owner in 2017 at a valuation of around 14x EV/EBITDA.

Allegro is by far the largest marketplace in Poland having roughly 36% market share in e-commerce, which is much more than the 2nd place Alibaba with less than 7%. Also Poland is underpenetrated in e-commerce with around 14% share of retail sales in 2020 making Allegro's growth prospects even more compelling. However, competition can still spoil the game. Although Allegro has a very strong market share versus its competitors, still Alibaba and Amazon are larger by several orders of magnitude with much more sector experience. If they think Poland is an interesting enough market with its close to 40 million population and decide to compete more aggressively, it can create a big headwind for Allegro in terms of market share and margins. Amazon actually already operates several logistic centers in Poland serving the German market.

Looking ahead to 2021, we will likely see a year with significant economic rebound fueled by the vaccines. As we previously highlighted in our previous Quarterly Insights, the rebound will most likely continue to  benefit the cyclical sectors of the CEE equity markets, which has less weight than in the past thereby potentially limiting the rebound of regional indices. Seeing that Allegro currently trades at twice the price at which the private equity owners IPO-ed it, we expect that they will be eager to continue their exit in Allegro once the 180 day lockup expires in the spring. So far they only sold a 20% stake. In turn this selling will further reduce the weight of cyclicals and put them under temporary pressure by passive sellers.

## CAPTURING ALPHA WITH INDEX DROPOUTS

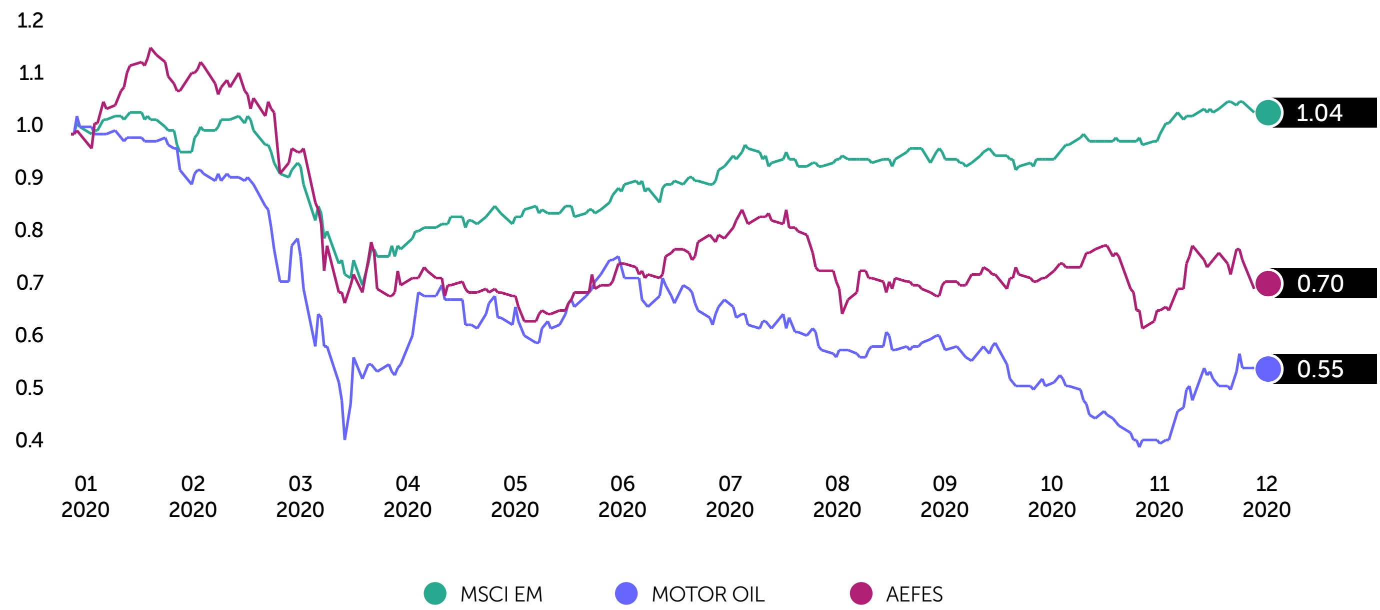
As discussed above, recent winners take the place of recent losers at index revisions, which means laggards get a further headwind from both active and passive sellers before the rebalance date, potentially pushing their prices further away from their fundamental values. Buying from motivated sellers is one of the centerpieces of Seth Klarman's investment philosophy, whose Baupost built one of the best long term track records in the hedge fund world with a value focus. Among other tactical alpha opportunities we presented in previous white papers, we at HOLD also actively capitalize on this idea. A recent study based on the past five years by Morgan Stanley also showed that in the CEE + Greece universe, index dropouts have overperformed their index by close to 20% during a six month period right after exclusion from the index.

MSCI index revisions during the fall of 2020 again presented us with similar opportunities in our larger Emerging Europe focus area with the dropout of Motor Oil in Greece and Anadolu Efes in Turkey. We were following both names well before the index revision, had positive fundamental view of them and already had some exposure in our regional equity funds.

At the time of the revision (30th November 2020), they were significantly down on the year in EUR terms (-30 to -45% as seen below vs. MSCI EM Index) , even as global markets were already rallying and were positive YTD on the favorable vaccine news. The index revision in both cases has given us a tactical opportunity to further increase our exposure at favorable prices.

3 PERFORMANCE OF MOTOR OIL AND ANADOLU EFES IN 2020

before the november index exclusion (in EUR)




SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT

Motor Oil is an owner operated refinery in Greece. Its major and founding shareholder, Vardis J. Vardinoyannis has been serving as its chairman since 1972. Motor Oil has a well-established track record in the Mediterranean. Its Corinth complex is technologically a top tier refinery with high flexibility both on the feedstock and on the product side. It has a multi decade long track record of being the arbitrageur of the Mediterranean refining market that stems from the heritage of not being able to produce for the Greek market for a certain period of time. It still exports the bigger part of its production.

Even though the refinery sector was hard hit by the COVID crises, the underperformance of its shares versus sector peers is hardly justifiable by the fundamentals. The company has a relatively strong balance sheet and since March it proved its operational and financial excellence again, thereby overperforming its peers in margin capture. In the first nine months of 2020 its adjusted EBITDA only fell by 26% yoy, while the very indebted Turkish Tupras, its closest peer, suffered 80% EBITDA deterioration. Besides the outperformance of the peers on the earnings side Motor Oil has an edge on the capital expenditure side as well. Historically it managed to keep investment level per unit of capacity lower versus peers, many of them having the state as major shareholder.

Anadolu Efes owns the largest Turkish, and through a JV with ABInBeva Russian beer operation and also owns Coca Cola Icecek, the Cola bottler servicing Turkey and surrounding countries.

Even though on-premise beverage and beer consumption suffered from lockdowns, it was well compensated by increasing home consumption, pricing measures and cost rationalization. Furthermore, its Cola operation, which accounts for roughly half of its value is separately listed in Istanbul and was slightly up on the year at the end of November in EUR terms. Which means that the beer production side of the business lost almost half of its value in EUR terms, which seems to be an unjustifiably big impact from COVID.

## CONCLUSION

As we described above, index composition and rebalancing methodology exposes passive investors to an often neglected risk, the risk of being a latecomer, instead of an early bird contrarian. This risk is even more relevant in times when extraordinarily divergent movements develop between different sectors. 2020 was an exceptional year in this sense, the COVID winners acquired significant share from the COVID losers in the major indices, which was especially pronounced in Emerging Europe. However as the world is getting back to normal, the "COVID trend" is about to revert, likely resulting in further outperformance of cyclical/value stocks hence leaving significant alpha on the table by passive investors for active ones to capture.