Any impact on CEE if Britain leaves?

Main impact via uncertainty on how Britons vote and how potential Brexit would be facilitated. So far, visible relations in exports, funds, etc., appear manageable.

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The main Brexit impact for the CEE region should come via massive uncertainty prior to the referendum. Also, quite some volatility in equities, bonds and currencies should be expected for CEE markets in the event of a "leave" vote. The latest polls see "leave" voters gaining momentum, while bookies still put higher odds on "remain".

As potential channels for impact, we have reviewed economics, politics, fund flows and individual stocks/sectors. However, even this can only demonstrate the potential impact, since it remains uncertain as to what kind of agreements would potentially replace EU membership, in terms of restoring trade relations, etc. It should be certain that there would be a substantial and immediate short-term impact on the markets if it happens.

Economics: The UK accounts for about 4.4% of total exports within our coverage universe, compared to an average of 23% heading for Germany. CZ leads, with UK exports accounting for 4% of GDP, going down to 0.3% of GDP for HR. Hence, any Brexit-induced impact on exports would be visible, but appears digestible. The UK's contribution to the EU's structural and investment budget, net of rebates and receipts, ranges within 4-9% (UK or Commission way of calculation) according to our estimates. Hence, some impact could be expected for big EU fund receivers such as HU, PL or RO.

Politics/contagion: EU skeptics might see the vote as supporting their case. Also, as a response to the entire situation, the EU could slow down the pace of further EU integration, which might be somewhat bad news for Serbia. Cancelling the free movement of labor would affect EU (and CEE) citizens living and working in the UK. Overall, politics might be the most difficult impact to handle.

Liquidity: As the UK is home to the financial industry in Europe, Brexit might impact fund flows into regional equity markets. UK-domiciled funds account for 5.4% of estimated allocations in EM Europe. Flows and allocations from UK-domiciled funds have already been on a declining trend for some time. Brexit might add slightly to this, at least in the short term. Overall, the impact seems limited.

Sectors: We would expect some impact on telcos via roaming, if the UK were no longer under EU regulation. Banks would be the most likely sector to be most hit by the overall uncertainty. Real UK exposure is also limited. Pharmaceutical companies might face higher costs when introducing new products in the UK.

Companies: We identified **Zumtobel** (18%), **Wienerberger** (10%) and **DO&CO** (10%) as the highest in terms of sales in the UK (2015), with local production providing a natural hedge. **Palfinger** and **SBO** also run local production in the UK, while **Wolford** has some 8% of sales coming from the UK (3% of expenses). **KTC** is working on a telematics solution in which the UK authorities have expressed interest. **Krka** and **Richter** have UK exposure of 2.6% and 1.8% of 2015 sales, respectively.

Brexit – what is the risk? Uncertainty!

In summary we see the main risk related to a Brexit in massive uncertainty. Even in case Britons vote to remain, it might still support EU skeptics also in CEE and will continue to impact the political scene. While the outcome is fairly uncertain since polls indicate a race head to head (with “leave” taking a lead lately), there is no clear conclusion on what the result of a “leave” vote would be. Assuming that the UK will not cut off relations with the EU entirely, different options based on already existing agreements are possible.

Other than overall uncertainty and market volatility, via exports, fund flows and direct company/sector impact is strong enough for not being neglected, but still on a level that could be handled. Given that it is absolutely unclear what a post-Brexit scenario could look like in terms of trade agreements, etc, all shown impacts are just potential and will finally largely depend on what resulting agreements will look like.

Potential impact on CEE economics and politics

Export impact limited, but visible

Looking at CEE, the direct economic consequences of Brexit might be relatively minor. Direct trade linkages to the UK in our universe average at 4.4% of total exports, showing the highest numbers for Poland and Turkey. However, CEE shows much higher export exposure to Germany. Hence, some weakness might also come via indirect links (Germany exports 8% of its total to UK).

Share of exports to UK in total exports (2014)

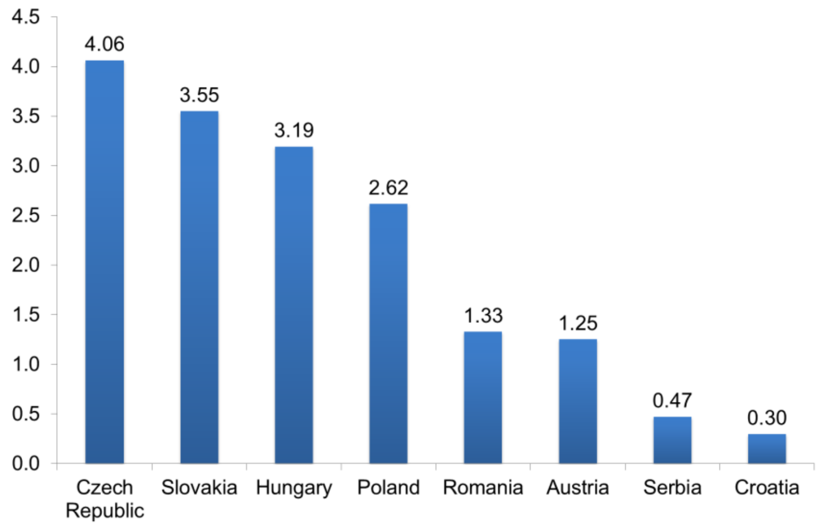
	PL	TR	CZ	RO	HU	AT	HR
Highest exposure to	DE	DE	DE	DE	DE	DE	IT
Highest exposure %	27.2%	9.9%	32.5%	19.6%	28.9%	30.6%	13.9%
Exposure to UK	***6.6%***	***6.5%***	***5.2%***	***4.2%***	***3.8%***	***3.2%***	***1.5%***
UK rank in total exports	2	3	4	6	9	10	13
Top ten	68.0%	49.2%	73.8%	64.2%	70.1%	69.1%	70.3%

Source: Thomson Reuters

At least short-term effect on trade

It is not clear whether the trade flow would be affected by Brexit at all, as scenarios for the UK range from Norway/Switzerland type EEA (European Economic Area) membership to treatment like any WTO member. Basically, the impact would come via two routes. For one, trade barriers might arise at least for the short-term, as long as new relations are not established. Secondly, any Brexit induced weakness of the UK economy should also be seen in weaker demand for imported goods.

Exports to the UK (% of GDP 2015)



Source: Eurostat

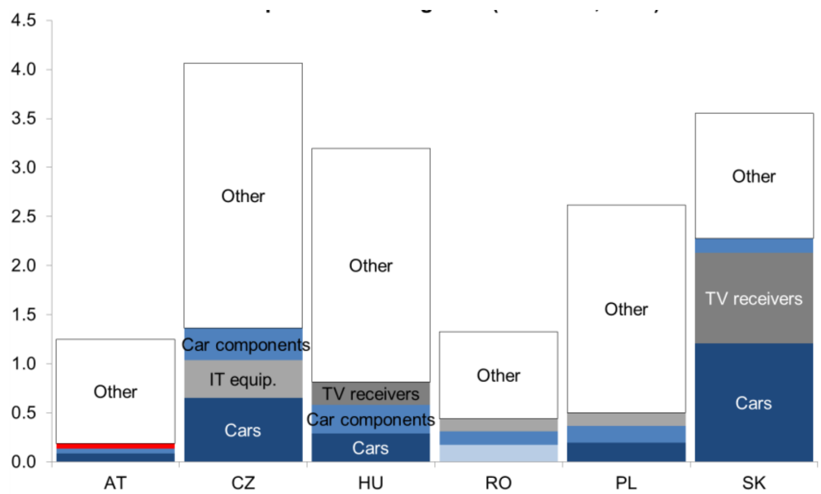
CZ, SK, HU show strongest exposure, PL some

The strongest impact of any disturbance in exports to the UK should be felt in the Czech Republic, Slovakia and Hungary, which comes as no surprise since these markets are typically the most open economies in the region, strongest relying on exports as a contributor to GDP. However, also Poland, generally less dependent on exports (about 40% of GDP) still has a meaning full number for UK exports as a % of Polish GDP.

Automotive industry strongest part in exports

Looking at export structure, quite a dominance of the sector automotive and parts is not a big surprise. The strongest overweight comes for the Czech Republic, Slovakia and Hungary somewhat balanced by IT equipment and consumer electronics. Also Poland shows a similar structure as far as its top 3 categories in UK exports are concerned, on a much lower relative scale, though. Overall, Slovakia seems to have the least diversified export structure, which in turn means that any Brexit related export disturbance would hit mostly VW and Samsung, producing in Slovakia.

Exports to UK – top 3 categories (% of GDP, 2015)



Source: Eurostat, Erste Group Research

Free movement labor

Somewhat stronger consequences would hit migrant CEE workers in the UK through cuts in social benefits and the curbing of the free movement of labor, but even this does not make it likely that most of these workers would lose their jobs or return to their home countries.

Contagion risk

Political risk – support for EU skeptics in the region

However, there would be more costs on the political side. Brexit could question the irreversibility of the economic and political integration of CEE countries within the EU and in particular increase the divide between Euro Area and non-Euro Area countries (core-EU and non-core EU), triggering a discussion on the existence of the EU as a whole. Such speculation could lead to strong market developments (such as safe haven flows).

Pace of integration to slow down

EU skeptics in the V4 countries (Poland, the Czech Republic, Slovakia and Hungary) would see the UK vote as support for their cases. On the other hand, the EU could see itself forced to slow down the pace of integration. German Finance Minister Schäuble already mentioned in a recent interview that, regardless of what the result of the referendum is, the EU could not simply continue to follow a path of unquestioned further integration. EU politicians have to prove that they heard the voices and that they are willing to address criticism. At some point, that might make life somewhat more difficult for EU aspirants, such as Serbia. At least it will stretch the path to accession over time.

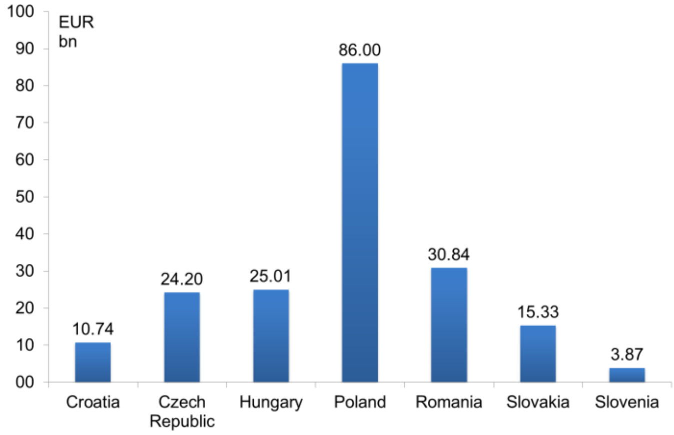
Potential funding loss for structural and investment funds

If Britain indeed leaves the EU, then it is an important question as to what extent its net contributions will be missing from the total budget and the structural and investment budget (the latter is very important for CEE countries, as the largest net beneficiaries of this funding).

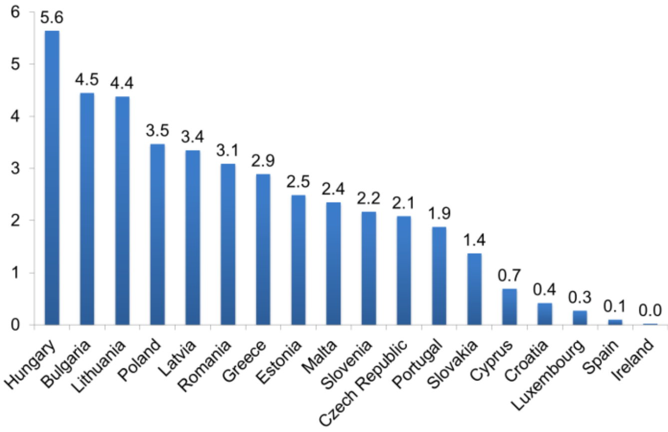
EU skeptics show high portion of EU funding

Interestingly, EU skeptics such as Hungary or Poland rank pretty high in terms of EU fund receipts as a percentage of respective GDP, hence any disturbance in EU budgets and availability of funding would be felt. In our note **Is it time to go back to Poland?** in March 2016 we already mentioned our concerns on Poland's ability to close its potential budget gap, given its generous social spending plans.

EU funding planned for CEE 2014-2020



Receipts from EU as % of local GDP



Source: Commission, Eurostat

UK contributes 9% of structural and investment budget funding (based on HM Treasury numbers)

A few aspects must be considered to calculate Britain's contribution to the EU's total budget and then to the structural and investment fund's budget. Britain is getting a so-called 'rebate' from other EU countries (still negotiated by Margaret Thatcher in 1984) and the UK also gets some funds from the EU. According to documents on HM Treasury's website[1], Britain is planned to contribute to the total EU budget with GBP 99.7bn (roughly EUR 129bn) in 2014-20 on a gross basis (but already deducting the rebate), and if we deduct the inflow of EU funds too, the amount declines to approx. GDP 67.6bn (EUR 87.6bn). This is the contribution to the total EU budget, however, of which the structural and investment budget is roughly 40-45% (EUR 454.1bn) for 2014-20.[2] These figures overall mean calculating with a net contribution from Britain, while roughly EUR 35-40bn will be missing from the structural and investment budget. This corresponds to approx. 9% of the structural and investment budget's funding[3].

UK and EU show different way of calculating net contributions

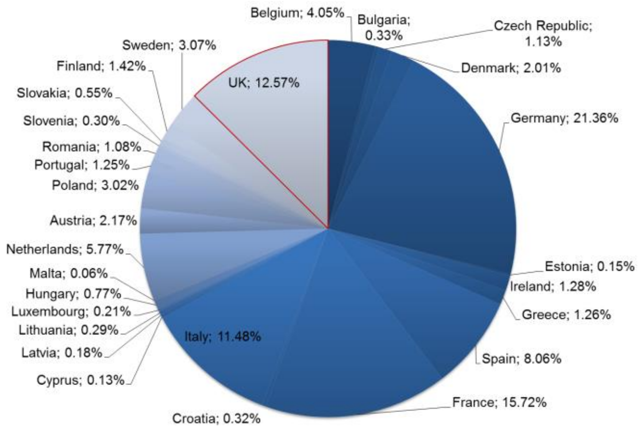
When looking at these numbers, however, we need to know that the British treasury and Office for Budget Responsibility shows net contributions to the EU budget different to what the Commission shows. The difference is that the Commission takes into account all of the UK's receipts including those that go directly into the UK private sector. The calculation shown above based on data provided by the HM Treasury includes only receipts that go through the UK public sector. Hence, the number for net the UK's contribution in 2014 as shown by the Commission would be EUR 4.9bn (assuming a stable contribution over the coming years, this would yield some EUR 34bn for the period 2014-2020, for the entire budget, not only for the structural and investment budget). This means that the 9% loss of funding calculated above can actually be an overstatement if one includes funds not going through the public sector of the UK, decreasing any potential negative impact of a Brexit. If we were to use UK's net contribution as provided by the Commission and would assume that it would remain proportionally to what the HM Treasury reports as planned contributions, UK's contribution to the structural and investment budget would come in at 4%.

[1] source: HM Treasury (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/483344/EU_finances_2015_final_web_09122015.pdf) and own calculations for EUR value

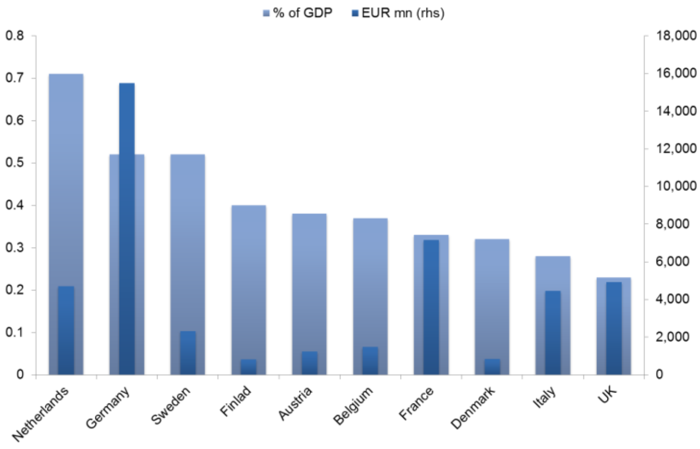
[2] own assumption for the total EU budget for 2014-2020

[3] We must note that we deduct the monies originally planned to be sent to the UK from the total structural and investment fund budget (which monies will, of course, likely not be paid to Britain if it leaves the EU).

EU budget revenue 2015* - percentage after rebates by member



Ranking by net contribution



**gross contributions; Source: European Commission's Draft Amending Budget 8 to the 2015 budget, www.bpb.de (European Commission, EU budget 2014, Eurostat)*

It is also to be mentioned that, since it is already 2016, we now have running structural and cohesion fund programs, and it remains to be seen if this calculated funding will indeed be fully cut off. In addition, after 2020, when EU structural and cohesion funds to CEE countries are reasonably expected to decline substantially, the problem of missing funding from Britain also gets less important.

Some impact in any case

Regardless of which number finally is used to capture the UK’s contribution to the EU budget, it should be fair to assume that it disappearance of the UK contribution will not endanger the entire structure, but might cause some re-thinking and reallocation of resources.

Liquidity - fund flows

Leaving EU = impact on investment behavior of UK-domiciled funds?

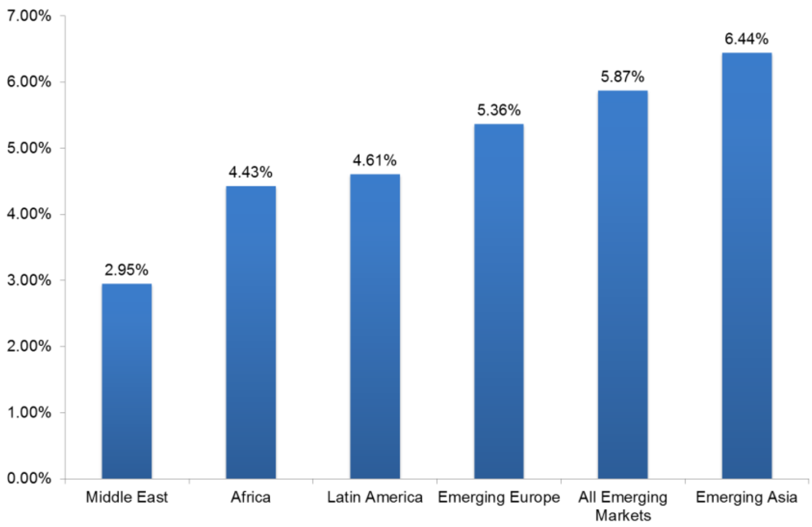
The assumption of a potential impact of Brexit on CEE equity markets in terms of fund flows relies on the assumption that leaving the EU would have an impact on the investment policies of UK-domiciled funds. Also, leaving the EU-regulated area might have at least some temporarily disturbing impact on acquiring assets, which in turn might have an impact on available funds to invest. In the following we compare total flows and allocations to flows and allocations stemming from UK domiciled investors as provided by EPFR. They look at where the fund is domiciled and not where the domicile of the respective fund manager is. Hence, overseas funds just managed in the UK might not be included here.

Overall, we would consider the risk of flows from UK-domiciled equity funds showing a visible impact on CEE equity markets as minor, in particular since flows have been on a downturn already for a while. Nevertheless, we will spend a few minutes reviewing UK exposure towards the region.

UK-based funds account for 5.4% of estimated allocations to EM Europe

The estimated allocations of UK-domiciled funds account for 5.4% of the entire estimated allocations of equity funds for EM Europe (based on data since January 2010). The UK share in estimated allocations for most of the time has hovered around the average. At the beginning of 2015, UK-domiciled funds apparently started to increase their exposure, but this trend has again reversed to average levels since the beginning of 2016.

Share of UK domiciled equity funds in estimated allocations, regional



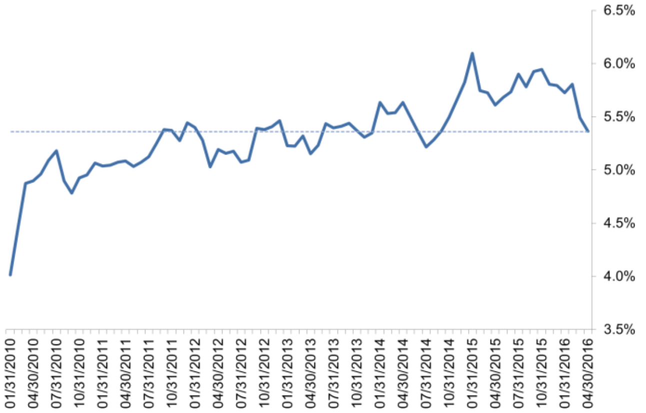
Source: EPFR Global

Turkey lowest allocation from UK-domiciled equity funds

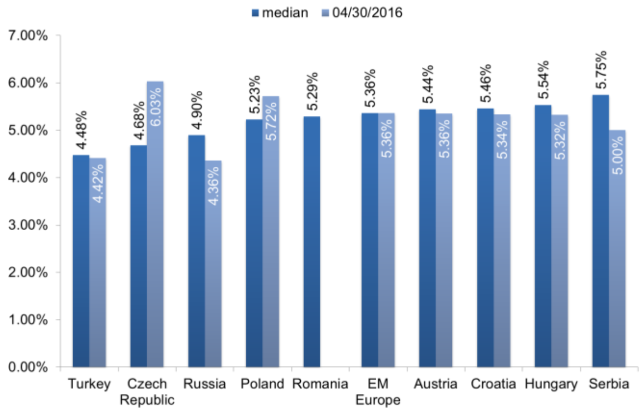
In terms of countries, Turkey appears to be the least liked, based on estimated allocations of UK-domiciled equity funds. Interestingly, Serbia comes in with the highest exposure on average, although it has lately been on quite a declining trend. Other visible deviations from current (May 2016) and average (back to January 2010) can be seen only for the Czech Republic and Poland – UK domiciled allocations have been falling for both markets, but less than the total. Russia shows the highest negative deviation of today’s weight in allocations vs. the average.

UK share in estimated allocations for EM Europe

Over time…



…and current



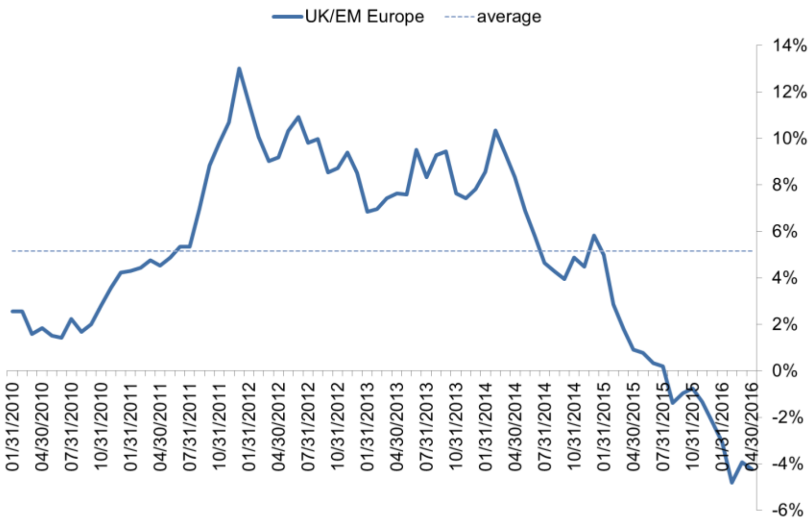
Based on country flows
Source: EPFR Global, own calculations

Accumulated flows into EM Europe from UK on downtrend since 2014

Monthly flows seem to offer less of an insight into what could be the impact of UK-domiciled equity funds, since they are quite volatile by nature. In any case, accumulated flows into EM European equity markets (accumulated since January 2010) have been on average at about 5% of overall accumulated monthly flows into EM Europe. Since 2014, accumulated flows of UK-domiciled funds have been on a declining trend as a share of overall accumulated flows into the region.

As of August 2015, accumulated flows of UK-based funds have even turned negative and have remained so ever since. Given that this is just an extension of an already longer-lasting trend, we would not relate it exclusively to any Brexit impact. For now, Turkey is the only market still showing positive accumulated monthly flows from UK-domiciled funds. The trend here is, however, also negative.

Accumulated flows since January 2010



Source: EPFR Global, own calculations

With London being home to quite a number of banks and brokers and with access to regional markets via DMA, changes arising from potential Brexit might cause lower liquidity at least temporarily.

Trading of CEE stocks on LSE

UK listings of CEE might temporarily face lower liquidity

Some CEE stocks have listings on LSE International, such as **Stock Spirits** (which is even organized in the form of a PLC) and **Romgaz**. Depending on what form the UK chooses for further work with the EU, we might face different scenarios in regulations that also might affect the attractiveness of trading the respective stock via its UK listing. In the best case, this might move some liquidity back to its respective home markets. The same uncertainty should apply to market access in Vienna, Budapest and Prague via Turquoise as a vehicle of the LSE.

Impact on stock and sectors

We have screened our coverage universe for any particular Brexit impact on individual stocks or sectors. We looked at things such as trade links, local production, passporting issues, GBP indebtedness, etc.

Telecom

While there is no particular impact on any individual company, roaming might be a channel that could also impact the sector in CEE in case of Brexit.

Roaming could be channel to impact telcos

Roaming revenues have been steadily reduced according to the EU roaming tariff regulation. If the UK were to exit the EU, it could choose to apply higher roaming rates to EU visitors than the regulated EU tariffs. Nevertheless, EU operators would also hike their rates for British visitors. We therefore see a neutral impact for CEE/Austria telecoms.

Utilities

Regional utilities would be virtually unaffected by Brexit. Also, any potential impact from being part of the European power grid should be marginal. As an island, the UK is not significantly connected to the European grid.

Banks

London to remain a banking gateway to EU?

What are the effects of Brexit on the financial sector? Much discussed has been the impact on London as a financial hub for international banks. Banks that used London as a location to gain access to the EU as a whole will be forced to partially relocate to other destinations within the EU. This does not mean the locational advantage of the City as a whole will be endangered. The high density of expert knowhow, the usage of the English language and well-established business ties will prevent a more comprehensive loss of appeal.

Banks mostly impacted top-down

Leaving the common regulatory framework (passporting, etc.), intuitively, banks doing business in one of Europe’s financial centers should be among the main potential victims. For CEE, however, the impact should come mostly via its links to the European sector overall (apart from economic impact), not via direct exposure/presence to London. UK presence via branches, such as in the case of PKO BP, seems to have more of a symbolic character, but, looking at the reported numbers, it does not seem to have any tangible impact.

For Austrian banks, the impact of Brexit seems at this stage manageable, as there is a clear strategic focus on CEE and not on global financial markets. Nonetheless, a downturn in the real economy as well as capital flows to safe havens will affect CEE, which would temporarily weigh on business activity.

Individual stocks being impacted

Apart from the sectors that at first thought might have some exposure, we list a rather limited number of companies that might see some more direct impact from a potential Brexit.

Most companies in our coverage universe report no or negligible exposure to the UK (not shown in any segmental reporting).

Zumtobel: has local production, total exposure to UK about 18% of sales (2015).

Wienerberger: has local production, total exposure to UK about 10% of sales (2015).

DO & Co: According to the rough company estimates, UK accounts for about 10% of DO&CO revenues as well as 10% of the total expenses. The company has no GBP denominated loan and hence DO&CO enjoys a nearly perfect natural hedge.

Wolford: net sales in the UK deliver 8% of total sales, while UK expenses account for 3% of the total. The company does not have any GBP-denominated loans. Hence, a weakening pound would affect Wolford negatively, although the impact would not be sizable. Moreover, a weaker pound could contribute to higher tourism-derived sales volumes in the UK, partly compensating for the negative effects of a weaker GBP.

Palfinger: runs a small production facility near London, producing for local business, total exposure to UK about 5% of sales (2015).

Andritz: has two small local production facilities, total exposure to UK about 1% of sales.

KTC: working on a telematics solution in which UK authorities have expressed interest.

SBO: has two local production facilities, recently merged, local production mostly exported, mostly sold in USD, loan of GDP 8mn – weaker GDP would be mostly positive.

Krka: sales in the UK delivered nearly EUR 30mn, or around 2.6% of total sales in 2015, no significant exposure to the British pound.

Richter Gedeon: sales in the UK contributed EUR 21.1mn, or just 1.8% of the total sales in 2015, no significant exposure to the British pound.

Both **Krka and Richter** could be negatively affected by somewhat higher costs of introducing products to the UK market, especially temporarily, with EU-wide marketing approval being no longer being valid for the UK and with the necessity to submit all documentation for drug approval separately. Nonetheless, in the long run, harmonization can be expected, or even possibly acceptance of the marketing authorizations issued for the EU (similarly to Norway), although some delays in introducing products to the UK following BREXIT seem to be inevitable (as is now the case now for other countries in Europe outside the EU).

Non-EU companies: Within our coverage universe, only Turkey and Serbia are not part of the EU. Hence, for these markets the situation would be different in the sense that they are not part of the common market via membership, but via other agreements. It remains unclear as to how Brexit could impact these agreements. To the extent that agreements on trade, etc., were concluded with the EU, it might happen that new bilateral agreements will also have to replace existing relations.

The UK is the third-largest trading partner for Turkey after Germany and Iraq (6.5% of exports, 2014). In our coverage, we find no company with local production in the UK. However, both **Ford Otosan** (23% of sales) and **Arcelik** (10% of sales) report visible exposure to the UK (not covered: **Vestel**: 12% of sales, **Tofas**: 7% of sales, **Sisecam**: 1% of sales). While foreign currency financing is always a sensitive topic for Turkey, we find no material financing in GDP for Turkish companies in our universe.

Brexit – what do we talk about?

Britons are being asked to vote for or against membership of the EU on June 23. This perennial decision may end the UK's 43-year-long membership. In the event of a leave vote, David Cameron (or whoever leads the UK government) will invoke Article 50 of the EU's Lisbon treaty and begin exit negotiations with the Common Market; these could last up to two years, unless the EU decides to extend the timeframe to settle a deal.

Polls give little guidance, bookies bet on 'remain'

What are the odds of this scenario materializing? Based on current polls, the result will be a close call. The original "remain" margin of 5 to 10 percentage points has basically disappeared. Latest polls indicate that the "leave" voters are gaining momentum, taking a lead. However, as far as we want to include betting companies, we find bookies currently putting some 70% likelihood on a 'remain' vote.

Emotional decision, not only based on economics

Our best guess is that, in the end, economic rationality will prevail over Britons' undeniable penchant for EU skepticism. So far, the majority of the substantial economic research on the topic sees far more disadvantages than advantages for Britain. The economic fallout would probably not be catastrophic, but it would still be far from being imperceptible. However, listening to campaigns, it seems there is a great deal of emotions involved in the discussion. Hence, a view simply based on economic arguments would not be a complete view.

Who would lead exit?

Should Britons nonetheless vote against the European club, the divorce could easily end up a messy process. In terms of first reactions, it is conceivable that David Cameron, the face of the "remain" faction, would have to step down. A newly-appointed Eurosceptic prime minister would enter negotiations without being able to change much instantly, as Britain would remain subject to EU legislation until a deal is struck. This means that the country would continue to pay contributions to the EU budget and would not have much of a handle to curb immigration from Eastern Europe.

At least short-term shock across markets

At the same time, a Brexit vote could be perceived as a trigger event for a mini EU-crisis. An uncertain perspective for business relations would hamper foreign investment in the UK. Turbulence on stock and bond markets, as well as a temporary shock to the real economy, would quickly feed through to other markets outside the UK, namely to the EU. Reaction patterns from the euro crisis suggest that investors would flock to typical safe havens, such as German and Austrian government bonds, driving yields down further.

EU might not be too generous in any post-exit negotiations

How severe might the downturn be? Before losing our heads, attention should be directed to the fundamental picture. Britain will continue to be an attractive business partner and financial center and the continent will be interested in keeping business ties alive. Being outside of the common market, however, will reduce part of the appeal that the UK currently enjoys. A number of banks have already announced their intention to relocate their operations to the mainland should Britain decide to leave. And while in the long run neither the UK nor the rump EU has any interest in ruining business relations entirely, the EU is not likely to be too generous when negotiating post-Brexit relations, not least to discourage the remaining EU countries from taking similar steps.

Short-term shock for sure

Also, in the short run, the economic shock potential of a Brexit vote should not be played down. Market turmoil tends to quickly hit economic sentiment and may result in a lengthy period of uncertainty. Looking back at the Lehman shock and subsequent euro crisis, a time span in the area of 6 to 12 months does not seem improbable. Subdued investment and weak consumer sentiment could hurt fledgling growth in both the EU and UK. Capital flows that currently finance the UK's gaping current account deficit (5% of GDP) could slow down and increase the chances of a recession. The magnitude of a Brexit-induced downturn may not be as severe as, e.g. in the wake of Lehman, but still, any slowdown in the current environment seems critical.

So in short, Brexit would be a negative market event triggering turmoil, especially in the short run. Once this has settled, it will become clear that Brexit may be negative for growth, but not a Lehman-type catastrophe, as long as the cohesion of the EU as a whole is not put into question.

Options for post-Brexit arrangements between UK & EU

Arrangemen	Template	Main features
European Economic Area	Norway Iceland	· Full access to the single market · Outside EU Customs Union · Adoption of EU standards/regulations **· Contribution to EU budget** **· No immigration restrictions**
EFTA	Switzerland	· Bilateral agreements with EU countries across sectors; no passporting for banks · Outside EU Customs Union · Limited impact on EU standards/regulations **· Contribution to EU budget**
Customs Union	Turkey	· No internal tariff barriers; but access restrictions in certain sectors · Very limited influence on EU regulations · Acceptance of EU external customs regime
FTA		· Mostly tariff-free single market access · Adoption of EU standards/regulations · No full access in financial services; no passporting
WTO MFN		· Trade based on WTO/MFN-rules · UK subject to EU tariffs · Regulatory divergence over time

Source: OECD, 2016; Global Counsel, 2015; Erste Asset Management

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Published by:

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Commercial Register No: FN 33209m
Commercial Court of Vienna
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