GUEST BLOGGERS

Celebrating Romania

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Ten years ago, Fondul Proprietatea (Fondul) was established to compensate Romanians whose properties were confiscated by the former communist government, and we were selected as its investment manager in September 2010. My colleague Grzegorz Konieczny, based in Bucharest, spearheaded the effort to list Fondul on the Bucharest Stock Exchange in 2011, and now Fondul is making its debut on the London Stock Exchange on April 29. In honor of the occasion, I've asked Greg to share his thoughts on investing in Romania today, and the exciting changes that have taken place there in the past few years.

Romania Macroeconomic Outlook

Romania's economic growth outpaced most of Europe last year, and we believe the Romanian economy can continue to grow at a similar or even higher pace than the 2.8% increase in gross domestic product (GDP) seen in 2014.[1] Romania has access to European Union (EU) structural funds, which are one of the main EU instruments designed to sustain economic growth while reducing disparities between regions in the EU. We think Romania's growth going forward is largely dependent on an increase in EU funds absorption, which can provide a significant source of financing for current and future projects, as well as for government spending on much-needed infrastructure projects.

Various forecasts for Romania currently look bright. The World Bank estimates Romania's economy will grow on average by 3% per year in the period 2015 – 2017, driven by strong domestic demand).[2] We think a new loan agreement with the International Monetary Fund (IMF) should also aid economic growth in Romania by increasing the country's financial stability, while at the same time providing oversight with regard to the implementation of structural reforms. Romania has undertaken a major fiscal adjustment, mainly through cutting expenditure and reducing some taxes. value-added-tax (VAT) for all food items, as well as non-alcoholic beverages, will be lowered from 24% to 9% starting on June 1, 2015, the prime minister announced in early April 2015. In addition, VAT for all other products will be lowered from 24% to 20% on January 1, 2016.

Earlier this month, ratings agency Standard & Poor's confirmed Romania's ratings for long- and short-term foreign debt to BBB-/A-3 (the lowest investment-grade rating), with a stable perspective.[3] S&P also estimates that Romania's economy could grow on average by nearly 3% per year in the period 2015–2018, driven by the increase of internal consumption. While Romania's public debt-to-GDP has increased significantly since 2006-2007, it is still at a relatively moderate level (around 40%).[4] Domestic consumption has picked up significantly and we have seen strong export growth in Romania. We believe consumption growth looks strong in 2015, but investments are still lagging behind. However, like economic growth in general, investments could be partially boosted by a better absorption of EU funds. Additionally, Romania registered a current account surplus of €285 million in the first two months of 2015, compared to a current account deficit of €201 million in the same period of 2014.[5] We also view the Romanian government's continued fight against corruption, which has intensified in recent months, as a positive factor for investors.

Progress on Privatizations

We are encouraged by Romania's privatization efforts, including the listing of several key State-Owned Enterprises (SOEs) on the Bucharest Stock Exchange (BVB) in the energy sector recently. Some of these companies have also been listed through global depository receipts (GDRs) on the London Stock Exchange. There is also an anticipated pipeline of initial public offerings (IPOs) ahead, including a large hydro power producer in Romania. Romania is currently considered a frontier market by index provider MSCI, but officials in Romania seem determined to implement the changes required to be upgraded to emerging market status; we are encouraged by the Romanian government's efforts toward further improving its capital markets. As such, there are several ongoing efforts led by the government, the local stock exchange, the market regulator and several key stakeholders in the Romanian capital market to accelerate capital market development. One particular initiative in this regard aims to identify and remove eight barriers that prevent the development of capital markets. Coupled with another initiative launched by the market regulator, the Financial Supervisory Authority, these programs aim to facilitate investor access to Romania.

Romania has implemented a highly ambitious corporate governance code for SOEs, which has generated positive outcomes for various companies, including improved financial performance, operational efficiency and competitiveness, higher transparency, and accountability of general managers and boards. In our view, efforts to strengthen corporate governance need to be continued, given that it plays a major role in enhancing SOE performance and reassuring potential investors that SOEs are on an irreversible restructuring path. SOEs are a significant part of the Romanian economy, and we believe the process of improving the efficiency and profitability of the SOEs must continue. We see the implementation of corporate governance standards as a step in the right direction, but there is still a lot to be done in terms of much-needed improvements for independent boards, professional managers and listings.

Foreign Investments and Capital Markets

Foreign direct investment is on the rise in Romania, increasing by 45% year-on-year to €409 million in the first two months of 2015, according to Romania's Central Bank (BNR).[6] In our view, structural reforms, including a push for more fiscal predictability, coupled with a new IMF loan agreement, should likely boost investor confidence in Romania. In addition, we believe the efforts undertaken to facilitate investor access to the local capital market, which has been quite difficult in the past, are positive steps towards attracting more foreign investments in Romania. We think development of the capital market and higher liquidity of the BVB would be beneficial for attracting more foreign investors. We also see predictability in fiscal policy as very important to stimulate investments; enacting new legislation or changing existing legislation through emergency government ordinances should be avoided. We believe all changes should go through the Parliament and public consultation should be a key component of the legislative process.

Investment Opportunities—and Risks

Romanian equities generally appear undervalued to us when compared with other countries in the region. For example, as of March 2015, the price-earnings (P/E) ratio for the BET Index Romania was 9.9, while it was 10.1 for the XU100 Index in Turkey, 14.4 for the WIG Index in Poland, and 13.6 for the BUX Index in Hungary.[7] And, we think dividend yields on Romanian equities have also been attractive. We continue to see good potential opportunities in the energy and infrastructure sectors in Romania. Key drivers should be further privatizations (including IPOs of SOEs) that could result in efficiency improvements, better corporate governance, and improved absorption of EU funds allocated to Romania. In addition, we see further growth in domestic consumption amid general economic improvement that should also speed up a recovery in the banking sector.

Risks of investing in Romania include political volatility, lack of a new agreement with IMF, delays in implementing structural reforms and low absorption of EU funds. Lack of predictability also remains a key issue, discouraging many investors. An unannounced tax on special constructions, which greatly reduced the profit margin of energy sector companies, was introduced shortly after the IPO of one of these companies. In addition, the regulated rate of return of electricity distributors was also reduced only months after the IPO of the largest distributor and supplier of electricity in Romania.

Romania and the Euro

Romania's goal of adopting the euro by 2019 may be achievable in our view, provided that the economic growth of the country continues in a steady pace and it can continue to improve in key areas. In order to assess a country's preparedness to adopt the euro, several transition indicators may be used, according to the European Bank for Reconstruction and Development (EBRD). These include large scale privatization, small scale privatization, governance and enterprise restructuring, price liberalization, trade and forex system and competition policy. Compared with the situation of other countries at the time of euro adoption, such as Slovakia (2009), Estonia (2011), Latvia (2014) and Lithuania (2015), we think Romania still needs to make significant improvements, particularly in terms of governance and enterprise restructuring, as well as competition policy. We believe progress in these areas may unlock Romania's growth potential and ensure better preparedness for the goal of euro adoption by 2019.

QE and Romania

The European Central Bank's (ECB) quantitative easing (QE) program highlights the central bank's desire to inject liquidity into the markets, and this could reflect positively on the Romanian capital market, in our view. In addition, the QE program offers the BNR more maneuvering space with regards to monetary easing; Romania's central bank cut its key policy rate to a record low of 2% in March. At the same time, we think the downward pressure exerted as a result of the ECB's QE program on interest rates for deposits and state bonds could further stimulate foreign investments and consumption.

Dr. Mobius' and Mr. Konieczny's comments, opinions and analyses are personal views and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice and it is not intended as a complete analysis of every material fact regarding any country, region market or investment. Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments opinions and analyses in the material is at the sole discretion of the user. Products, services and information may not be available in all jurisdictions and are offered by FTI affiliates and/or their distributors as local laws and regulations permit. Please consult your own professional adviser for further information on availability of products and services in your jurisdiction.

What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

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1. Source: NSI Romania www.insse.ro, April 2015.
2. Source: World Bank. There is no assurance that any forecast will be realized.
3. Source: Standard & Poor's, February 2015. See www.franklintempletondatasources.com for additional data provider information.
4. Source: Eurostat, 2014.
5. Source: Romanian National Institute for Statistics (INS).
6. Source: Central Bank of Romania.
7. Source: Bloomberg L.P. As of March 31, 2015. The P/E ratio is a valuation ratio of a company's current share price compared to its per-share earnings. Indexes are unmanaged and one cannot directly invest in an index.

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