Private equity in Central and Eastern Europe: Opportunities in an “emerged” market

By Dr. Petra Salesny
Managing Partner
Alpha Associates, Zurich

Emerging market growth at developed market risk

The opportunity for private equity investing in Central and Eastern Europe (CEE) looks more attractive than ever, and, intriguingly, in the light of the global credit crisis, Eastern Europe has become a lower risk choice for private equity investors than leveraged buyout investments in the traditional developed private equity markets of Western Europe and the U.S. Notwithstanding the credit crunch and the fact that it has almost entirely bypassed the Eastern European market, there are a number of unique elements at work in the CEE region that together make the risk/return profile for private equity very attractive at present. Firstly, it is the opportunity to invest in what we like to describe as “emerging market growth at developed market risk”. On the one hand, the CEE economies show growth rates that significantly surpass the growth rates of the Western economies and are characteristic of emerging market countries: Romania’s GDP grew by 5.8% in 2007, Poland’s by 6.5% and Slovakia’s even by 7%. At the same time, the large majority of the Eastern European countries are now firmly entrenched within the European Union, having either joined in 2004 (Poland, the Czech Republic, Slovakia, Hungary, Slovenia and the three Baltic states) or in 2007 (Romania and Bulgaria). These countries are today stable democracies, have adopted the legal and regulatory framework of the European Union, offer a reliable and predictable macroeconomic and investment environment and are fully integrated European markets. The local currencies are converging towards the euro in anticipation of the countries’ accession to the European Monetary Union, which means investors are not only facing political, legal and economic risks that are comparable to that of the EU 15, but also a decreasing local currency risk.

On the other hand, the CEE countries do still feature certain emerging-market characteristics, which in combination with the strong economic growth and the ongoing catch-up race with the Western world in terms of infrastructure and living standards, open up enormous opportunities for private equity. There is a continuing scarcity of equity capital in the CEE region. Despite a record level of fundraising in 2007 compared to prior years, the CEE region is still significantly underserved with equity capital. The absolute fundraising volume in CEE in 2007 is estimated by Alpha Associates at 2.5 billion euro, which compares to 112 billion raised for private equity in Western Europe, according to Private Equity Intelligence, thereof over 80 billion euro alone for buyouts. Central and Eastern Europe also continues to lag behind the Western world in terms of private equity investment as percent of GDP: Bulgaria’s private equity investments are only equivalent to 0.14% of its GDP and Poland’s and Romania’s only 0.12%, compared to 0.55% across Western Europe and 1.26% in the United Kingdom. Low private equity penetration clearly results in less deal competition and more attractive entry valuations, which brings us to two further critical aspects of assessing the private equity opportunity in any market, namely the level of competition and the universe and quality of the fund managers operating in CEE.

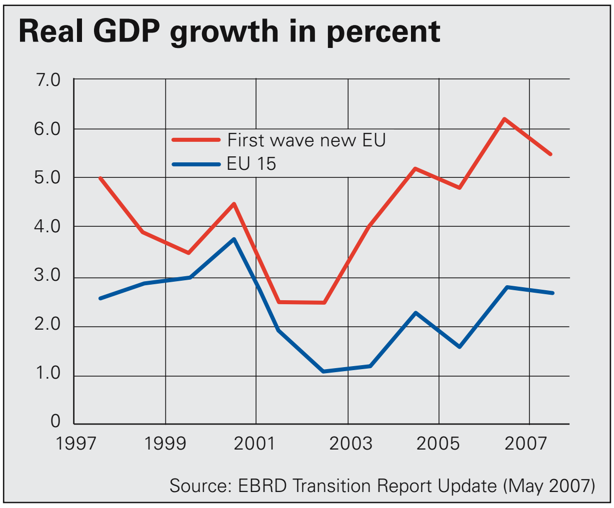
How many private equity fund managers are operating in the CEE region, what types of funds are there, and do they face competition from Western European funds?

The EVCA (European Venture Capital Association) lists more than 80 private equity fund managers operating in the CEE region. As a private equity fund-of-funds manager investing in CEE through dedicated private equity fund-of-funds since 1998, we know the universe of fund managers active in the region very well. We consider close to 40 to be of “institutional quality”, meaning they can demonstrate a history of operating in private equity in CEE and a track record, have a local presence, pursue hands-on value creation strategies and are professionally organized. The success of the established teams and the experience and know-how required for private equity investing in CEE form certain barriers to entry, so that competition over the past years has not increased significantly and arguably even decreased following the development of the industry and a certain segmentation of the market, which has crystallized over the past years. Only the few CEE fund managers who operate at the very high end of the transaction spectrum, pursuing equity investments in excess of 100 million euro and participating in bids for internationally auctioned deals, face competition from pan-European and global funds. As the private equity opportunity in CEE is dominated by buyout opportunities for mid-sized businesses and buy-and-build strategies, almost all of the local funds operate below the radar screen of the international players, who manage large funds and pursue only large leveraged buyout opportunities, which are rare in Eastern Europe.

What clearly distinguishes the private equity opportunity in CEE from an emerging market opportunity is the type of investment dealflow and the maturity of the fund manager universe. The market has moved well beyond the days of privatizations and early-stage growth capital, which dominated the deal-flow in the 90s. The fund manager universe has consolidated and matured and today has a clear survivorship bias. The fund managers successfully operating in the region today have gone through their learning curve, have weathered difficult markets, can demonstrate track records and at least one full investment cycle and are raising their funds II, III, IV or even V.

Dual exit route available

Although the local stock exchanges are developing strongly, trade sales remain the dominant exit route for CEE private equity by number. In terms of total M&A activity, including private equity, strategic and trade participants, 151 billion euro was invested in 2204 M&A deals in 2007. In 2008 it is expected that deal pipelines will continue to be robust. The CEE public markets are still lagging behind Western exchanges in terms of trading volume and sector diversification. Nevertheless in particular the Warsaw Stock Exchange (WSE) has developed into a viable exit route for private equity over the past years, as evidenced by Enterprise Investors, one of the most established and largest fund managers in the CEE region, who just completed their 25th jubilee IPO of a portfolio company at the WSE. Many of the CEE public markets generated attractive returns in 2007 despite mid-year corrections across global markets. In light of the strong run that regional exchanges have had, valuations of publicly listed stocks are robust. The average P/E ratio on the WSE as of December 2007 was 22, and the Prague exchange traded at an average P/E of 20, which has made local listing an attractive exit route for private equity. In late 2007 and the beginning of 2008, the CEE stock markets declined. This has had beneficial effects for private equity investors as it has reduced competition for financing from the public markets and has lowered the price expectations of sellers.



The global credit crisis and its effects on CEE private equity

The effects of the global credit and financial crisis have largely bypassed the CEE private equity market. The local banks had practically no exposure to U.S. subprime mortgages and have remained active lenders within the region. Importantly, the levels of leverage deployed in CEE buyout transactions, which are largely small- and mid-market transactions, have always been much more conservative than in Western Europe or the U.S.; "covenant-lite" lending has not been practised in CEE. As a result, and given the typically strong growth of CEE portfolio companies, the financing risk in the portfolios of the CEE private equity funds is minimal.

Have these opportunities created results?

Many investors ask us if they can expect to earn a risk premium in CEE. The answer to that question is "no" for the simple reason that investors do not have to take any significant extra risk today in CEE any more. It is rather the combination of the above-mentioned factors that allow investors in CEE private equity to earn a premium. Recent data supports this: According to EVCA data for Western Europe, data of Cambridge Associates for the emerging markets and the European Bank for Reconstruction and Development (EBRD), the largest private-equity investor in CEE, private equity in Eastern Europe has outperformed all benchmarks. According to 2007 EBRD data, CEE private equity has returned 24% over the 10-year horizon, 37% over the past 5 years, 57% over the past 3 years and 43% over the 1-year horizon.

Much of the above raises the question whether Eastern Europe is still an emerging market. The short answer is "no". However, that answer ignores the finer points that make the private equity opportunity in CEE attractive. If the answer is broken down along the aspects under which the private equity opportunity in any market can be analyzed, the picture today looks broadly as follows: As to GDP growth and capital supply, CEE resembles an emerging market, as to political, economic and currency risk, the reliability of the legal and regulatory framework, the universe, quality and track records of fund managers and the availability of exit routes, CEE qualifies as a developed market. As to type of dealflow, both early-stage opportunities typical for emerging markets can be found as well as a strong dealflow for late-stage expansion financing and buyouts.

The art remains to identify and access the most attractive CEE funds and build a portfolio that allows investors to take advantage of the spectrum of opportunities in Eastern Europe in terms of geography, investment style and industries. This is Alpha Associates' forte.

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