PRIVATE EQUITY international

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EMERGING MARKETS

Private equity investing in Central and Eastern Europe continues to mature, helped by deeper pools of leveraged finance, a more uniform regulatory environment and a string of successful realisations. As more international investors discover the region, Aaron Lovell *examines the drivers of CEE private equity one year after EU accession.*

Growth in the east

CENTRAL AND EASTERN EUROPE

A year has passed since eight accession countries – Poland, Hungary, Czech Republic, Slovakia, Slovenia, Lithuania, Latvia and Estonia – joined the European Union. Partly as a result of this historical event, the private equity industry of Central and Eastern Europe (CEE) continues to mature. The region is benefiting from an increased use of debt, open exit routes and growing interest from the corporations and private equity firms of Western Europe and the US. The past 12 months have also been a good year for fundraising, evidence that institutional appetite for the region is on the rise.

Local practitioners argue that from an investor's point of view, Eastern Europe is no longer the ultra-exotic destination it once was. "The biggest story about Central Europe is that it is Europe," says Gyuri Karady, managing partner at London-based Baring Corilius Private Equity (BCPE), which is part of Baring Private Equity International and focuses on Central Europe. "What you see in Western Europe you are now seeing in Central Europe."

Since the early 1990s, when privatisation was the main attraction to foreign capital, the industry has moved on. While privatization is still a relevant source of deal flow, the region now also produces increasingly sizeable, debt-funded buyouts in the private sector.

As a result, the optimism of last spring continues, with a number of investment successes to back it up. New types of investors are moving in. The large pan-European private equity firms are increasingly paying attention – despite the fact that they already have plenty of work to do in their Western European home markets. "It's not just for the €200 million or €300 million telecom deals," says BCPE's Karady of the influx of Western general partners. "They're looking at the €50 million and €100 million deals. If they're not yet investing, they're certainly building a pipeline. They're looking at transactions."

DEBT DRIVES DEALS

Arguably the most important development taking place in the region today is the growing availability and use of leverage in buyout transactions. Local commercial banks like Erste and BPH are providing senior debt, while specialists such as Mezzanine Management and Darby Overseas Investments are offering intermediate capital.

While debt has been available for growth capital investments for some time, banks are increasingly confident about lending into private equity sponsored transactions, which was not the case just a few years ago. General partners say they are now able to borrow increasing multiples of EBITDA to fund LBOs – though not at the heady levels seen in Western Europe – and to secure financing at attractive terms.

"Leverage is clearly becoming a standard feature of transactions," says Michal Rusiecki, a partner with Warsaw-based private equity firm Enterprise Investors. "Availability of leverage is improving on a daily basis, with most of the large, local corporate banks in the region beginning to enter into this activity, if they haven't been in it for some time already."

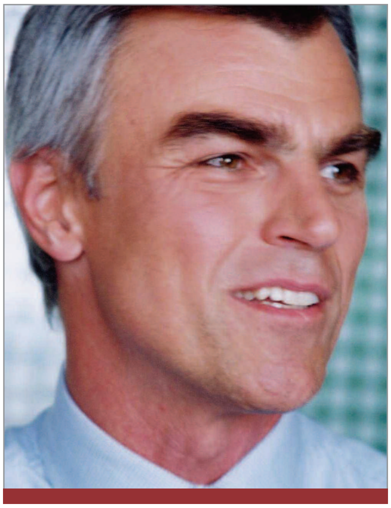
As a result, the novelty factor of buyout transactions in Central and Eastern Europe has now worn off. As Karady explains: "It's becoming more like Western Europe, [where] if you do a €30 million or €40 million equity buyout, there's nothing to write about. You don't make a big deal about it."

The arrival of big LBOs was marked in January 2004 when Advent International, the global mid-market investor, led the purchase of Bulgarian Telecommunications Company (BTC) from the Bulgarian government, a deal that turned the spotlight on some of the trickier aspects of completing large investments in the region. A deal two years in the making, the private equity firm paid €280 million ($342 million) for a 65 percent stake in the company after protracted wrangling with the Bulgarian authorities.

"We created value by doing the deal," says Joanna James, Advent's managing director for Central Europe. "Privatisations in Eastern Europe are very complex and have a high completion risk, but if you can do them, they can be attractive." The fact that Bulgaria is preparing to follow the eight accession states into the European Union gave the firm confidence that the government would not suddenly change the rules further down the road in ways that might harm its investment in BTC.

REGULATORY HARMONY

In order to gain entry to the European Union, Bulgaria is currently going through the same compliance process



Karady: Western corporates filling gaps

that the accession countries went through before it. "[Compliance with EU law] creates a framework of predictability," James says. "All the worries about the negative effects of EU entry haven't happened and all the positives have happened."

Mounir Guen, chief executive officer of London-based placement agent MVision, points out that the years leading up to EU accession brought a new level of transparency and regulatory consistency to the region, encouraging growth and the continued development of the private equity market.

Rusiecki at Enterprise Investors says EU accession has improved Central and Eastern Europe's trade environment in general. "The abolishment of customs barriers has made foreign trade much easier," he says. "So in terms of manufacturing exports, we see quite a boom in Poland, but I think it applies to other countries as well."

Also on the rise is capital inflow. According to a recent Deloitte and Touche survey of corporate executives in the Czech Republic, Slovakia, Poland and Hungary, 84 percent of respondents felt joining the EU had a positive effect on foreign investment in their countries a year after the event. In Western Europe, 86 percent of those interviewed felt that accession had been good for investing in those countries.

Data compiled by the Organisation for Economic Co-operation and Development (OECD) appears to confirm this. Direct investment saw a jump in 2004, with an estimated $6.2 billion of capital flowing into Poland last year, up from $4.1 billion in 2003, according to the OECD. Hungary saw around $4.2 billion in foreign investment, up from $2.2 billion in 2003 and surpassing the $3 billion invested in 2002.

Private equity firms investing in the region are among the obvious beneficiaries of this trend. International corporations moving east in their hunt for strategic acquisitions are fuelling an exit market in which trade sales remain the dominant liquidity route for equity sponsors.

Rojicek: fundraising high in 2005

For example, in September 2005, Bucharest, Romania-based private equity firm GED Capital Development arranged for the sale of portfolio company Sicomed, a Romanian generic pharmaceutical company, to Czech drug maker Zentiva, a former portfolio company of global private equity provider Warburg Pincus.

In another high-profile trade purchase in April 2005, Warsaw's Enterprise Investors and Innova Capital led a consortium of financial investors in their sale of a stake in Orange Romania to France Télécom, Orange's strategic investor, for $523 million. Funds advised by Enterprise achieved a 4x multiple on their investment in Orange.

To be sure, successful sales of private equity-sponsored regional businesses

GOING FULL CIRCLE

Selected exits from CEE, April 2004 – September 2005

Date	Exit description	Exit type	Country
April 2004	Enterprise sells Polish building supplies firm Bauma to Spanish trader buyer	Trade sale	Poland
June 2004	Warburg Pincus lists generic drug maker Zentiva on the Prague Stock Exchange in a €580 million offering	IPO	Czech Republic
August 2004	Argus sells Hungarian cable operator FiberNet to Warburg Pincus for €60 million	Secondary	Hungary
September 2004	Enterprise lists Comp Rzeszow on Warsaw Stock Exchange in a €44 million IPO	IPO	Poland
January 2005	Argus sell Polish cable TV operator Aster City Cable to London-based Lion Capital	Secondary	Poland
April 2005	Innova, Enterprise and AIG-CET sell their stake in Orange Romania to France Telecom in a $523 million deal	Trade sale	Romania
May 2005	Baring sells stake in Hungarian printer Allami to the deal's co-sponsor, a local entrepreneur	Trade sale	Hungary
June 2005	An ABN AMRO-led consortium sells Bulgarian mobile phone concern Mobitel to Telekom Austria for €1.6 billion	Trade sale	Bulgaria
August 2005	Barings sells Polish printer Poligrafia to Chicago-based printer R.R. Donnelley	Trade sale	Poland
September 2005	GED sell Romanian generic drug maker Sicomed to Zentiva	Trade sale	Romania

to trade buyers are not expected to explode over night. Rather, a step-by-step increase is being anticipated. Says James at Advent: "The story isn't a huge amount of direct investment; the story is a continuing upward trend."

Ernest Lambers, head of emerging markets at Amsterdam-based private equity fund investor AlpInvest, agrees: "Some strategic buyers are getting into the market now," he says. "That may be a positive sign. There's a little bit more investment from foreigners and more M&A activity."

BCPE's Karady also expects to be doing business with Western buyers going forward: "The European corporate world has woken up to the fact that they may have a European strategy, but they have inadequate coverage in [Eastern] Europe, so they're filling in the gaps."

In addition, Karady adds, home-grown trade buyers are also becoming more important. "There is beginning to be an exit market that isn't a sale to a Westerner or a listing, but a sale to a local entrepreneur." He points to a deal completed in May this year when his firm sold an interest in Hungarian security printer Allami back to the company's Hungarian co-sponsor, Lang Biztonsagtechnologial Holding.

IPO EAST

In addition to trade sales, exits by IPO are increasing, and even secondary buyouts are possible now that more and larger equity sponsors are looking to deploy capital in the region. For example, Argus Capital Partners, which manages a $170 million CEE private equity fund and invests from offices in Hungary, Poland, the Czech Republic and the UK, sold Hungarian cable television company Fibernet to Warburg Pincus in August 2004.Six months later, Argus passed Polish cable television and broadband concern Aster City Cable to Lion Capital in London, formerly the European arm of US private equity firm Hicks, Muse Tate & Furst.

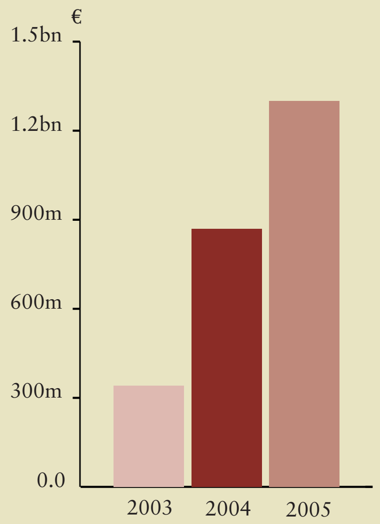
Nevertheless, according to Michal Rusiecki at Entreprise Investors, his firm will continue to achieve the bulk of its realisations through trade sales and IPOs. Public offerings, says Rusiecki, represented more than half of the firm's exits in 2005.

"The Warsaw Stock Exchange was the most active exchange for IPOs in the region in terms of number and, as a matter of fact, the most active national stock exchange for IPOs in Europe after London," says Petra Salesny, a partner with Zurich-based fund of funds Alpha Associates, which specialises in CEE investing.

In 2004, the Warsaw bourse saw 36 new offerings. In the second quarter of 2005, it attracted nine new listings valued at €522 million, according to PricewaterhouseCoopers, up from five offerings worth €166 million in the same quarter of 2004 and five IPOs worth €222 million in the first quarter of 2005.

CAPITAL INCREASE

Private equity fundraising in CEE is on the rise



Source: Alpha Associates, EVCA

Investors say the Polish stock market has been buoyed with a rush of new cash thanks to newly enacted private pension reforms in the country. Similar reforms, says Robert Luke, managing director at GED Development Capital, are being considered in Romania and Bulgaria, which could eventually bring more liquidity to those markets as well.

MORE LPS LIKE WHAT THEY SEE

All these trends are contributing to the region's growing appeal to international limited partners. Private equity fundraising is picking up, enabling the well-established players to organise increasingly sizeable vehicles. For instance, Enterprise Investors closed its latest offering on €300 million in June 2004. In April 2005, Advent followed suit closing its third dedicated vehicle on €330 million.

Other firms including London-based Emerging Markets Partnership, manager of a $550 million emerging Europe infrastructure fund, and GED Development Capital are currently marketing new vehicles as well.

New entrants have also found institutional support in the market recently, such as Centurion Capital, a London-based outfit that closed its European New Horizons fund on €150 million last June to invest mainly in Poland and the Czech Republic.

Petr Rojicek, a partner at Alpha, predicts that 2005 could be a record-breaking year for capital raised in CEE. The firm estimates that as much as €1.3 billion could be raised for private equity this year, up from an estimated €870 million raised in 2004 and €340 million raised in 2003, based on its own research and information from the European Venture Capital and Private Equity Association.

"To a large degree, the perceptions of many investors – previously having had only a casual look at the region – have changed due to the [EU] integration event and heightened awareness of the opportunities," Rojicek says.

"This is now a sustainable market and considered as such by the LPs"

James of Advent concurs that recent fundraising activity is an indicator of growing limited partner confidence in the region. "This is now a sustainable market and considered as such by the LPs," she says.

VALUE FOR MONEY

It remains to be seen how much capital the region can absorb at this point of its evolution, and whether private equity firms can continue to return satisfactory amounts of capital to their backers at fast enough rates. Uncertainties remain: if, for example, large corporations retreat from CEE – as some have from Latin America – the exit environment could change dramatically, and with it the region's return potential.

But limited partners such as AlpInvest's Lambers, whose firm has committed to some of the pan-regional funds investing in the area, feel that there remains much potential. "It's a good investment environment," he says. "Private equity players that have been active there can probably still do well."

The general partners also detect optimism from their own investors. Enterprise's Rusiecki says the past year has been a good one for the investors in his fund. "Our LPs have been receiving substantial amounts of cash back," he says. "Their behaviour at our board meetings has been quite satisfying."

To keep things this way, locally active managers will do well to keep distributions flowing back to their clients at a steady pace. The promise of Central and Eastern European private equity remains significant. The coming years will bring clarity as to how much the industry can deliver. ■