Between The US And The Far East Lies Untapped Opportunity

By Marine Cole

3/1/2006 -- We're thinking of a region of the world. Here are some clues: Annual GDP growth is expected to beat 5% for the foreseeable future, well ahead of growth in more developed nations. Legal and political systems are being brought into line with Western standards, resulting in an improved environment for doing business. Domestic demand is expanding, creating stronger markets for home-grown businesses. And wages are low relative to the rest of the world, meaning the cost of doing business can be lower as well.

Did you guess Central and Eastern Europe? Because that -- not Asia -- is the area we are describing. Western Europeans have recognized the opportunity, and are investing heavily. But, somewhat surprisingly, U.S.-based limited partners, who have been moving heavily into other emerging markets, are mostly absent.

It's an area of great opportunities," says Mounir Guen, chief executive of placement agent MVision. The ability for people to move up on the economic scale is very strong. It efficiently creates an opportunity to create an extra capital return."

To be sure, Asia has several advantages over Eastern Europe: It has more fund managers and much bigger markets that can accommodate multibillion dollar deals, such as Goldman Sachs Group's $2.58 billion investment for a mere 7% of Industrial and Commercial Bank of China in January. Eastern Europe's funds are fewer and smaller, and that translates on the deal side, where the largest transaction to date has been a consortium's 2004 acquisition of Bulgarian mobile operator Mobiltel EAD for $1.2 billion, including $450 million in equity.

But in a lot of ways, Central and Eastern Europe -- which for the sake of this report include the Czech Republic, Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia -- appears to be keeping up with Asia, and in some cases surpassing it.

A Rosy Outlook

Overall growth in these countries is forecast at about 5% for the next several years, below the 7% or so in Asia, according to the World Bank. But unlike China, growth is built more on the domestic economy than on exports, which are riskier as they are more subject to the whims of foreign demand.

Some of the growth is driven by ongoing privatization of government-owned enterprises, but a bigger factor lately is the entry of these countries into the European Union. As they join, countries like Romania and Bulgaria are having to make sure their legal systems, debt levels and tax regimes are in line with broader EU standards. That process gives Western European investors, already intrigued by the potential of Eastern Europe's relatively inexpensive labor force, the additional confidence they need to take the plunge.

The EU accession is critically important to our ability to invest in these countries," says Joanna James, managing director with Advent International Inc., which has been investing in the region for 10 years or so.

With all the changes, some crucial parts of the private equity picture have fallen into place. For instance, firms such as Washington-based Darby Overseas Investments Ltd. and Mezzanine Management, London, have raised mezzanine funds in the past couple of years focused just on Central and Eastern Europe -- a crucial factor if buyouts are to increase. Second-lien loans and paid-in-kind notes have also become available.

The outlook for exits is improving as well. While still small, initial public offering markets are growing, especially in Poland, where the number of companies listed on the Warsaw Stock Exchange totaled 255 at the end of 2005, up from 230 a year earlier.

The strategic exit picture is even stronger, as Central and Eastern European companies are finding their Western European counterparts to be willing buyers. The market is even seeing some secondary buyouts by PE firms, a sure sign of maturity.

And while -- so far -- the deals are smaller in Central and Eastern Europe than in Asia, the returns are not. The region is showing a one-year return of 53.2% and a three-year return of 29.6%, well ahead of the 14.6% and 11.6%, respectively, that Asia has shown over the same period, according to data from Cambridge Associates and the Emerging Markets Private Equity Association (see table, page 61). The Central European data includes Russia.

PE Steps It Up

European general partners have cottoned on to the improving picture in the region over the last few years, and fund-raising totals prove it. In 2005, EUR1.2 billion was raised by funds with a Central or Eastern European focus, more than double the EUR496 million raised in 2004, according to emerging markets consultant Liberty Global Partners. Funds that successfully raised money last year included Advent International and Mid Europa Partners, which in 2005 spun out of American International Group Inc.

These two, along with Enterprise Investors, are the biggest players in the region, although there are a number of smaller homegrown participants as well, like Budapest-based Euroventures Capital Advisory Kft. and Warsaw-based Cornerstone Partners. These latter funds tend to focus on fewer countries and are investing smaller funds, rarely above the EUR200 million mark.

Although a big pan-European or U.S.-based firm occasionally does a deal in the region, firms like the ones above are really the only game in town for LPs wishing to get in on the action.

Western European LPs accounted for more than 60% of all commitments to these firms in 2004, according to the European Venture Capital Association. [Home-grown LPs made up another 14.6%.] Among them are large Dutch pension fund TNO, Dutch fund-of-funds manager AlpInvest Partners, BMW AG's Quandt family, 3i Group PLC and German fund-of-funds Global Vision AG. French insurance company AXA made its first commitment to the region last year.

Such LPs are planning, if anything, to ramp up in the region. AlpInvest, having invested EUR150 million in four funds in the region since 2000, plans to put in another EUR100 million to EUR150 million over the next three years.

US LPs Take A Pass

In contrast, the U.S. LP presence in the region is slight, with the EVCA estimating that U.S., Middle Eastern and Asian LPs together accounted for 22% of all investments there in 2004.

I think U.S. pension plans didn't have their mind on [Central and Eastern Europe] at the time we raised," says Advent's James. People said, ÔIt's really interesting. We'd love to know more, but not yet.'"

A few U.S.-based financial institutions and some endowments are getting involved. For instance, Columbia University is an investor in Mid Europa's latest fund. But the only major U.S. pension fund known to have a presence is California Public Employees' Retirement System, which has committed a total of $255 million to three funds in the region -- since 2000.

A much more typical example is Pennsylvania State Employees' Retirement System, which doesn't have any current investments in funds specifically targeting the region. While a spokesman says Central and Eastern Europe is an area that our folks have been evaluating," it has no current plans to invest.

Part of that is structural. Thierry Baudon, managing partner with Mid Europa, says a large U.S. pension fund such as Calpers wouldn't fit his firm's profile. They are very consistent and make very large allocations, but that played against us because at EUR650 million, in the global landscape we're dwarves," he says, adding that Mid Europa put a EUR60 million cap per investor.

Because they don't have the resources to investigate small, regional funds, especially overseas, many U.S. LPs are primarily in the big pan-European funds, which have solid track records and management teams and can take large individual commitments. U.S. LPs' commitments to regional strategies have mostly come in the form of funds of funds. The one such vehicle operating in Eastern Europe right now, Alpha Associates, is currently raising its second fund, and says it has spoken with prospective investors from the U.S.

But U.S. LPs also may be missing out simply because they're too focused on Asia, especially China and India. Many of the large public LPs are on the West Coast, making Asia more of a back yard for them, and a big Asian-American community there helps cement ties.

In the U.S. in general, Asia and China clearly get more attention than Europe," says Petr Rojicek, partner with Alpha Associates. In general, from what we hear in Europe, [European] investors are more cautious about investing in Asia."