CENTRAL AND EASTERN EUROPE

Diamonds in the rough?

Central and Eastern Europe has not had an easy few years; fundraisings have been lengthy, deal flow is subdued and LP appetite is not as strong as it used to be. But when PEI *sat down with five industry experts, they explained why the region should not be overlooked. By Yolanda Bobeldijk*

It is a pleasantly sunny afternoon when *Private Equity International* arrives in Warsaw. Office workers are enjoying their lunchtime sandwiches in the parks and squares near the city's business district, while the number of students around also helps to give the city a young and vibrant feel. And there's a similar optimism in evidence up in the office of CMS, where the five industry experts in conversation at our roundtable are convinced that the region has put the economic crisis behind it.

Of course, they acknowledge that the last few years have not been easy. Deal flow has been notably subdued. Last year, 41 private equity deals were completed in Central and Eastern Europe, roughly the same number as in 2012, according to data from Mergermarket – a big drop from the 75 deals completed in 2007.

The problem in CEE currently is that business owners don't feel compelled to sell, says Dariusz Prończuk, managing partner at Enterprise Investors. "There are quite a noticeable number of people considering selling their businesses, but they have another perception of the value of the business than the buyer. If they don't get the preferred value, they will just wait. So many deals are being delayed and deferred."

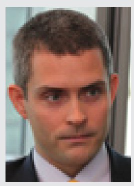
This issue is also recognised by Przemyslaw Bielicki, a partner at Royalton Partners, which buys the majority of its portfolio companies from founders. But he believes the situation is improving. "I think in the region the effects of the »

MEET THE ROUNDTABLE

DARIUSZ PROŃCZUK
ENTERPRISE INVESTORS
Prończuk is one of the three managing partners. He specialises in the financial services, IT and construction materials sectors, and is responsible for Enterprise's operations in the Czech Republic.

ANNE FOSSEMALLE
EBRD
Anne Fossemalle has been in charge of EBRD's investments in equity funds since 2009. Previously, she was responsible for EBRD's direct investments in banks. She joined EBRD from Natixis.

HENRY POTTER
ALPHA ASSOCIATES
Potter is a partner at Alpha Associates. He has been investing in private equity funds and companies in Central & Eastern Europe and Russia/CIS since 1992. He joined Alpha Associates in September 2008 from the European Bank for Reconstruction and Development (EBRD) where he was a senior banker.



GRAHAM CONLON
CMS
Conlon is the global co-head of international private equity, and the head of corporate and M&A in Ukraine at CMS. He has a regional role and advises on private equity and M&A transactions throughout Europe, and beyond.

PRZEMYSLAW BIELICKI
ROYALTON PARTNERS
Bielicki has been a partner at Royalton Partners since 1997. Between 1997 and 2004, he was also a principal of EDCM. Prior to joining Royalton Partners, Bielicki was chairman of W. Frackowiak & Partners.

LPs know that it is different from Western Europe and why, so they consciously make decisions either to invest or not to invest

Darius Prończuk

» financial crisis were slightly delayed. All the entrepreneurs still believed their businesses were worth much more, as they were referring to pre-crisis stock market valuations. They are now much more realistic about the price."

While deal-doing takes longer, deal flow seems to be improving, the panel agrees. "There's an increasing number of very interesting manufacturing companies that are growing in Poland, Czech Republic and Hungary," says Prończuk. "We haven't seen this in the last eight to 10 years. These companies are building really a very good investment story based on strong exports – and [they're] building market share, not only in Europe, but also outside of Europe."

On the exit front, things are looking much better, according to the industry experts. "We've seen a good number of exits last year from various countries in our eastern European portfolio, including IPOs, trade buyers and recapitalisations," says Henry Potter, a partner at Alpha Associates.

This view is echoed by Graham Conlon, a partner and global head of international private equity at CMS. "Many funds that invested in the boom years are now getting close to the end of their lifecycle and hence are under pressure to exit, even if deal terms are not quite as good as they would have hoped. So we've definitely seen an increase in deal flow in recent times, and my prediction is that this trend will continue into the rest of the year."

Enterprise has also seen a noticeable improvement on the sell-side. "[We] had the highest ever proceeds from exits last year," says Prończuk. "It's a combination of IPOs, selling to strategic buyers both from the region and outside of the region. We have been able to do dividend recapitalisations as well to realise some of the value of the businesses."

BETTER ACCESS TO CREDIT

These exits – especially at the higher end – are often fuelled by improved credit conditions.

Banks are lending again, says Conlon. "For the right transactions, there is adequate financing available."

In fact, the banking sector in CEE has come out of the crisis relatively unscarred, according to Potter. "An example from a couple years ago illustrates why. We invested in a Polish buyout, and the financing was provided by a Polish daughter bank of a German bank. This German bank was in the middle of asking its government for money and almost certainly would not be financing buyouts in Germany. But the daughter bank in Poland was well-capitalised [and] liquid, so in Poland it was 'business as usual'. I think the Central Bank in Poland – and I think the IFIs supported this – did a good job insulating local daughter banks from the problems of the mother banks in Europe."

This wasn't the outcome many people expected, he adds. "When Lehman collapsed, if you read the *Economist* or the *Financial Times,* you might think that the Austrian banking sector was about to collapse under the weight of massive bad loans generated in Eastern Europe. The message seemed to be: 'Eastern Europe is going to bring down Austria'. But in the end, it was more important to make sure that the region was insulated from the problems in Western Europe, typically caused by overleverage of the mother banks. The daughter banks in eastern Europe were often better off than their owners."

These improved credit conditions may explain why deal value has increased substantially, despite slowing dealflow. The 11 transactions completed so far this year have had a combined value of $1.4 billion. Last year, the 41 deals done totalled a whopping $3.3 billion, compared to a combined deal value of $996 million for the 40 transactions a year prior and the $1.7 billion across 62 deals in 2011.

A REGIONAL APPROACH

To find the best deals at favourable prices, it's best to take a regional approach, Bielicki argues.

"Poland is the largest economy in the region and the largest deals are done from this country. But I wouldn't say most of our deal flow is from Poland, it is a mix." For LPs – especially from outside the region – it can be very difficult to assess which region or country is better for investment, he adds. "The EBRD is experienced, but not all LPs have similar knowledge about the region. We talk to people from every country in the region and observe what's going on."

But not all LPs agree. "There's no rule for whether pan-regional funds are better; we're not religious about this," says Potter. "But I think most of the managers in CEE that have a strong track-record have a strong business in Poland." Yet that doesn't mean deal flow is necessarily stronger in Poland, he adds. "Our last fund has almost as much exposure to the Czech Republic as Poland, which is somewhat unexpected, but we saw some good investments there."

Probably the only small country funds that are going to survive are in Poland, according to Potter. "If you have a €100 million fund, you can be a lower mid-market Polish specialist [and] have enough deal flow; with that size fund, it makes little sense to set up in Romania. But it's harder to imagine having the deal flow for a €100 million Romanian-specific fund."

While a regional approach can work, it's important to remember that countries in Central and Eastern Europe can be very different from one another.

Twenty years ago, CEE could be seen as one homogenous region from a private equity perspective, says Conlon. "The countries within it were all starting more or less from the same point – they all had the ex-communism story, the conversion story and the growth story, with similar risk and reward dynamics. But what exactly does 'CEE' mean today from a private equity perspective? On the one hand you've got Poland and Czech Republic, which are almost on par with Western Europe in terms of risk and appetite. But then you've got Hungary, Romania, and Bulgaria in a different bucket, in my view. And then you've got countries like Ukraine and Russia which fall within in entirely different bucket in terms of risk and opportunity."

EMERGED, OR EMERGING?

Therein, it appears, lies CEE's biggest problem: in which bucket does it belong? Should it be considered as part of the European allocation, or do investors treat it as an emerging market?

Anne Fossemalle, director of the equity funds, industry, commerce and agribusiness group at the European Bank of Reconstruction and Development (EBRD), is clear: "CEE is not an emerging market; we consider it definitely as Europe."

But not all the panellists agree. "The region is split into at least two parts," says Prończuk. "Poland, Czech Republic and some sectors in Hungary are already quite similar to Western Europe. In other countries, »

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>
> **Henry Potter**

» the growth rates are different and you can still expect higher growth in future in basic industries. So in practice, this means that the type of deals in these countries are quite different, because GDP level, disposable income and consumption are also different in each of the countries."

Whether CEE is an emerging market or part of Europe is a difficult question to answer, according to Bieklicki. "It is somewhere in between, because we are combining good points from both areas. We have comparable political stability, infrastructure, and legal framework as in Western Europe. We can offer lower risk while giving access to higher growth markets."

GPs don't have to explain the region to European investors, says Pronczuk. "LPs know that it is different from Western Europe and why, so they consciously make decisions either to invest or not to invest in this part of Europe. Most European LPs see CEE as a European allocation. However in the US, not all LPs are looking at CEE in the same way. Some of them would consider CEE as a classic emerging market. They would book a number of meetings in the same day and meet with us, then an Argentinean GP and Indonesia-based GP, for instance. So we then have to compete with other emerging market managers."

The current crisis in Ukraine isn't doing the region any favours either. "During [a] conference in the US recently, questions about Ukraine did not appear during the panel sessions," says Bielicki. "But at the drinks afterwards, [LPs] did mention it. We haven't started fundraising yet so it's difficult to say how much we will be impacted by the crisis there, but I think it will be a part of the process."

Due to the current upheaval in the Ukraine, this split will become clearer, Potter argues. "CIS and CEE should have a completely different investment profile in terms of risk/reward. Our investments in Russia have performed very well, but we expected higher returns since we perceived the risk to be higher. I think that this distinction in risk perception between central Europe and Russia will become more important. Poland is becoming perceived as more of a European market."

For now, it is too early to say how the Ukrainian situation will play out, Potter adds. "We absolutely get asked about this by our own clients, despite the fact that we have almost zero exposure to Ukraine. I think unfortunately what's going on in Ukraine and Russia will mean that it is more difficult to fundraise for the region."

FUNDRAISING WOES

Collecting capital for Central and Eastern Europe has been far from easy lately. While the amount of capital raised has slightly improved, the number of funds being raised is declining, according to data from *PEI*'s Research and Analytics division. In 2013, only three funds were raised in the region, totalling $1.2 billion. In 2012, five funds raised $430 million, while in 2011 GPs amassed $820 million across five funds. That's a fraction of the combined $4 billion collected by 12 funds in 2008.

One of the big GPs in the region, Mid Europa Partners, is currently nearing its €850 million revised target for its fourth fund, *PEI* revealed in May. Mid Europa originally targeted €1 billion for the fund, which came to market in February 2013, but agreed with LPs to cap the fund at €850 million amid concerns that it would be too

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Anne Fossemalle

large for the deals in the region. Another reason for the cap was that Mid Europa wanted to continue to offer 50 percent of each fund in co-investments. Although more than half of Mid Europa's LPs re-upped, the fundraising process wasn't straightforward, as LP appetite for the region has declined, a source told *PEI* in May.

Some of this negative sentiment has been fuelled by the fact that Boston-based Advent International decided last May to shelve its plans to raise another CEE-focused fund, according to two sources. Because Advent is such a well known GP with a good track-record, it sent out a message that CEE was no longer an attractive market, the sources said. While Advent continues to invest in CEE through its global fund, the way it explained its strategy change has "tarnished the image of the region", according to another source.

IMAGE ISSUES

All of our roundtable participants declined to comment on Mid Europa and Advent. But they agreed that a lack of investor appetite was a problem.

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>
> **Graham Conlon**

There is a fashion element to the industry, according to Prończuk. "Latin-America was considered sexy, but these things tend to change quickly. Two years ago, people were ecstatic about Turkey, and now Turkey seems to be out of fashion. LPs were talking about how Brazil was great and these days I would bet most of the people say [that] Brazil is maybe not such a good place to invest. It's also a question of the perception of risk and returns. I speak to investors who say: 'we are busy with Latin America' – but I don't think the grass is so green over there."

"There was a wave of enthusiasm for CEE assets after they joined the EU and pre-Lehman," says Potter. As a result, a number of managers doubled their fund sizes and the ones that did so tended to have the highest number of new investors, he adds. "The more you increase your fund size, the harder it is to maintain high returns. Many of the new investors, who had never invested in Eastern Europe before and who had never made the terrific historic returns, were disappointed by the under-performance, especially when the financial crisis hit."

Long-time investors are less concerned when there is a bad cycle, he says. "It's easier for us to place it in context. But if you come in for the first time, make an investment, and it doesn't do what you thought it was going to do, it's tempting just to retreat from that region. What should fund managers do? Work hard, invest the next fund really well, show great returns, and the investors will come back."

It is extremely important to underline that this is a perception issue, according to Fossemalle. "You have to look at the underlying reasons why some funds haven't performed as well – you can't just blame it on an entire region. That is a false excuse in my opinion."

Potter agrees. "Following the crisis, most GPs have had no issues deploying the capital they had raised. Where you do see recent issues getting a fund fully invested are the teams that had internal issues – teams that had to spin out of a bank, for instance. These were not problems made in CEE but rather in London, Paris or New York."

If anything, funds currently operating in the region are bound to do well, they argue. "Post-crisis vintages should »

> *Only by differentiating from other markets and communicating the advantages will [CEE's] appeal to LPs improve*
>
> **Przemyslaw Bielicki**

» actually be quite good because there's less money around, so I expect LPs to come back to the region in a few years," says Fossemalle.

DOMESTIC DEARTH

Unfortunately, in the meantime, CEE cannot rely on its domestic investor base: local LPs have been almost entirely absent from the region's buyout market.

"The Polish pension funds are not investing in private equity and there is little likelihood of that changing anytime soon with the ongoing pension fund reform," explains Fossemalle. "There's no steady continuous source of domestic long-term capital investing in this region."

Polish pension funds have never invested in private equity, and part of that is due to the regulator's sceptical attitude, says Potter. "In a transitioning economy like Poland, private equity is an important tool [to] support growth, innovation and jobs. If you're a regulator or a politician and you are considering a policy that will cause private equity to be smaller, to suffer or to depend more on foreign money – this is shooting yourself in the foot. Unfortunately that is what is happening at the moment."

So with the absence of domestic capital, what needs to be done to improve the image of the region elsewhere? "We should promote the industry more – and we have tried to play a role in this," says Fossemalle. It's worth remembering that many GPs in the region are very experienced investors, she points out. "GPs have raised many successful funds in this region. They're not just raising their first or second one; many GPs are on their sixth or seventh fund. Therefore they really have the experience and have gone successfully through many crises. The experience in this region is much deeper than I understand it to be in China or Latin-America."

"CEE needs to promote its distinct identity as another sub-region of Europe, like Scandinavia or DACH," suggests Bielicki. "Only by differentiating from other markets and communicating the advantages its appeal to LP's will improve."

If anything, the data support the region's case. "Our overall [CEE] portfolio (including Russia) has yielded a net return with an IRR of 18.8 percent over a 10 year horizon," says Fossemalle. "If you're looking at the Cambridge Western European Index or Western European Private Equity Index, the market returns are all much lower despite their survivor bias. This means our portfolio in this region has performed better than the benchmarks."

Both LPs and GPs on the panel agree that the region remains an attractive place to invest. It just need to sell itself a bit better.

"I was in the US recently [talking] about how to promote the region, and I presented this graph which shows average number of hours worked by employees in various countries – CEE came out quite well," says Bielicki. "Western European productivity grew over the last 10 years between 0.5 to 1.5 percent. For Central and Eastern Europe it was between 2.5 and 4.5 percent. So we are improving our efficiency and that means it's a good place for investment."

Fossemalle agrees. "We have invested for over 20 years [in CEE], and we continue to focus on investing in good GPs with a relevant strategy and strong team which leads to growth in the real economy. There remain good opportunities [in] this promising market." ■