Private Equity in Central Europe: Strong Growth in Opportunities

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About the Sponsor:

Baring Private Equity Partners Central Europe

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1. Introduction

Central Europe (CE) has made substantial progress over the last ten years in its political, economic and social development. With the imminent formal accession of the first eight former communist countries to the European Union, these nations offer increasing private equity opportunities for growth capital and management buy-outs. The CE countries (Poland, Hungary, Czech Republic, Slovakia, Slovenia and the Baltic countries of Lithuania, Estonia and Latvia, which will join the EU in May 2004, along with Romania and Bulgaria, scheduled for EU entry in 2007), have the potential to be significant contributors to the future growth of European private equity activity.

After the fall of communism in 1989, each CE country embraced its own version of capitalism modelled on the practices of Western Europe (WE) and the US. This included an early start in the development of a private equity market as institutions such as The European Bank for Reconstruction and Development (EBRD) and US Congress supported “Enterprise Funds” began active equity investments in the emerging private sector. This first phase of CE private equity deals was characterised by a process of experimentation as fund managers, business owners and governments made their initial steps in the emerging economies with privatisation, transformation and start-up investments dominating.

Now, over a decade later, we are in the midst of the second phase of CE private equity development, with the long-term investment terrain having been solidified and increasingly comparable market to WE’s market. Driven by the demands of EU membership and the requirement for harmonisation of legal, regulatory and business practise with the rest of Europe, the Accession countries have developed the key elements for western-style private equity investment, including sourcing of deals, entrepreneurial culture, depth of management skills, experienced professional services such as lawyers and consultants, better supporting capital market infrastructure, particularly for debt, and the development and diversification of exit routes for private equity investors. Each of these elements signals an improved environment for private equity investing.

We see many parallels in the development of CE private equity with that of WE. Many of the step-changes in the industry in the west were triggered by structural changes in tax, business or other regimes that provided impetus for the industry to grow to a new level. Similarly in CE, the process of harmonisation with the EU has provided the structural change that has in turn created improved private equity opportunities for the Region. The pace of reform and structural change since the early 1990s in CE, combined with the ability to build on the accumulated learning and development of the private equity industry in WE, has accelerated the development of the private equity industry in CE.

With Accession now in sight and many of the key structural changes already achieved, we believe, overall, the potential for CE private equity investment looks bright. The rate of improvement and increased overall investment in CE is striking, as is the near-term ability to exit. Aside from the larger auction situations, competition to invest in mid-market opportunities appears to be less intense than in many WE markets. Thus, investing in CE’s Accession countries, while not without risks, offers an opportunity
that may produce attractive returns as compared to those in existing EU states. Figure 1 shows our comparison of the state of key private equity drivers in selected WE countries with those found in CE.

In this report we first briefly summarise the key lessons from the development of the private equity industry in WE and set the stage for the potential CE private equity environment with a brief review of the individual countries during the first phase of their development.

We then examine the prospects for post Accession development of a private equity market in CE by reference to the following elements:

- Current Private Equity Landscape
- Supply of Deal Opportunities
- Demand for Private Equity
- Infrastructure to Complete Deals
- Opportunities to Realise Gains

The report relies on two main data sources. First, interviews were conducted with leading players across the Region to obtain insights on the factors influencing market development. Second, data on trends in the market, deals and case examples were obtained from various public sources and supplemented with interview material.
Fig. 1: Comparison of Current Factors Affecting Private Equity Development in Western Europe and CE

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<th>UK</th>
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<td><strong>Supply of Opportunities</strong></td>
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<tr>
<td>Need to deal with family</td>
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<td>**Infrastructure to Complete</td>
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<td>Grew from</td>
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<td>Venture Capital market</td>
<td>from early 1980s</td>
<td>late 1980s</td>
<td>small &amp; not</td>
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<td>but many</td>
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<td>Supply of debt</td>
<td>High</td>
<td>Moderate</td>
<td>Tradition of high leverage</td>
<td>Low but growing</td>
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<td>Intermediaries network</td>
<td>Highly developed</td>
<td>Moderately developed</td>
<td>Fragmented</td>
<td>Highly developed</td>
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<td>Favourable</td>
<td>Moderately favourable</td>
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<td>**Favourability of taxation</td>
<td>Favourable</td>
<td>Favourable</td>
<td>Reforms in progress</td>
<td>Moving to favourable with EU reforms</td>
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<td>regime**</td>
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<td><strong>Realisation of Gains</strong></td>
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<tr>
<td>Stock markets</td>
<td>Receptive to p.equity cos. from mid-1980s; now more difficult</td>
<td>Development of 2nd market</td>
<td>New issues sparse</td>
<td>Growing domestic capital pool and appetite</td>
</tr>
<tr>
<td>Trade sales</td>
<td>Highly active</td>
<td>Becoming more active, especially for partial sales</td>
<td>M&amp;A market developing</td>
<td>Highly active</td>
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<td><strong>Secondary Buy-outs/restructuring</strong></td>
<td>Increasing interest</td>
<td>Favoured route</td>
<td>Possible route</td>
<td>Possible route</td>
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Source: CMBOR
2. Overview of CE Private Equity

2.1 A Parallel to WE Development

The context of private equity development in CE today has parallels with WE. Twenty years ago, the private equity industry in WE was still in its infancy. The US market had developed during the mid-1970s but in WE, only the UK and the Netherlands showed significant activity in 1983. Today, private equity markets in many WE countries are well established with progress accelerated by the learning curve undergone in the lead countries as deal technology was quickly spread and developed. Deal value across WE was negligible in 1983 but two decades later was close to €70 billion (Figure 2).

Fig. 2: Value Trends of WE/UK Buy-outs/Buy-ins, 1979 - 2002 (€m)

Developments in WE markets have been dependent on changing factors relating to the generation of opportunities, the infrastructure to complete deals and opportunities for the realisation of gains. In particular, a number of key structural developments have driven the development of the private equity market in the principal WE countries over the past two decades. These include privatisation programmes and the need for restructurings to create opportunities, improved tax and fiscal incentives for equity investment to attract capital and improve returns, the development of debt markets to provide leverage and scale, increased financial intermediation to assist companies in accessing private equity, and the increasing harmonisation of the business landscape across the EU which gave rise to opportunities for pan-European private equity. Figure 3 summarises some of the key developments generally and in the lead markets.
2.2 CE Development Path

Overview
While each of the CE countries have followed individual paths, the
progress since the launch of the transformation process in the early
1990s has been stark with the developments driven by many of the
same factors that drove the private equity industry forward in WE.

Privatisations generated the first larger scale deal opportunities.
These gave way to restructuring and spin-offs as industry
redeveloped and became more competitive. The early arrival of
experienced western trained private equity professionals, often
supported and funded by US and other governments, provided a
jump start to the local knowledge base and imported a high level of
skills and the Anglo American business model. Continued revision
of laws and regulations to western standards as required for EU
entry provided an improving infrastructure for doing deals. Figure
4 summarises this development.

Fig. 3: Development of WE Private Equity

Fig. 4: Development of CE Private Equity

Source: CMBOR
As detailed in later sections, these factors have led to a strong increase in deal activity. Total private equity investment exceeded €1.3 billion between 1998 and 2002 according to EVCA. These figures clearly understate the extent of actual activity as not all countries are reported and the reporting systems in those that did have become rigorous only of late.

The following briefly summarises the development path in the individual countries during the initial development of CE private equity.

**Poland**

Before the adoption of capitalism in Poland, there were approximately 8,400 large State Owned Enterprises (SOEs) that contributed between 70 and 80% of GDP. As of 2003, all SOEs of major industrial significance that were slated to be privatised had been privatised, and over 3,000 had either been liquidated or re-assigned to more viable businesses. The major privatisation of over 500 businesses was completed in conjunction with 15 National Investment Funds. By 1988 there were over 200,000 small businesses, primarily in retail trade and services to complement and jump start privatisation. The state quickly privatised the vast majority of these through windfall placements with employees, generally at well below any market measure of value. These businesses became some of the early growth capital opportunities. GDP derived from the private sector reached 70% by 1999, while private-sector non-agricultural employment rose from 14% of the labour force in 1989 to 61% in 1999.

After a short sharp recession in the early nineties triggered by a shock therapy approach to reform, Poland became the most active private equity market, reflecting the country’s position as the largest in the region in terms of population and GDP (although not on a per capita basis). Substantial foreign direct investment (FDI), providing opportunities both for deal sources and exit opportunities, a strong entrepreneurial class generating growth capital opportunities and a well developed deal infrastructure have contributed to the substantial activity. The close ties and early support for Poland from the US and Europe (including the establishment of the Polish American Enterprise Fund and several private initiatives for private equity in the early 1990s) have also driven an influx of capital and skills that jump-started the industry in the early 1990s.

**Hungary**

In the late 1980s, over 85% of Hungary's enterprises were state-owned. However, in 1989 the reform oriented government created the foundation for privatisation with substantial changes to securities, banking, tax, investing, and trade policies and regulations. Various innovative and overlapping privatisation
techniques were initially deployed, including spontaneous privatisations, free distribution of assets and preferential selling. By the mid 1990s, Hungary was ready for the big privatisation push, with large asset-intensive and financial sector privatisations open to strategic and foreign investors. By 1998, approximately 1,200 of the roughly 1,850 state portfolio companies targeted for privatisation were transferred to private investors, with the remainder being liquidated. As a result, over 80% of Hungary's GDP is generated by private firms, with substantial portions held by foreign and institutional investors.

Hungary’s early openness to and relative ease of foreign investment, both privatisation and greenfield, encouraged private equity development from an early date. Funds including the US Congress supported Enterprise Fund, and two closed end funds with North American and UK management introduced private equity to Hungary and started to do deals as early as 1990. EBRD also actively invested directly in both equity and debt, further developing the market. Hungary's industrial heritage, strength in global industries such as pharmaceuticals, and aggressive privatisation generated attractive candidates for investment, despite the smaller size of its economy. Although stop / start growth in much of the mid-1990s retarded overall economic progress as fiscal and monetary imbalances where worked through, harmonisation with the EU has led to a rapid improvement in the deal infrastructure.

**Czech Republic**

In the former Czechoslovakia, approximately 95% of GDP had been generated by state enterprises. Czechoslovakia began, and the Czech Republic completed the privatisation of 1,700 companies between 1991-1994, mainly through a voucher scheme. By 1995, over 60% of GDP was in the hands of companies owned by private investors, and by 1999 that number had risen to 75%. Within the same four year period, an additional 632,333 new businesses were established, of which 218,871 were wholesale and retail firms.

The original voucher privatisation scheme and other structural factors resulted in the relatively concentrated ownership of a broad section of the Czech economy, slowing the restructuring process and the development of a similar range of opportunities as emerged in the other markets. Combined with a lack of effective large scale bank privatisations prior to the late 1990’s, private equity in the country lagged its potential. However, with a highly educated and technically oriented workforce, strong industrial engineering heritage and the highest GDP per capita in the region, the Czech Republic has seen recent strong organic growth in GDP along with a flourishing services sector. This has led to increased private equity activity since 2000, which accelerated as bank privatisations
progressed and the continued flow of FDI stimulated opportunities through spin-offs, divestments and outsourcing.

**Slovakia**

Initially sharing the same industrial heritage as the Czech Republic, the “Velvet Divorce” in 1993 left the south eastern part of the former Czechoslovakia with an inheritance of heavy industry, focused on engineering and armaments. Burdened with an anti-Western and anti-privatisation government led by Vladímir Meciar for much of the 1990s, the country only emerged as a substantial investment focus for private equity after 1998 with the defeat of the Mercier government and the election of a pro-EU coalition. Substantial progress on restructuring and privatisation, as well as legal and regulatory harmonisation has ensured the country’s place among the first wave of EU entrants with an increasingly active private equity market. The private sector now accounts for over 80% of GDP.

**Romania**

Heavy industry and agriculture have traditionally dominated Romania’s economy, which is the second largest in the region by population. However, light industry is now increasing in importance as privatisation and foreign direct investment boost these sectors in particular. Romania’s labour cost advantage remains highly attractive versus the rest of the EU and with continued improvement in infrastructure the country should attract increasing FDI going forward. The private sector’s share of GDP was estimated at 65% in 2002, reflecting the on-going nature of the privatisations in heavy industries, and showing an improvement on the 1993 level of 35%.

Burdened with an especially poor inheritance from the communist period, Romania’s early transition was hampered by political divisions and a lack of reform commitment. Following several economic crises, high inflation and substantial devaluations, the period post 2000 has proven to be one of increased stability and better progress on reform and substantial progress on key privatisations. With the increasing development of a stable consumer society as growth creates increasing personal wealth and a pick-up in foreign investment stimulates growth from exports, Romania has been generating a steady flow of deal opportunities. The country is viewed as holding some of the region’s greatest potential for private equity going forward and has attracted substantial interest from investors, with most regional funds maintaining an office in Bucharest.

**Bulgaria**

Bulgaria has a strong industrial heritage with a mix of heavy and light industry. Agriculture also remains an important part of the economy. Located on the Black Sea at the southern tip of Europe...
and adjacent to Greece, it is an important transportation hub and gateway to the continent. Since the early 1990s the private sector’s share of GDP has grown steadily, largely as a result of organic growth of businesses launched by entrepreneurs and is now over 75%, up from 35% in 1993.

The country really emerged as a serious investment opportunity for private equity in 1997 when a currency board and government reforms drew a line under a period of economic crisis and relatively slow reform. The lack of progress in early transition had meant that most private equity opportunities were from growth or expansion capital investments rather than direct privatisation. The exception has been some recent headline privatisations in the financial, telecoms and pharmaceutical distribution sectors, which provided the larger private equity opportunities in the country. Increased foreign investment, the completion of the remaining key privatisations and continued overall stability will further encourage activity going forward.

**The Baltics**

The Baltic countries of Estonia, Latvia and Lithuania are much more economically tied to Scandinavia and Russia than the more southern EU entrants. As a result, they operate in a distinct market environment with its own dynamics. These relatively small and closed markets, with a total population of only seven million, have limited opportunities for sizeable private equity investments, with some exceptions. Progress and development have been quickest in Estonia but accelerated in Latvia and Lithuania in recent years, which ensured their place in the first wave of EU entrants. GDP accounted for by the private sector is 80%, 75% and 70% in Estonia, Lithuania and Latvia respectively, up from 40%, 35%, and 30% in 1993.
3. Development of Private Equity in CE

The framework we will use for analysing key elements influencing the scope for development of private equity in CE is:

- Supply of Deal Opportunities
- Demand for Private Equity
- Infrastructure to Complete Deals
- Opportunities to Realise Gains

The status of these key elements is summarised in Figure 5 and analysed in detail in the following sections.

3.1 Supply of Deal Opportunities

As indicated above, the beginnings of the transition process in CE in the early 1990s was marked by the extensive systemic shift from public to privately owned firms, through both the privatisation of SOEs and the start-up of new ones, as evidenced in Poland (Figure 6). Depending on the country concerned, SOEs accounted for between 70% and 95% of GDP at the beginning of the 1990s.

**Fig. 5: Factors Affecting Future Private Equity Development in CE**

<table>
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<tr>
<th>Supply of Opportunities</th>
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<tbody>
<tr>
<td><strong>Buy and Build</strong></td>
<td>Significant scope for platform buy-outs to consolidate fragmented markets and create regional market leaders</td>
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<tr>
<td><strong>Divestments</strong></td>
<td>Active and significant scope for further sell-offs of non-core assets as foreign and CE owners rationalise holdings</td>
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<tr>
<td><strong>Growth and Expansion</strong></td>
<td>Establishment of strong base of owner managed businesses over past decade now looking to expand or exit; less attachment to ‘family business’ concept than in many countries of W. Europe</td>
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<tr>
<td><strong>Public to private transactions</strong></td>
<td>Becoming active with significant scope for deals involving companies with little free float and wanting to focus on restructuring or development of core activities</td>
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<td><strong>Privatisation of state-owned companies</strong></td>
<td>Mainly complete but some scope for divestment of non-core activities of State-owned firms</td>
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<tr>
<td><strong>Development stage of M&amp;A markets</strong></td>
<td>Activity becoming comparable to Western countries on a relative to GDP basis; potential for post-acquisition sell-offs</td>
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<tr>
<th>Demand for Private Equity</th>
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<tr>
<td><strong>Capital Scarcity</strong></td>
<td>Need for growth and development generates a demand for private equity following years of communist imposed capital scarcity.</td>
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<tr>
<td><strong>Entrepreneurial Climate</strong></td>
<td>Widespread experience in running privatised and new firms over the past decade; managers still building initial wealth need private equity funding; embracing market capitalism; ‘leap-frogging’ of attitudes of many managers in Western Europe</td>
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<tr>
<td><strong>Availability of Professional Managers</strong></td>
<td>Pool of talented expatriates, CE managers with international experience and track record; widespread exposure to Western and International expertise from substantial FDI</td>
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Fig. 5 (cont.): Factors Affecting Future Private Equity Development in CE

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<th>Infrastructure to Complete Deals</th>
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<tr>
<td>• Private Equity &amp; Venture Capital market</td>
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<td>• Favourability of legal framework</td>
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<td>• Favourability of accounting reporting regime</td>
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<tr>
<td>• Supply of mezzanine and senior debt</td>
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<td>• Intermediaries network</td>
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Realisation of Gains

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<tr>
<th>Stock markets: IPOs</th>
<th>Number of notable exits by this route; Market dynamics suggest appetite for smaller market capitalisations than in Western Europe; Growth of domestic pension funds likely to lead to increased market liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic sales</td>
<td>Number of notable exits by this route. Development of active M&amp;A market providing strong scope for further growth; partial sales to strategic buyers also taking place; local strategics providing new momentum to this route</td>
</tr>
<tr>
<td>Secondary Buy-outs and Recapitalisations</td>
<td>Future prospects positive as number of deals are underway</td>
</tr>
</tbody>
</table>

Source: CMBOR

Fig. 6: Migration of Polish Companies into Private Ownership, 1990-1999

By the end of the decade, the vast majority of privatisations had been completed and private sector share of GDP had reached some 65% to 80% in the major CE economies (Figure 7).
This move from a state to a private economy, while different in degree, has many similarities to the catalytic effects of privatisations on private equity in the UK.

**Fig. 7: Private Sector Share of GDP (%) in Major CE Economies**

![Private Sector Share of GDP (%) in Major CE Economies](image)

*Source: CMBOR, Various*

Over the same period, there was a massive increase in the number of new businesses established, driven both by local start-ups and by foreign direct investment. Building on the programmes of “Goulash Communism” in place at the end of the 1980s in Hungary and other markets, which had permitted small scale private enterprise, entrepreneurs took advantage of liberalisation to pursue new opportunities while many world scale companies established greenfield operations to benefit from the significantly lower costs and tax breaks. The winners from this early competition grew increasingly large, both consolidating and diversifying their businesses. Although many of the entrepreneurs failed, the experience has strengthened the overall management pool in the Region.

One example of an early winner was Fotex, now a major Budapest listed Hungarian retail company with a current market capitalisation of some $40 million (down substantially from its late 1990s peak) but which started life as a one hour photo development kiosk, providing a service that previously involved a long wait.

These developments have created an extensive pool of commercially oriented enterprises that forms the basis for the supply of private equity opportunities. We examine the supply of these opportunities in terms of:

- M&A and Deal Opportunities
Private Equity Development in CE

- Completed Deals and Deal Potential
- Deal Sources

M&A and Deal Opportunities

As much of private equity in both WE and CE is M&A driven, it is important to look at the level of this activity as a benchmark for market potential. Historically, about 60% of M&A deals in CE have occurred within national borders, and only 30% from outside the Region. This left on average a tenth of deals either originating within the CE and targeting non-CE firms or originating within the CE and targeting a fellow CE firm in another country.

M&A activity in CE has shown stronger resilience in the last two years than in many other Western markets. Although deal numbers and the overall value of the market in CE were flat, this was a favourable trend compared with the steep falls of approximately 30% worldwide and 40% in the US. In the three leading CE markets M&A activity in 2002 was equivalent to $US 3.1 billion or 1.6% of 2002 GDP in Poland, $2.3 billion or 3.3% for the Czech Republic, and $1.9 billion or 3.0% for Hungary. These levels are not far below that of the US in 2002 of 4.4% of GDP and indicate the presence of significant M&A activity already.

Fig. 8: Potential Scope for M&A Activity in Major CE Economies
(Based on US M&A Share of GDP)

The prospects are however for significant further M&A activity growth in CE. Inward M&A is likely to increase as CE Accession countries are recognised as presenting opportunities for growth in customers (because of higher expected GDP growth) and an alternative source of cost-effective supplies and manufacturing (because of lower-cost labour and excess capacity). Additionally,
intra-CE M&A may also increase as the restructuring of markets following EU membership presents opportunities to consolidate currently fragmented sectors.

Continuation of these developments may lead CE countries to achieve comparable metrics to the recent peak in the US when M&A exceeded 7% of GDP. At this level, or even if growth is restricted to the 2002 US level of 4.4%, annual M&A activity might reach $8.3-13.2 billion, $3.0-4.9 billion, and $2.8-4.4 billion for the three leading CE countries, respectively. This would represent a tripling of the value of M&A activity, as shown in Figure 8. Both the current level of M&A activity and the scope for future development provides opportunities for private equity firms to identify both new deals resulting from the disposal of unwanted parts of acquisitions as well as exit mechanisms from existing deals.

**Completed Deals and Deal Potential**

Total venture capital and private equity activity in the principal countries of CE as recorded by the European Venture Capital Association (EVCA) is shown in Figure 9 in respect of the number of investments and in Figure 10 in terms of their value.

**Fig. 9: Number of Private Equity Investments in CE, 1998-2002**

These figures include both initial and follow-on investments and cover the range of investment stages from start-ups through expansion capital to management buy-outs. The data show that Poland is the largest individual market during the period 1998-2002 both with respect to numbers and values. Close to one thousand investments were completed over the five year period 1998-2002. The annual total number of private equity investments almost doubled from 120 in 1998 to more than 200 in each of 2000, 2001
and 2002. The value of venture capital and private equity investment during the period amounted to €1.3 billion and annual amounts invested more than doubled, from €166 million to €396 million per year.

**Fig. 10: Value of Private Equity Investments in CE, 1998-2002 (€m)**

Source: EVCA

*Poland, Hungary and Czech generate the bulk of buy-out opportunities.*

The majority of buy-out stage deals continue to originate from three leading CE countries - Poland, Czech Republic, and Hungary- with their proportion of deals increasing from about half in 2000 to about two-thirds in 2002 and the first half of 2003 (See Figure 11). Romania, because of its size has also seen a significant level of activity with some 58 deals reported during 2000-2002 by EVCA.

**Fig. 11: Development of Buy-out Deals in CE Countries, 2000-2003**

Source: CMBOR
Because of the lack of consistent information, it is difficult to assess the total value of transactions for the Region and each country. According to our calculations based on publicly available data, Hungary and Poland appear to be the leaders with over $630 million and $440 million, respectively, of deals completed since 2000.

Based on additional information from interviews with local players, our estimates indicate that the Polish private equity market alone represented $140m in 2001, $120m in 2002, and will be about $360m in 2003. This is approximately $160 million more than publicly available deal information would suggest. Difficult macro-economic conditions contributed to a fall in private equity investment in most of CE in 2002 after a period of marked growth. This pattern was also evident in several countries of WE, notably Germany and Spain.

Countries like Poland and the Czech Republic are poised to enjoy further significant increases in private equity investment as they catch up with WE. For example, if Poland were to see private equity investment at levels comparable with Spain or Italy, then the value of activity would double from recent levels. If Poland were to achieve private equity investment matching the EU average, it would perhaps triple. Under the most optimistic conditions, Poland would match private equity market leaders like the UK and could see an improvement in deal value of more than 8x. On a similar basis, the Czech Republic and Slovakia would enjoy nearly twice as much growth as Poland. Hungary, on the other hand is already far advanced by this metric (See Figure 12).

**Fig. 12: Potential for PE Investment Growth**
**Based on Current PE to GDP Levels in W. Europe**

![Comparison to private equity investment levels in WE shows the substantial growth potential for deals in CE.](Image)

Statistical inaccuracies may mean that the actual deal market is much larger than published.

Comparison to private equity investment levels in WE shows the substantial growth potential for deals in CE.
Private equity transactions represent from 2% to over 40% of the value of M&A transactions in advanced Western markets, depending on the economic cycle and stability. In 2002 a combined total of over $7 billion in M&A were completed in Poland, Hungary, and the Czech Republic. On the basis of experience in Western markets, this suggests that these three countries could eventually see up to $2.8 billion annually in private equity transactions. Thus, there is both a significant current level of private equity opportunities in the region and clear prospects for further growth.

**Deal Sources**

A decade ago, most CE private equity investments were privatisations of SOEs or the funding of start-ups. Both deal types carried the inherent increased risks of business transformation and venture investing. In the case of privatisations, investors needed to restructure firms to western commercial standards to be able to realise value through a listing or sale to a strategic buyer. Management transformation, cost reduction and product renewal, were key challenges. In newly launched initiatives, investors were often involved in transferring western technology, products or concepts to the CE. In seeking to realise strong organic growth in these economies, investors faced the challenges of finding the right management expertise and dealing with overall market volatility.

During the current, second phase of its development, private equity is seeing a significant expansion of deal sources. As transition has progressed, private equity deal sources have grown to include expansion capital opportunities, buy-outs, non-core business unit spin-offs, and consolidation plays. Key deal sources involve businesses that were privatised and have undergone thorough westernisation and restructuring, as well as businesses that have grown over the last decade from a start-up.

This diversification of deal sources matches the progress seen in many other European markets. For example, the early UK privatisations led to opportunities for spin-offs and buy-outs. Similarly, initiatives to encourage entrepreneurs have led to subsequent buy-out and growth capital opportunities.

In addition, similar to their WE counterparts, CE private equity firms can now base their decisions to invest in new deals on clear evidence that management have developed a successful track record. They can also now frequently invest after the first round investors’ exit and once the venture has established a market presence. The more stable and developed markets allow for investments on the basis of clear scope for diversification and development.
Currently, private equity firms may unlock untapped value in freeing a firm from its corporate ownership, changing or improving management, providing funding to capture new markets, or consolidate existing ones. Some deals also look to correct past mistakes: firms that were taken public too early and can be now taken private to enable management change or investment for example. Alternatively, a firm that was acquired as part of an earlier corporate acquisition or private equity deal but might be more valuable if all or part of it were sold to a more aggressive sector specialist private equity investor provides an opportunity to create value.

These broad investment opportunities give rise to the following main deal sources for private equity firms:

- Buy and Builds
- Divestment by CE Owned Groups
- Spin-offs by Western Corporates
- Growth and Expansion Capital
- Public to Privates

The scope for transactions from these sources is analysed below:

**Buy and Build**

Private equity firms in WE have been engaged in buy and build strategies to consolidate fragmented markets for over ten years now. Changing competitive pressures, that are likely to grow with Accession, introduce similar opportunities in CE to reconfigure fragmented industries through private equity led buy and build strategies that create national and eventually regional market leaders.

**Case Examples of Buy and Build**

- When Baring Private Equity Partners and EBRD invested in Boyar Estates in 1998, it was on the back of an integration strategy that saw the combination of a strong distribution presence in London, with backward integration into production through the acquisition of two wineries and building a Greenfield plant. In late 2000, the company merged with its largest domestic rival, Vinprom Rousse, which had also made winery acquisitions since its privatisation, to create the largest quality wine producer, commanding over 60% of Bulgaria’s quality wine exports to WE.

- Riverside came in as a private equity investor to combine Mifan of Poland with another portfolio company, to build up something that had not existed before in the Region – a regional leader in disposable medical/dental devices. The private equity firm saw a market opportunity and combined the two firms for their strengths.
• **Divestment by CE Owned Groups**

Buy-out opportunities are emerging from private CE owned groups as well. Much as in the west, listed CE corporations are under pressure to rationalise holdings built up during the initial transformation period and return cash to investors or re-invest in their core business. Similarly, as the first wave of entrepreneurs seek to realise the gains from their efforts, businesses are increasingly available to buy-out from their founders. Developments over the past decade mean that the next layer of capable management may well already be in place to take over from the founder. As examples, Exbud in Poland, the listed construction company, sought to return capital by selling to private equity investors a printing company in which it had invested in 1991, and a consortium of Polish banks and other shareholders recently disposed of their credit card processing joint venture.

**Case Examples of Divestments by CE Owned Groups**

- In 2000 Exbud, the listed Polish construction company, now part of Skanska, was under pressure from investors to return cash. It decided to unload Poligrafia, a successful but non-core heat set commercial printer to Baring Private Equity Partners in a classic buy-out. Interestingly, Poligrafia was itself listed and BPEP was able to acquire over 75% of the company’s shares through public offers on the Warsaw Stock Exchange. Under BPEP’s ownership the company increased sales by more than 2.5 times between 1999 and 2003 both organically and through acquisition.

- A consortium of previously state owned enterprises, including Pekao, Millenium, and Przemyslowo Handlowy PBK banks as well as Orbis, the state hotel operator, together recently sold stakes in Polcard to a strategic investor and Innova Capital. The sellers recognised their core businesses were not in credit and debit card processing, and that the company would flourish better under a different management team. Innova and Gtech, a leading western transaction processing company, purchased nearly all the company for almost $61 million.

- Advent International’s acquisition of Bolix, a Polish based global leader in exterior insulation and finish systems marked the hand-over of this entrepreneurial led company to western style management. Advent head-hunted leading executives and appointed the company’s first CFO as a key part of their programme to strengthen the leadership and development of the company.

**Spin-offs by Western Corporates**

As seen earlier, strategic divestments by both foreign and local corporations have become major sources of buy-outs in WE over the last two decades as pressures to restructure have grown. Western corporates selling their CE operations are now becoming the most noteworthy sources of private equity deals, particularly at the large end of the size scale. Although this is just beginning, we anticipate that divestments will provide major opportunities for buy-outs in CE, much as they have traditionally been an important source in the UK and the Netherlands and more recently in France. Going forward, corporations will face a need to restructure while...
the growing M&A activity is also likely to generate spin-offs of ill-fitting parts.

**Case Examples of Spin-offs by Western Corporates**

- Pernod Ricard of France, a spirits and wine company, had acquired a large Polish group with diverse drinks and trading activities in 2000. Along with it came a fruit juice business as a subsidiary. Pernod decided to focus on its core spirit business and sought to realise cash from its successful juice subsidiary. Enterprise Investors stepped in and bought the entire unit for $54 million in late 2002, making an add-on acquisition to an existing juice company in its portfolio. Pernod stands to make a significant return on its investment and partial sell-off, as it is estimated to have paid $69 million for the spirits business and the Agros subsidiary together. Agros is thus an example of private equity players benefiting from the rationalisation of larger groups and acting as local, strategic consolidators to source investments.

- When Vivendi of France found itself in financial trouble at home, it turned to its central European assets to raise significant cash. The divestment of its Hungarian fixed line telecoms company to CE private equity players AIG Emerging Europe Infrastructure Fund and European communication specialists GMT raised much needed cash with some reports citing a €160 million sale price. Similarly, Vivendi is reportedly seeking the sale of its stake in PTC, the Polish cellular operator, with a reported price tag above €650 million, although this transaction has yet to close.

- Another type of divestment deal that can involve either an operating company, a private equity investor, or both, is a “Westernisation and Cleanup” buy-out. Kabelovne of Czech Republic demonstrates some of the salient characteristics of this type of deal. Siemens had purchased Kabelovne during privatisation and made significant investments in this business, although later determined that it was outside Siemens’ core business. Bancroft Eastern Europe stepped in, cleaned up the group to stand on its own feet with not only Western compliant books and transparency, but US palatable versions as well.

Some Western corporations expanded perhaps too quickly into the Region without understanding it. Other large firms have benefited from their CE investments but need to address difficulties in their core-business that create pressure to divest these more distant activities. Finally, some corporations have earned good returns from being early buyers in the Region and are simply selling good businesses that are now outside their main focus. Noteworthy deals in these circumstances other than those profiled include:

- Kingfisher of the UK selling its Nomi chain of DIY retailers in Poland to Enterprise Investors, following Kingfisher’s merger with Castorama of France, which had a more developed rival chain already in Poland (IBO, 2003, $11 million);
- GWR Radio facing UK market pressures, exiting the Hungarian market with a sale to Advent International (IBO, 2003, $29m);
- KPN Qwest unloading both Czech Vision Networks Tsjechik Holding and Polish STK cable operations from its Vision division to consortiums of private equity investors (IBOs, 2002, $64m).

**Westerners’ disposals in CE often reflect need for cash at home or changes in their home business rather than issues with their CE business.**
• Growth and Expansion Capital

Market conditions are generating a supply of private sector companies seeking to take advantage of the Region’s growth opportunities. These deals may involve relatively new companies seeking capital to grow as well as established companies that see private equity firms as suppliers of growth capital that is otherwise scarce in the Region. Established companies are likely to have undergone initial post-privatisation restructuring and now need to move onto the next stage. Many new firms created at the beginning of the transition process are now at a point where they require further capital for expansion. Some fast growing companies are also providing significant opportunities for private equity firms to provide follow-on funding.

EVCA figures show that in 2002, 50% of the €118 million total private equity invested in Poland was expansion capital. The comparable shares in the smaller Czech and Hungarian markets were 81% and 48%, respectively.

Case Example of Expansion and Follow-on Investment

Euromedic International is the largest investor in the health-care area in Central and Eastern Europe. The company operates high quality medical centres mainly in the fields of Radiology and Dialysis. Euromedic International's activities started in 1991 by opening its first Medical Diagnostic Centre in Budapest. The company expanded throughout CE during the 1990s. In September 1999, GE Equity and Dresdner Kleinwort Benson invested $8 million in a capital increase to back the founders of the company Mr. Joseph Priel and Mr. Janos Meszaros. In December 2001, the Company had a second equity capital increase in which it raised an additional $8.4 million for expanding activities into other Central European countries. Global Environment Fund invested $7 million in this round. In December 2002, Dresdner Kleinwort Capital and GE Capital invested an additional $22.5 million to finance continued expansion. By 2003, the company employed close to 1,000 people and owned and operated 35 Diagnostic and Dialysis Centres.

• Public to Privates

The growth in public to private (PTP) deals seen in the UK, France and Germany is spilling over into CE. For many companies there are good strategic reasons to continue with a market listing, but for others in CE with little or no free float of shares this rationale is absent. This is particularly true in the Polish, Czech and Romanian markets where early mass privatisation strategies and easy market access resulted in a relatively large number of companies being listed.

In Romania, the RASDAQ has some 4,489 companies registered but most have little or no trading. The Warsaw Stock Exchange formally included 202 companies (excluding national investment
funds) at the end of 2002. Despite this large number, the top 20 stocks accounted for over 90% of the Warsaw exchange trading volume by value. The remaining 10% is accounted for by prime candidates for private equity investment and delisting.

**Opportunities for PTP set to increase.**

Historically, pure PTP transactions have been hampered by regulatory attitudes to delisting and the existence of various investment funds (National Investment Funds in particular in Poland) which often held stakes in these nominally quoted companies but were unwilling to delist the companies. With these funds coming to the end of their statutory life and the greater ability of a more mature private equity industry to tackle these transactions, PTP should become an increasingly important source of deals going forward.

Notable Public to Private deals to date in CE are:

- Cofinec in Hungary going from Public to Private to focus on its core business, with investments from Frantschach AG and Raiffeisen (MBO/IBO, 2000)
- KFM going Public to Private in Poland to focus on its core pressure-gauge business, with investment from Riverside CE (IBO, 2001)
- Terapia going Public to Private with investment from Advent International in Romania (IBO, 2003)

**Case Examples of Public to Privates**

- Terapia is Romania’s third largest pharmaceuticals business. The firm was listed on the Bucharest Stock Exchange in 1997 after being privatised in 1996 and receiving a private equity investment in 2000 from a number of Romania focused funds. This profitable branded generics manufacturer had sales in 2002 of $32 million. The young, dynamic team of managers had recently completed a major restructuring which resulted in the development of a strong marketing function, new products for both domestic and export markets and modernised manufacturing facilities. The firm was taken private in August 2003 with backing from Advent International, which acquired 91% of the shares, the EBRD and FMO the Dutch Development bank. The buy-out was undertaken to implement growth plans: become the dominant local manufacturer, further strengthen the management team, develop further the finance function and bring in independent directors with extensive pharmaceuticals experience in CE.

- In February 2000 Raiffeisen CE Private Equity Fund together with Frantschach, a major European packaging group, acquired Cofinec, a leading producer of high quality printed packaging. The company, which was listed on the Budapest and Luxembourg Stock Exchanges in 1996 by its then private equity owners, is dominant in its core markets in Hungary, with market shares as high as 85%. The company is a major supplier to many of the blue chip multinationals in the Region and is in a sector that has been one of the fastest moving in CE due to the convergence of consumption behaviour and marketing techniques with the EU. Following the buy-out, the focus has been on developing core businesses and divesting other businesses.

**PIPEs also represent an active deal source.**

A variant of the PTP is the private investment in public equity (PIPE). Where the delisting cannot be easily accomplished or the
private equity manager wishes to retain a listing to raise capital in the future, this form of investment can be attractive. Given the large number of nominal or quasi listings in the Region, PIPE opportunities are substantial. Examples of these types of deals are Poligrafia and Polfa Kutno of Poland profiled elsewhere, and a number of Romanian transactions where a small public tail remains following investment by private equity. The increasingly active public markets in the region are now providing ready made exit opportunities for private equity investors from these investments, including exits from Polfa Kutno, Grupa Kety and others.

3.2 Demand for Private Equity

The demand for private equity is driven by:

- Capital Scarcity
- Entrepreneurial Climate
- Professional Management Expertise

**Capital Scarcity**

CE remains a region of fast growth and development, with most observers forecasting the region to outperform the rest of Europe. However, with this growth and its communist heritage, it is also a region lacking in equity capital, generating a demand for private as well as public capital. By most measures, Stock Market Capitalisation to GDP, Institutional Funds/GDP etc., the region remains under-served compared to other markets. As growing and restructuring firms with high demands for investment are unlikely to have the cash flow characteristics to support significant amounts of borrowing, they are prime candidates for private equity investment.

**Entrepreneurial Climate**

Key to the development of private equity in France and Germany was the steady improvement in the entrepreneurial climate, providing a willing and able base of management talent to work with private equity investors. The entrepreneurial climate in CE has also developed significantly, increasing the demand for private equity finance throughout the region.

Constrained by decades of communism, the fall of the Wall unleashed a boom of new company formation and entrepreneurial development that sought to capture the opportunities to satisfy pent up demand for long missing products and services. During the 1990s, entrepreneurs in the Region developed their expertise in the
turbulent conditions of the first decade of capitalism, gaining valuable experience in management of both growth and contraction.

Transition to the market economy over the past decade has been driven by an approach that is closer to the Anglo-American perspective than the traditional Continental European one. Extensive privatisation activity, active foreign direct investment, the presence of Western advisors with M&A backgrounds and the lack of long histories of family ownership have enhanced the acceptance of the transfer of asset ownership, in contrast to parts of WE, such as Germany, Spain and Italy, where considerable resistance to the sale of private businesses remains. In addition, in contrast to WE, entrepreneurs and managers in CE are still building their initial wealth, making it more likely that they will need to resort to outside financing to grow. These features suggest that the younger generation of managers in particular have ‘leap-frogged’ the attitudes of many of their counterparts in WE towards entrepreneurship and acquiring businesses with private equity financing.

Importantly, role models are now emerging of managers who have successfully grown and developed their businesses alongside private equity players. These include Akos Erdos of Lang Holdings in Hungary and Mariusz Lukasiewicz, founder of Lukas Bank in Poland. These examples have an important demonstration effect to other managers of what can be done.

*Case Examples of Entrepreneurs*

- **Akos Erdos**, a journalist turned entrepreneur, privatised his first company in 1991 buying Allami Nyomda, a specialised security printer from the state. When Szikra Nyomda, the largest newspaper printing plant in Hungary came to be sold in 1996, he turned to EBRD for debt and equity financing to complete the deal, in a private equity style transaction. Needing funds for the expansion of Allami into plastic card printing in 1998, he turned to Baring Private Equity Partners’ Central European Fund. Later, when opportunities to develop a media focus emerged, he sought out the assistance of European Development Capital Management, a fund with a particular interest in this area.

- **Three entrepreneurs** started Lukas as a small network of video and stereo stores. When they introduced instalment purchase plans to drive sales, their transformation into a consumer finance company with a nationwide network of branches began. Enterprise Investors put in about $15 million in 1997 and set out to expand the branch network and loan book. In 2001 the business was sold to Credit Agricole in a hotly contested auction that resulted in an estimated return for EI of some 5.6x money and made Mariusz Lukasiewicz a wealthy man. The Polish press now follows the new investment ideas of Mr. Lukasiewicz, setting a strong example for others of the money to be made with private equity.

Another positive development for private equity investment is the growing number of potential MBI candidates in CE countries. Entrepreneurial managers working for Western companies frequently find promotion difficult beyond a certain level and many are actively seeking local MBI opportunities.
Professional Management Expertise

Alongside entrepreneurial attitudes, greater commercial management expertise is developing as well as an increasing pool of experienced middle management. This provides a broader pool from which private equity can draw talent generally for their portfolio companies or identify teams willing and capable of leading MBOs. The need to back a single stellar leader, as was often the case in early investments, has given way to the opportunities to back teams, with management depth that helps reduce keyman risks.

According to local CE private equity investors, the talent available within CE is increasing steadily. The combination of western-trained management who are returning to their homelands and new CE management who have worked in western firms is generating a talent pool that is increasingly able to apply western practices to CE companies. During our research, investors in Poland were the most optimistic about this trend, as well as about local entrepreneurial talent.

With over a decade of Western investment by Global 2000 companies, numerous mid-level managers learnt on-the-job how to manage according to commercial principles, putting them in a strong position to run stand-alone businesses with private equity investment as the management buy-in market grows. Looking at Poland as an example, over $65 billion of FDI was made between 1990 and 2002. Top investments by country of origin came from Germany, France, UK, US, Italy and Netherlands, with recent leading investors including GE, Glaxo, Delphi, Volkswagen, GATX, Tesco, Credit Agricole, France Telecom, Deutsche Bank, Citibank, and Rodamco.

Case Examples of Developing Western Management Practices

- George Soros' CEU Graduate School of Business in Budapest has produced approximately 1,000 western-style MBA alumni since its founding in 1988. An even more widely influential example is the British Government’s Know-How Fund, which worked in conjunction with UK and CE educational institutions to fund curricula and training for over 30,000 managers, in conjunction with the Lublin Business School in Poland and other CE institutions.

- The growth of the British Chamber of Commerce, which is not limited to UK membership, provides another measure of the development of business communities. The number of companies that belong to the branches in Poland, the Czech Republic, and Hungary have each grown markedly from a few dozen in the 1990s to 327, 300, and 206 members respectively in 2003. Members include firms such as Citibank, American Express, and GM from the US, and Unilever, Tesco, Vodafone, ING, BT, BP, and Shell from Europe. In the case of the Czech branch, its mission specifically includes working with businesses and government bodies to prepare for EU Accession and promote a positive business environment.
According to the Polish Ministry of Economy, in 2000 there were approximately one million Polish employees who worked in one of the 44,000 companies that received foreign direct investment. Other studies suggest that there are at least 1 to 2 million CE employees who work for foreign-owned companies and thus should have everyday exposure to western practices. With additional FDI over the last few years and the continual turnover of employees moving to better positions, often with domestic companies, the number may be even higher. Many more employees are likely to work for companies that supply western firms, and thus have some practical exposure to western procurement and purchasing principles. As EU membership for CE countries breaks down borders for capital and labour, more cross-border sourcing will make western business practices widespread.

In addition to direct experience, there is also a marked growth in professional management education and the development of professional business communities. Early education efforts to develop professional management included George Soros’ CEU Graduate School of Business and the British Government’s Know-How Fund, described in the case example above. A growing number of executives in CE are completing MBA and Executive Development programs in major business schools in the US and WE and bringing their lessons back to their home markets.

The development of both entrepreneurial attitudes and professional management expertise can only help foster a more developed market for buy-outs, as management focuses on generating value from corporate assets. These practices help ensure that businesses end up in the hands of those teams who are best able to generate value.

### 3.3 Infrastructure to Complete Deals

Perhaps the greatest improvements taking place to facilitate private equity investment in CE involve improved deal infrastructure. Deal infrastructure is considered in terms of:

- Private Equity and VC Market
- Legal Infrastructure and Enforcement
- Senior and Mezzanine Debt
- Tax Stimulus
- Development of Professional Services

**Private Equity and Venture Capital Market**

Since its early beginnings at the start of the 1990’s the industry and professional expertise in the industry has increased dramatically.
Initially, funds were raised with government support, particularly the US sponsored “Enterprise Funds” in Poland, Hungary, Czech and Slovak Republics, Romania and Bulgaria. Management teams were a combination of local and expatriate professionals. EBRD was also active, providing seed commitments for a number of country and regional funds.

Managers with previous experience or affiliated with international private equity houses also helped a rapid technology transfer to the region, which aided the ability of the industry to quickly come up the curve in terms of deal capabilities. With the early funds and EBRD providing a training ground for many of the partners still managing funds today, some individual and team track records are now exceeding 10 years.

Today, private equity associations in Poland, Hungary and the Czech Republic boast a total of about 43 management companies as members, eliminating duplications as regional funds are members of multiple associations. These associations are increasingly playing a development role providing a forum for practitioners, advisers and even some recipients of private equity to work together. With active participation in EVCA and support from that organisation, the industry is increasingly maturing along with the countries it serves and following very much the footsteps of WE fund managers.

**Legal Infrastructure and Enforcement**

In many CE countries in 1990, the first legal actions were to re-implement the commercial codes that existed in the early 1930s before the communist period. These very early steps were quickly improved upon and over the last decade substantial revisions and improvements have been implemented to facilitate commerce and private equity in the process. Underlying these changes has been the requirement to conform to European Union norms. The Acquis Communautaire (the full body of EU legislation and case law) has provided a ready drafted and acceptable basis for reform.

In addition to implementing the laws, the EU Accession states are focused on improving their bureaucratic and judicial infrastructure. Entry to the EU also hinges upon achieving stable institutions guaranteeing the rule of law as well as functioning market economies. EU Accession states must ensure implementation to the same standard as elsewhere within the EU. Specific admission criteria require simplification of legal and administrative procedures, reform of public administration and the civil service, computerisation of land registries, improvement of the judicial system, including capacity, training, and dispute resolution.
Some countries, like Slovenia have been widely recognised as even being ahead of Germany, France, Portugal and Italy on some dimensions of readiness. Others, like the Czech Republic, Hungary, Estonia and Poland lead the EU Accession candidate list, but may require progress in particular areas. In all cases, however, the required progress is being made.

A key issue concerns contract enforcement, which may impact the operations of portfolio companies and can be important in connection with shareholders and other typical private equity deal agreements. The enforcement of contracts can take longer than in a WE context but major strides have been made over the last decade and improvements continue. The ability to govern and enforce contracts offshore, for example under English law, is frequently used in private equity to increase certainty. With European Union integration and the development in recent years of local expertise by intermediaries and the courts themselves, established private equity providers can increasingly deal with potential problems should the need for enforcement arise.

**Senior and Mezzanine Debt**

The transfer of the banking sector from state to private hands has resulted in a marked increase in banks’ willingness to provide senior debt to corporations and, increasingly, debt for private equity transactions. The early history of CE was characterised by a lack of long term debt and only limited and very expensive, short term financing. Security packages and other structures also proved inflexible and often ill-suited to growing businesses. In this context, private equity players had to drive returns often without using financial leverage, an important source of returns in western private equity transactions.

Privatisation and restructuring of banks has progressed apace in CE. Since the mid-1990s foreign strategic investors have become major owners of key local banks. In Hungary, foreign investors now own over three fifths of local banks, with even greater shares in the Czech Republic and Poland. Figure 13 illustrates the increasing dominance of foreign and private sector institutions in the financial sector.
Today, local (foreign owned) banks are beginning to offer specialist leveraged finance capabilities for mid-market deals. Teams focused on opportunities for providing mezzanine debt are active with London based Mezzanine Management recently raising Accession Mezzanine Capital, a €115 million fund dedicated to CE. Erste Bank Acquisition Finance based in Prague also provides mezzanine debt. One of the first larger deals making extensive use of mezzanine finance was Mezzanine Management and Advent International’s acquisition of Danubius Radio from the British GWR Group for €30 million.

We believe that the development of a larger debt market will spur CE buy-out activity, much as the availability of debt - mezzanine and junk bonds - was instrumental to the growth of the WE private equity industry and in particular the buy-out market. CE private equity firms are now increasingly able to leverage their returns, increase deal size and access one of the key drivers of value creation in western private equity.

**Tax Stimulus**

One of the important drivers of the development of private equity in WE has been favourable changes in the tax regime. In CE, the continual harmonisation with EU rules is creating an increasingly positive environment for investment and private equity. The lowering in most countries of personal and corporate tax rates will encourage owners to realise their existing wealth as well as re-invest to create new wealth. The decrease in tax rates in Poland from 27% in 2003 to an anticipated 19% in 2004 for corporates is
indicative of the positive trend. Corporate rates of 28%, 16% and 19% are expected in 2004 in Czech Republic, Hungary, and Slovakia, respectively.

**Development of Professional Services**

In the 1990s, the arrival of western companies was accompanied by the entry of international professional service firms. With the expansion of western business principles and practices, and the evolution of more complex deals, the supporting professional infrastructure has risen in capability as well. These firms emphasised the importance of western business principles as they advise both the subsidiaries of western companies as well as leading domestic businesses. Firms like Baker & McKenzie, The Boston Consulting Group; Deloitte; PriceWaterhouseCoopers; McKinsey; and Weil Gotshal and Manges have opened offices in multiple cities within CE (Figure 14). These firms acted as hands-on educators of local staff and clients.

**Fig. 14: Presence of Major International Professional Services Firms**

<table>
<thead>
<tr>
<th>Firm</th>
<th>CE City</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Warsaw</td>
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<tr>
<td>Deloitte</td>
<td>●</td>
</tr>
<tr>
<td>Ernst &amp; Young</td>
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<td>KPMG</td>
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<td>PwC</td>
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<tr>
<td>McKinsey</td>
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<td>BCG</td>
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<tr>
<td>Egon Zehnder</td>
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<tr>
<td>Korn Ferry</td>
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<tr>
<td>Baker McKenzie</td>
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<tr>
<td>Clifford Chance</td>
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<tr>
<td>Dewey Ballantine</td>
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<tr>
<td>Linklaters</td>
<td>●</td>
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<tr>
<td>Weil Gotshal</td>
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</tr>
</tbody>
</table>

Source: CMBOR

With consultancies, accounting firms, and lawyers coming from the US, UK and other EU members, local business practices have made a transition towards western norms. The critical issue is not so much that firms’ accounts already adhere to strict IAS or US GAAP, but rather that there is a consistent, well-applied set of accounting principles to work from to fairly represent the financial state of the business. If an accurate set of books exists, reputable professional service firms can readily repackage them into an appropriate format more reflective of western practice. Now, in
2003, many differences in business reporting and perceived transparency may not be as problematic as many outsiders initially considered.

From the private equity management perspective, the increasingly well-established industry in CE has generated a pool of experienced private equity managers and provided a training ground for future investors. Legislation has been passed or is in the process of being enacted to facilitate the creation of limited partnerships and similar structures in several countries, which should lead to the strengthening of a domestic industry, focused perhaps on smaller deal sizes than the more internationally oriented groups of today. For example, the development of the industry has been aided in Hungary by the 1998 Law on Venture Capital, which provides private equity firms with certain tax exemptions.

### 3.4 Opportunities to Realise Gains

With the bulk of private equity funds by value having been raised since 1995, it is still relatively early days in the development of a private equity exit record in CE, but realisations of investments are building. As with new investment activity, Poland has seen the greatest extent of realisations in terms of both numbers and initial costs of investment. According to EVCA (Figures 15 and 16), a total of 591 exits were identified in CE during the 1998-2002 period (although this figure was distorted by the 192 exits in Romania in 2001). The total initial portfolio value of these exits was €608 million of which 60% was accounted for by Polish exits.

![Fig. 15: Number of Divestments in CE, 1998-2002](image)

Source: EVCA
Trade sales remain the main exit route.

EVCA data indicate the dominance of trade sales as the main exit route in the Region, with almost a third of private equity realisations via this route. Data available for the period 2001 to 2002 show that IPOs in CE also accounted for a greater percentage of realisations than was the case in WE (Figure 17). Similarly, albeit to a lesser extent, greater shares of exits in CE were accounted for by secondary sales to other private equity firms. A slightly smaller proportion of exits in CE than in WE were through write-offs or other means (notably repayments of preference shares and loans).

Fig. 16: Value of Divestments in CE, 1998-2002 (€m)

![Graph showing value of divestments in CE, 1998-2002 (€m)](image)

Source: EVCA

Fig. 17: Share of Venture Capital and Private Equity Realisations in Western Europe and Major CE Economies 2001-2002 (%)

![Graph showing share of venture capital and private equity realisations in Western Europe and Major CE Economies 2001-2002 (%)](image)

Source: EVCA
Exit options in CE are analysed in terms of:

- Sale to Strategic Buyers
- IPOs and Private Placements
- Developing Market Sophistication through Secondary Sales

**Sale to Strategic Buyers**

An active market has developed for both full and partial realisations through this route. As is the case throughout WE, to date the majority of realisations of private equity backed investments in CE have been through sales to strategic investors. EVCA figures for 2001 and 2002 show that a third of realisations of companies were through this route.

The rapidly growing M&A market in CE seen earlier provides evidence of the continuing importance and practicality of this exit route in future. The combination of growing markets, continued opportunities for consolidation and a dramatically lowered political risk premia post Accession mean that additional western strategic investors who might have been waiting on the sidelines for Accession will now be prepared to invest in CE.

**Case Examples of Exits to Strategic Buyers**

- In 2003, Riverside sold Spofa Dental of the Czech Republic, a manufacturer of dental materials, to the American Sybron Dental Specialities. Riverside had owned Spofa Dental since 1998 and the sale price was reported to be at a valuation of six times EBITDA.

- In Romania, Baring Private Equity Partners exited part of its 1999 investment in Topway Industries with a sale to Orkla Foods in mid-2002. This deal highlights the trend of smaller strategies looking for market positioning in CE. Topway’s leading position in margarine and condiments in the Romanian food market proved attractive to Norwegian Orkla, which had a growing presence in central Europe. Although smaller than Unilever, Nestlé and other leading multinationals, Orkla saw the opportunity to acquire an attractive market position in a market with continued growth prospects and gain an important foothold against its arch competitors.

- In August 2000 Advent International and Jupiter Asset Management, as original investors in Brewery Holdings, sold their stakes to BBAG, the market leader in Austria and number two in Romania. Brewery Holdings had been created by the two private equity firms in 1997. Starting with one brewery and a 4 per cent market share, the company had grown organically and through acquisition to become the Romanian national market leader with three breweries and a 19 per cent share. The growth of the company initially involved upgrading production assets to enhance product quality followed by the creation of a nationwide distribution system and the building of brand awareness. The two private equity firms had provided several rounds of finance, with Oresa also providing an injection of $2.6 million one year after the initial investors, and played a leading role in identifying and negotiating acquisitions, guiding the restructuring of the group and recruiting management.

- United Bulgarian Bank was formed in 1992 by the consolidation of a number of regional banks. Privatised to a group of financial investors in 1997, the bank was sold to National Bank of Greece in 2000. The AIG New Europe Fund had acquired a stake in the bank in 1998 from an exiting financial investor. Within 18 months, they were able to exit, realising a reported 4x their investment. Earlier investors earned even higher multiples. UBB is now the second largest Bulgarian bank.
Conversations with professionals active in the Region confirm the increasing willingness of strategic buyers to look at CE opportunities, despite the depressed conditions in the more developed markets. The approach of EU Accession has hastened the realisation that CE has decreasing logistical, regulatory, and administrative hurdles to completing deals, and importantly, operating the businesses after the acquisition. As legal harmonisation makes the ground rules familiar to most businesses active in Europe, EU buyers have greater comfort and familiarity with the legal implications of owning CE businesses and the related tax, employment and registration requirements, thereby lowering the risk premium and intangible costs of owning a business in the region.

The growing pool of capital as well as the emergence of local (and sometime regional) consolidators means that portfolio companies can be increasingly marketed domestically to domestic players in addition to international strategic buyers. The 2002 sale by DBG and Bank of America of Hungariocamion to a local trucking company is a prime example of this trend. The active role of MOL, the Hungarian oil company as a regional consolidator with investments in Slovakia and Croatia is also an important example.

**Case Examples of Exits to Local Strategic Buyers**

- In November 2003 Baring Private Equity Partners disposed a second portion of its Topway investment with the sale of its interest in the holding company of Ultx, one of Romania’s largest oil-seed crushing facilities with a sales turnover of €40 million, to Mr. Vasile Nitescu, chairman of Romilexim, one of the country’s largest companies. This sale illustrates the growing availability of domestic buyers with the expertise and resources to acquire businesses from private equity portfolios.

**Russians are re-emerging as important buyers of CE assets.**

The trading ties and understanding between CE and Russia developed during the communist period also mean an established understanding of each others’ markets and in many cases past personal business relationships. With substantial wealth and ambition, Russian buyers are increasingly becoming acquirers of CE assets, as they are in the west. Boyar Estates’, a Baring Private Equity Partners investment, disposal of its Rousse Winery asset to a Russian buyer is an example of this trend.

**IPOs and Private Placements**

Stock markets in the Region are developing and have been receptive to IPOs. The Warsaw Stock Exchange has a track record of meaningful recent IPOs. European Venture Capital Association data for 2001 and 2002 covering all venture and private equity investments show that 15 per cent of exits in CE (specifically...
Czech Republic, Hungary, Poland and Slovakia) were through a market listing (Figure 17).

Despite the generally difficult exit environment across Europe in 2002, EVCA figures show that the number of companies across all stages of venture and private equity backed investments divested through public offering rose in both Poland (from 5 to 8) and Hungary (from zero to 2). In Poland, public offerings accounted for 32 per cent of the value of all venture and private equity backed investment realisations in 2002 as against 7 per cent the previous year.

Case Examples of IPOs & Private Placements

- Eldorado is one of the largest food distributors in Poland. Having acquired a 44% stake in 1999, Enterprise Investors successfully listed the company on the Warsaw Stock Exchange in 2002, disposing part of its stake. Subsequent share sales in 2003 gave the fund a full exit and a reported 3x return on investment.

- The Polish manufacturer of rubber components used by European car makers, Stomil Sanok, became the first management buy-out on the Warsaw Stock Exchange in late 2003. Enterprise Investors had invested in the company in the early 1990s and over the ensuing decade worked with management to restructure the company and implement a €50 million investment programme. The company was floated in 1997 raising additional capital. In 2003, Enterprise agreed with management a series of share buy-backs and institutional placements, which left management in control of the business. Enterprise Investors received proceeds totalling $60 million, which represented a 6.8x return on its initial investment.

Indications are that stock markets in major CE countries may begin to move towards the levels of liquidity seen in other more developed markets. There are at least two major trends anticipated to accelerate the market’s development post-Accession.

Polish, Czech and Hungarian pension funds currently are building on the sidelines. Since their creation in the late 1990s, they have steadily been accumulating assets and now have meaningful (in a CE context) amounts under management. While these assets have to date largely been focused on government bond and debt instruments, the decline in interest rates, liberalisation of the asset allocation rules as well an increase in the pool of potentially interesting companies is expected to increasingly draw pension funds and other institutional investors to the listed equity markets, thereby strengthening the IPO market. As many of these funds, even after EU Accession, will continue to face restrictions on investment abroad, the combination of asset growth and increased appetite for equity risk to boost returns will provide an underlying level of demand for domestic equities. CE will thus have its own captive audience of domestic buyers for public equity issues from private equity sponsored companies.

It is also interesting that the liberalisation of pension fund investment options and the adoption of EU standard investment...
Domestic capital is ready to invest in private equity funds. Structures will facilitate the movement of domestic institutional investors into private equity. Much as the increased willingness of western institutional investors to increase allocations to private equity fuelled the WE industry’s growth, the CE institutions are now preparing to do likewise, to the benefit of the overall private equity market.

Developing Market Sophistication through Secondary Sales

Our conversations with bankers and fund professionals indicate that the market is beginning to see the emergence of secondary institutional investor buy-outs as a means for partial or complete exit.

Case Examples of Secondary Sales

- At the end of 2002, Erste Bank Acquisition Finance led the leveraged recapitalisation and secondary buy-out of GZ Digital Media in the Czech Republic. The company had low leverage and strong cash flow. The deal allowed Winslow Partners, who invested in GZ in 1997, to obtain a partial exit while at the same time leveraging up their potential returns from a future sale. Alongside the extra leverage provided by Erste Bank, management increased their investment and a number of other investors obtained equity stakes.

- In 2003, Enterprise Investors sold its stake in Polfa Kutno of Poland to a group of institutional investors. Although listed on the Warsaw Stock Exchange, 69% of the company’s shares were held by Enterprise Investors. The company had been extensively restructured since Enterprise Investors first invested in it in 1995. Restructuring included the sale of various activities to strategic buyers and the development of management structures and systems. At the time of the exit, Polfa Kutno had become Poland’s second largest independent pharmaceutical company. The sale price presented a 5.4 multiple on Enterprise Investors’ investment.

Secondary sales and leveraged recapitalisations are expanding. Investors wanting to close out funds are becoming motivated to exit from early CE investments as the early funds near the end of life. Secondary sales accompanied by a leveraged recapitalisation can enable private equity players to obtain a partial exit on their investment. This option may be especially attractive in deals that have deleveraged and which have strong cash flow but where a sale to a strategic buyer is not currently available. Releveraging can provide a tax-efficient structure enhancing the potential for significant future returns. These conditions are similar to those in WE, which has a much more developed secondary market. In fact, by some measures, the majority of UK private equity exits last year were secondary sales to subsequent private equity investors.

European Venture Capital Association data show occasional secondary deals in Hungary and Poland. Our research indicates that about a half-dozen further secondary deals were under active consideration in CE. Were this technique to develop, all private equity investors would gain increased exit potential, earlier exit opportunities to improve IRRs, and an additional deal source.
A potential new source of secondary exits will arrive with EU Accession in May 2004, as any non-CE fund having the EU as its investment region would now potentially have a mandate to pursue opportunities within CE as well. This could generate increased opportunities for partial sell downs as EU private equity funds co-invest retrospectively in CE.
4. Conclusion

This report analysed the prospects for private equity investment in CE. The Region represents a unique and new opportunity for investors. Our analysis shows encouraging developments in terms of the supply of and demand for private equity opportunities, the infrastructure to complete deals, and the scope for the realisation of investments. The status of the key factors influencing the development of a private equity market in CE has been summarised earlier in Figure 4.

Combined with existing professional services support and the true blossoming of western-style capitalism, diversified deal sources and improved management practices, CE private equity investors should find an enhanced environment for investment and returns. The optimism that substantial investment opportunities are now available is reflected in the latest Deloitte Central Europe Private Equity Confidence Survey published in November 2003, where 74% of private equity firms reported that they expected market activity to increase over the following six months.

Comparison of the current prospects for private equity in CE with the position in WE is shown in Figure 1 and reveals encouraging similarities. There are numerous positive similarities when comparing the current state of CE development with WE today or with WE in the 1980s, when private equity blossomed:

- The expected strong growth in GDP, especially compared to the rest of Europe, provides fundamental support for the deal environment, generating ample opportunities.
- Pressures and opportunities for corporate restructuring are similar to the current situation in WE.
- The M&A market across CE is rapidly closing the gap in terms of the current WE position.
- The entrepreneurial culture among the younger generation managers and the willingness to trade assets is already in advance of many WE markets today.
- The infrastructure of professional service firms is developing rapidly to the level in WE.
- The state of development of leading stock markets in CE is in some cases virtually on a par with continental European today.

As the analysis in this report demonstrates, over the last decade CE has undergone major structural changes. These changes have positioned the Region and the EU Accession countries in particular, as an attractive source of private equity investment opportunities. The rate of improvement and increased opportunities for investment in CE is striking. While not without risks, as with any investment in any jurisdiction, the Region is exceptionally positioned to generate significant returns for investors in private equity deals that may outshine performance in the more mature markets of existing EU members.