

CEE: Down but not out

On 21 May *unquote*” hosted its third annual *Central & Eastern European Private Equity Congress*.

The day-long event brought together industry veterans as well as newcomers to discuss the region’s major developments. The overall theme was that while CEE private equity is down, it’s certainly not out, with the market looking set to revert to the less frenzied days of five years ago, when pricing and competition were lower, and leverage rare. No bad thing, since higher risks should mean higher returns to come.

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GPs in CEE are doubly lucky

In the first LP panel of the day, moderator Henry Potter of Alpha Associates pointed out that CEE incumbent GPs may be doubly lucky now: not only are most fully armed with capital, but the competitive landscape is shifting back in their favour, as non-indigenous players retrench in the wake of the turbulent economic conditions. Panellist Warren Hibbert of placement agent MVision concurred, predicting that GPs investing in the region now will fare well due to a reduction in competition.

Most LPs suffered losses in the past quarter, and consequently sober expectations for 2009 were expressed by both Alessandra Pasion of the European Bank for Reconstruction and Development and Uli Grabenwarter at the European

Investment Fund. Yet, the overall sentiment in the panel was optimistic. Indeed, Potter presented data showing post-crisis vintages have generated higher returns in CEE compared to more normalised circumstances in the past, meaning this could be a strong vintage.

This dry powder coupled with the peak in LP commitments to CEE-focused funds in the period 2005 to 2007 paved the way for the 2006/2007 vintage to produce stellar returns, Pasion pointed out. Fundraising on the other hand, might prove more challenging. Pasion predicted that fund managers going to market this year are likely to reduce fund sizes and might face fundraising processes longer than the normal 12 months.



Henry Potter, Alpha Associates



Alessandra Pasion, EBRD; Warren Hibbert, MVision; Uli Grabenwarter, EIF

LP concerns in today's uncertain market

The second LP panel of the day set out to discuss what chairman Kimberly Romaine described as “the evil world of LPs defaulting.” A frightening scenario, but as the discussion revealed, by being proactive in their investor relations, GPs and LPs alike can still conduct business as usual.

Being in communication with LPs is crucial, moderator Michael Russell, partner of Altius Associates and head of its European operations, stated. He was backed up the panel. MVision's Hibbert stressed the importance of transparency, and Roger Pim, partner of SL Capital Partners, a fund-of-funds, grouped fund managers in three groups. The first have LP relations similar to those of Permira and Candover; the second group he labelled the ‘pro-active GPs’; and the last group simply sit on the fence. The



Michael Russell, Altius; Hannes Ambacher, Bank Gutmann; Warren Hibbert, MVision; Roger Pim, SL; Henry Potter, Alpha Associates

pro-active fund managers stay in close contact with their fund investors; providing early warning of future capital calls and in some cases assisting LPs in selling stakes. Pim predicted that this close relationship would become even more important going forward.

As various speakers noted throughout the day, the GP/LP relationship is indeed a marriage, and it requires consistent nurturing – stressing the long term aspects of private equity investing. Particularly among some LPs, it seems there has been a flight to more familiar markets. As Russell said in his introduction, while the

congress' first session pointed out that the increase in fund sizes was largely driven by investor demand, the tables have now turned and GPs might find themselves struggling to obtain fund commitments.

Getting a foot in CEE

The next panel discussed a number of approaches to investing in the CEE region, which suffers from not having a dominant financial centre that is comparable to London. Panellists noted that there were two operational models at the far ends of the spectrum: investors could choose between a remote-control operation based out of London or the US, or a completely dedicated local fund. Robert Feuer of Warburg Pincus stressed that a global fund enables investors to look at areas of opportunity on a global scale, free from the pressure to deploy capital in the region in a certain timeframe.

The other panellists stressed the importance of a local presence. Alan MacKay of 3i spoke of 3i's experiences of partnering with local partner 3TS after acquiring an interest in a CEE company ‘by accident’. “We felt this was something that we should nurture rather than extinguish,” explained MacKay. A slightly different model was championed by Felix Potishman of Candover Eastern European Partners, who outlined operations on the ground in the countries, but supported by a larger framework in London. Michal Chalaczkiewicz of Montagu Private Equity stressed the importance of maintaining the firm's culture by hiring local people, relocating them to London for a time and then moving them back to CEE to maintain company culture. Montagu will open a Warsaw office this July.

Returns are still 30-40%...

“Returns are still 30-40% – but it is capital, no longer returns,” pointed out Rod Selkirk, who had a day earlier stepped down as CEO of Hermes Private Equity to head up Bridgepoint Development Capital. He went on to quip that LPs' oft-quoted denominator effect was being mitigated by GPs' newfound ‘numerator effect’.

He cited scepticism of a bounce back in the industry, expecting more of a reversion to levels seen before the boom years. At the core of future challenges is the sense that private equity needs to return to its roots of identifying targets that the industry can add value to and demonstrate a willingness to play the long game.



Rob Feuer, Warburg Pincus; Michal Chalaczkiewicz, Montagu; Felix Potishman, Candover; Alan MacKay, 3i

Valuation woes in CEE

“Critical valuation issues in a downturn include leverage and cost of capital; the adequate completion of commercial and technical due diligence; and the careful comparison between base and new equity scenarios.” Such were the words of Tibor Almássy, partner at PricewaterhouseCoopers Budapest practice.

The fragmented nature of the CEE markets renders valuations very difficult. Add to this the volatility of commodity prices, currency exchange fluctuations, the decreasing growth rate and the increasing borrowing rate and what you end up with what could be a challenging cocktail to swallow.



Tibor Almássy, PricewaterhouseCoopers

Secondaries on the up

Secondaries increase as funds mature and capital calls from GPs force sellers' hands. The second part of the statement is an increasing phenomenon in today's market, according to Daniel Green of Greenpark Capital. He maintains that structured GP-led portfolio secondaries dealflow will continue, driven by portfolios requiring capital; limited levels of fundraising (primary) in the next 12-24 months; and the retrenchment of western banks from the markets.

This will lead to increased secondaries activity in Europe, though in CEE it will remain undeserved by secondary capital in the near-term. This should create strong opportunities for those with the appetite and capital to invest in the market in CEE.



Daniel Green, Greenpark Capital

10-year LP model here to stay

Despite the controversy surrounding the LP model, Sonya Pauls, partner at SJ Berwin, is an advocate for the 10-year fund structure. The model works, she suggested, because illiquidity forces partners to take a long term view and carried interest rewards actual performance in real cash terms, not valuation. There is also a certainty of available capital.

While Pauls alluded to alternatives to the LP model, such as the evergreen and listed fund structures, the conclusion was that both these options have problems of their own, including forced exits and PE valuation issues, which would entice LPs to favour the standard model.

There was also talk on the challenging fundraising situation in Central Eastern Europe and an overview of the market's general trends. While 2008 proved to be a 'relatively strong' year for the region, said Pauls, 2009 has unsurprisingly seen a reversal of this trend. In 2008, Central Eastern Europe was beginning

to widen their investor base to include global institutional investors, but has now returned to a stronger dependency on development capital with the balance of bargaining power shifting to LPs. Pauls remarked that it would be rare to see a fund that has not had assistance from the European Investment Fund. All this has led, she concludes, to Central Eastern Europe being perceived as an emerging market once again, reverting to its 'frontier category'.

Pauls then went on to discuss the terms and conditions of a typical fund in CEE in today's economic climate. Management fees are slightly higher in CEE with between 2%-2.25% for buy-out funds, while a 20% carried interest remains the standard. 'No Fault' corporate governance provisions are also generally higher in the region than in other emerging markets, while LP clawbacks are normally limited to 3 years following the termination of a fund. But exceptions to this rule are now appearing with more frequency for ongoing proceedings.

Growth to return to CEE in 2010



Professor Witold Orłowski, PricewaterhouseCoopers

‘We don’t know for sure’ proclaimed Professor Witold Orłowski when addressing the issue of when the CEE region will recover during his macroeconomic overview. Orłowski, chief economic adviser to PricewaterhouseCoopers, explained that CEE enjoyed the benefits of being a ‘globalisation latecomer’ until 2007; the integration into the global economy means that it is equally affected by it. He surmises the prospects for recovery will therefore also come from outside the region.

Based on IMF predictions for 2009, Poland and Greece are the only countries in the whole of Europe with any growth predicted. The likes of the Ukraine and the Baltics, however, are predicted to suffer drops in growth of 10%.

Even with currency issues currently affecting the region, Orłowski believes CEE will survive the crisis better than others with positive growth achievable in 2010.

Capital structures – back to the future

The market has reverted to a state last seen five years ago in CEE in terms of liquidity and structures, as Chris Buckle of Mezzanine Management pointed out. Leverage is scarce and pricing is high.

Matthew Strassberg of Mid Europa Partners noted that although there has been a shift in power towards lenders, documentation is still better for GPs than it was in 2002. He further added that the market is moving towards an

environment where lenders are working much more closely together with vendors and GPs to make deals work.

While David Vials of Unicredit Markets & Investment Banking acknowledged the much more consensual deal doing environment in the current market, he also noted that the market is still discovering the opportunities and limitations of club structures that are currently necessary to finance larger transactions.

Creativity and flexibility needed with vendors

Vincent le Stradic, managing director of Lazard, highlighted the difficulties the downturn has brought about, specifically dealing with vendors. According to le Stradic, M&A activity is down 30%, with deals ten times more difficult to get done.

Le Stradic suggested that vendors will be forced to adjust their price expectations, since trading multiples cannot be relied upon to provide a benchmark for future exits. This means more traditional methods of valuating targets were less reliable.

In addition to added rigour when assessing deals nowadays, he suggests new ways of doing transactions. Vendors may become more flexible, for example ceding minority stakes, performing asset swaps, earn-outs or sales with upside-sharing all possibilities in the coming months.



Vincent le Stradic, Lazard