CEE: The Party That Ended Early

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Private equity fundraising in the region has collapsed since the financial crisis but the absence of capital for new deals could offer opportunities

Private equity investment in central and eastern Europe can be likened to a cocktail party after the more glamorous guests have left in search of some more fashionable event – never to return, in all probability.

But the more loyal guests who stayed on are discovering plenty of tasty morsels – all the more so because, in the less cramped quarters, they no longer have to elbow other people out of the way.

As a result, some observers think that private equity investment in the region may start to grow again. Though this time they predict the growth will be limited. Jacek Siwicki, president of Enterprise Investors, a Warsaw-based private equity firm, said: “The best times of 2006 to 2008, when fundraising was at a record high, are definitely way behind us.”

Mr. Siwicki attributed the surge in investment of this period to excessively high expectations. “People saw CEE as an emerging market. They expected high risks and, therefore, higher rewards,” he said.

The rewards proved, instead, to be unspectacular. The European Bank for Reconstruction and Development, the single largest investor in private equity funds in the region, calculates that the average return from funds in which it invests fell to a low of only one times in 2010 – a zero return on the original investment – from a high of four times in 2008, though it recovered to just above two times by 2012.

Now that these expectations have diminished, so too has the fundraising. Zbigniew Rekusz, Warsaw-based senior partner at Mid-Europa, a private equity firm specialising in the region, said his firm’s latest fund, which closed in August 2014, “has investment from a significantly smaller number of [investors] than our 2007 fund”.

“Then we raised a record €1.5 billion. This time, we raised €850 million. The slower pace of investment and lower number of deals resulted in less appetite from [investors],” Mr. Rekusz added.

This issue appears to have been felt by all firms in central and eastern Europe. A peak of €6 billion was raised by CEE-focused funds in 2008, compared with only €400 million in the year to mid-September 2015, according to data provider Preqin.

Responding to this fall in enthusiasm, some companies closed their offices in the region. Carlyle shut its Warsaw office in 2008, only a year after opening it. Swedish private equity firm EQT plans to shut its Warsaw office shortly, according to a spokeswoman for the company. She cited administrative rather than strategic reasons, and added that Poland remained an “interesting” market.

Despite such departures, competition for dealflow can still be a problem – though these days the competition often comes from outside the private equity industry.

Mr. Rekusz of Mid-Europa cited the case of Pivovarna Laško, a Slovenian brewer bought by Heineken, the Dutch brewing giant, in April. Heineken outbid several private equity investors, including Mid-Europa. Mr.Rekusz said: “Some of the strategics” – companies that buy other businesses in their sector as part of a long-term strategy – “look overseas more, because there’s not much growth any more in western Europe.”

Competition

This competition is particularly strong in Poland, the region’s largest economy. Its strong gross domestic product growth – forecast for this year at 3.7%, according to the Organisation for Economic Co-operation and Development – makes it an attractive market for them.

Mr. Rekusz said: “We would like to do deals in Poland, but it has been particularly challenging because, although there have been a few transactions, they were done at extremely high valuations and attracted strategic investors.”

Mr. Siwicki of Enterprise Investors suggested that, as a rule of thumb, investors were currently paying about 8.5-times earnings before interest, tax, depreciation and amortisation for companies across CEE as a whole – similar to the levels in many western European countries.

Even so, private equity investors say that overall competition for deals remains less severe than in the years immediately after the fundraising boom that peaked in 2008.

Henry Potter, partner at Alpha Associates, a Zurich-based private equity fund of funds manager and adviser, put this into perspective, noting that until the fundraising bonanza of the late 2000s, “returns had been very good, but then the money came in a lumpy way to a handful of [firms] that more than doubled their fund sizes”.

As a result, “this vintage didn’t make great returns”. However, Mr. Potter added that “now money is scarce again and things are going well”.

The high prices appear to have pushed up the overall value of deals that have taken place. Private equity firms have purchased majority and minority stakes in the region worth €3.7 billion in the year to September, according to data provider Dealogic, putting 2015 on course to be the strongest year since 2009. The figure was already almost five times the total for the whole of 2014, though the number of transactions is, at 25, far below the 2007 peak of 87. Nevertheless, 25 is already higher than the 2013 total of 24 transactions, and looks set, by the end of the year, to beat the 2014 figure of 27.

This rise in dealflow, compared with recent years, may be partly due to a change in strategy at some firms.

Anne Fossemalle, director of private equity funds at the EBRD in London, said: “We’re seeing a lot of minority control private equity deals in central and eastern Europe. Many entrepreneurs started companies in the mid-1990s [after the fall of Communism] and have come to a stage where they are looking for partners to grow the company after their semi-retirement.”

Some observers forecast that a more favourable investment environment for private equity could lead to an increase in fundraising – but only a modest one. Ms. Fossemalle said: “It should rise a bit, but whether it rises substantially remains to be seen.”

Mr. Potter of Alpha estimated that the CEE private equity market could probably absorb significantly more than has typically been raised, “but any sudden change” – repeating the events of the earlier boom - “is going be difficult to absorb”.

Aspirational Consumers

Private equity investors often like to think in terms of grandiose themes. The overarching theme for central and eastern Europe, say private equity investors, is the striving by increasingly wealthy countries to move beyond basic needs to more ambitious aspirations.

Explaining these aspirations, Jacek Siwicki, president at Warsaw-based private equity company Enterprise Investors, said: “The main theme is the consumer making his life better.” That included a wide range of perceived needs, including buying organic produce, spending on private education because the state system did not meet expectations and making life not only better but longer by investing in healthcare. Mr. Siwicki said that these were not the needs of the luxury shopper, but of the “mid- to upper mid-market consumer. This is not about Ferrari dealerships”.

Healthcare is, perhaps, the sector mentioned most of all by private equity investors in the region. For example, Enterprise Investors bought a stake in 2012 in Nu-Med, a Polish company that is building its fourth radiotherapy clinic. EI has a 68% shareholding, and has invested €32 million in the company. As with most other healthcare ventures in the region, the strategy is twofold. The company generates revenue from private spending, by people who do not want to wait to be dealt with by the state system; it also receives revenue from the government, which pays to use private facilities because it cannot afford to buy public facilities.

In August 2015 Mid-Europa, a private equity investor specialising in the region, acquired 100% of Regina Maria, Romania’s largest healthcare company, from fellow private equity investor Advent International. Regina Maria runs clinics, hospitals and laboratories.

Zbigniew Rekusz, Warsaw-based senior partner, said: “Our strategy is based on the same fundamentals as for private healthcare in Poland: the very poor condition of the public system and a growing middle-class population that wants to be treated effectively.”

Mid-Europe sold its stake in Lux-Med, a Polish healthcare company, in 2013 for a 2.5 times return.