A Regional Feature: Central & Eastern Europe

Central and Eastern Europe[1] (CEE) perhaps best exemplifies what is at the heart of the emerging markets private equity opportunity–world leading returns can be garnered when emerging countries join larger trading markets, enact economic and regulatory reforms, or unleash market forces that enable talented entrepreneurs to find better efficiencies, tap new consumer trends, and grow companies through the power of private equity investing. While the CEE PE market has both grown and performed remarkably well over the past few years, there is still significant untapped opportunity in the region, as private equity penetration in the region's largest market of Poland is only 0.05% of GDP, compared to a European average of over 0.4%.

Exhibit 1: CEE Private Equity at a Glance

PE Funds Raised 2005:	€1.5 billion
PE Investments 2005:	€0.7 billion

Source: EBRD Market estimates for all CEE and Balkan countries.

Leading Returns

The European Bank for Reconstruction and Development (EBRD), a development bank and the most active LP in the region, is conducting an in-depth analysis of the 2005 performance of its PE portfolio, and provided some initial findings to EMPEA. According to the new EBRD data for 2005, the emerging and converging markets of Central and Eastern Europe generated returns of 36.8% over a one-year horizon (in US$), exceeding private equity returns from the US by almost 10 percentage points and Western Europe by approximately 12 points, as reported by Cambridge Associates (see Exhibit 2).[2]

The CEE investment opportunity appears to be quite steady, as the region also outperformed the US PE market by 4 to 5 percentage points in both the 3-year and 5-year horizons. Investors in the region are reaping rewards from years of robust growth with low inflation.

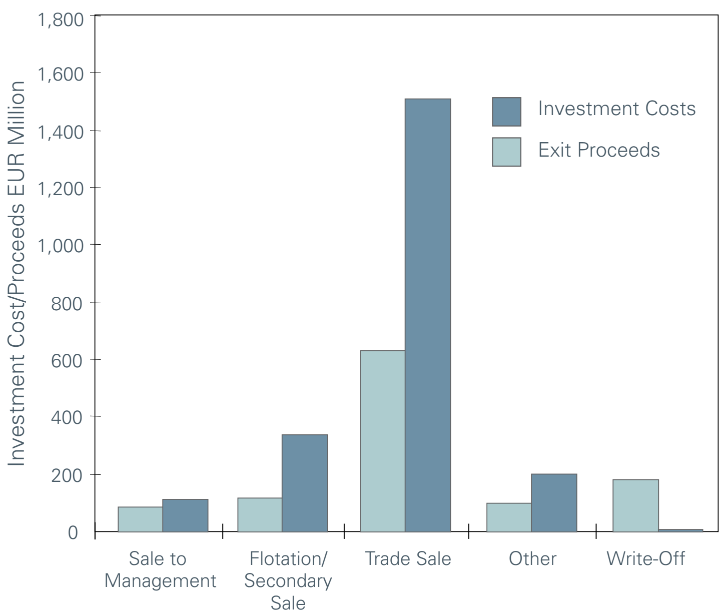
Exhibit 2: Comparison of PE Returns (Calculated for returns in US$)

	1 Yr	3 Yr	5 Yr	10 Yr
EBRD CEE Portfolio	36.8	29.8	14.4	11.2
Cambridge Assoc				
US PE Index	27.35	24.93	10.07	13.37
US VC Index	7.9	7.3	-9.89	39.34
W. Eur PE Index	24.7	28.42	19.91	21.13
MSCI EM Index	34.54	38.35	19.44	6.98

Source: Cambridge, Associates LLC Proprietary Database, EBRD Proprietary Database, Morgan Stanley Capital International.

The strong performance over the one-year time horizon has been driven by record distributions. In its latest data, the EBRD estimates that funds in which it invested returned €1.16 billion to LPs in 2005, up from €300 million in 2004. 2005 cash returns are 3 times the €0.38 billion of disbursements for that year. EBRD funds represent approximately 40% of the CEE market and therefore are a strong barometer of the market's overall performance. A majority of CEE exits were accomplished through trade sales and public offerings, with less than 5% of exits by proceeds involving sales to other private equity funds (see Exhibit 3).

Exhibit 3: Fully Realised Investments in CEE by Exit Type



Source: EBRD

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The Power of EU Convergence

Peter Derendinger of Alpha Associates, the primary fund of funds for the CEE region, offers the view that "Central and Eastern Europe is the only place in the world where an investor can find emerging market growth with developed world risk." According to Derendinger, "It is a result of the drive towards a larger European Union that creates an excellent convergence of factors— dynamic growth, rising family incomes, and understandable risk. Combine those factors with a backlog of opportunities in terms of companies that need capital and help to serve expanding consumer markets, and you have a perfect situation for private equity."

In 2004, 8 CEE countries joined the EU (see Exhibit 4) and Bulgaria and Romania are projected to join in 2007, and other candidate and potential candidate countries are already conforming their economies to the larger markets of the EU, and the continuing EU convergence is having a dramatic effect on the CEE economies. The GDP of CEE accession countries have doubled, tripled, and sometimes quadrupled GDP performance in the EU15. However, despite enormous progress over time, there remains a substantial income gap reflected in per capita GDP in the CEE countries that is between one-third and one-half of the EU15.

Exhibit 4: EU Accession Timeline for CEE Countries

Year	CEE Countries
2004	Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia
2007 Projected	Bulgaria & Romania
Projected w/o a timeline	Croatia, the Former Yugoslav Republic of Macedonia and Turkey

Source: European Union

Development of a CEE Private Equity Market

Henry Potter of the EBRD describes how private equity in the CEE region has gone through three phases of development since the fall of communism.

Phase One began in the mid-90s, and was characterized by privatizations, the reform of previously state-owned companies, and some start-up activity. Potter characterizes this first phase as "mostly driven by capital from western government-sponsored institutions going to funds mostly staffed by western managers, sometimes with private equity experience, sometimes without, and implementing mostly imported western style business models."

Performance was mixed, with several fund managers failing, but this first phase also spurred the success of a new cadre of fund managers. Two in particular continue to be leaders in the region with larger funds– Advent International and Enterprise Investors– and a third, Innova Capital Partners, that has built a series of smaller successful funds that have kept more to a focus on Poland.

Phase Two came in the late '90s, and was characterized by more opportunities to invest with expansion capital. By the end of the decade, a new generation of entrepreneurs had built companies to serve the newly-established free markets, providing ample deal flow for private equity transactions. Successful fund managers from the first phase expanded their operations with new funds, and new managers came to the region bringing the total number of GPs to approximately 100 and driving a surge in private equity activity. Extrapolating from the EBRD portfolio and its percentage of market share, a reasonable estimate for private equity investments in 1998 and 1999 would be $1.5 billion, nearly 2.7 times the amount of capital invested in the previous two years.

Stock markets became a factor as IPOs accounted for nearly two-thirds of the exit activity in 1999. The IPO market would cool in the early part of the next decade, but would rebound again towards the end of 2003. A new large player entered the market – EMP Global, a team led by former EBRD professionals. In 2005, this team became independent from EMP Global and is now called MidEuropa Partners. A new wave of mid-cap fund managers also proliferated, and successful ones include Argus Capital Partners, Global Finance SA, and Royalton Capital Partners.

In this second phase, western GPs began to look to CEE to expand their sourcing for larger buyout transactions. In 1997, Warburg Pincus turned its European attentions east, and completed the takeover of a Czech pharmaceutical company called Leciva (later renamed Zentiva) in June 1998. At the time, the $125 million investment for a 72% stake was the largest private equity transaction, as well as the region's first private equity-backed management buyout that involved taking a listed company private. Other western GPs such as APAX, Bridgepoint, and Candover have also been seen in the region.

Phase Three took hold at the turn of 2002 to 2003 with the emergence of leverage in the region. At the beginning of the decade, most of the bank privatizations had been completed, and international banks owned more than half of the assets in the Czech Republic, Hungary and Poland, but it took another couple of years for the bank buyers to reform operations and open credit lines to private equity players.

The EBRD reports that during this phase, a majority of all deals in the region were buyouts (see Exhibit 5). The availability of leverage has also broadened the types of deals that are now attractive for private equity investment. Without leverage, fund managers had to find companies with heavy growth or predictably expanding multiples, and this led to a focus on telecoms and related sectors. The availability of leverage has now made deals in the service, consumer and manufacturing sectors much more attractive.

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Fund managers saw considerable success in 2005, raising over €1.3 billion, compared to €900 million in 2004. Large central European and Balkan funds now tend to be in the €400 to €700 million range, but are still making investments at sizes below the level at which the large pan-European players compete. However, there also appears to be significant room for growth in the private equity industry, as penetration rates still lag those in the West (see Exhibit 6).

The Big Three Funds: Opportunities in the Upper Mid-Market

Advent International, Enterprise Investors, and MidEuropa Partners are the three biggest players with funds solely dedicated to the CEE market. (See Exhibit 7 for list of sample funds for the CEE region.)

Enterprise Investors was the first major private equity firm to form in the region and has the deepest track record in Poland. Enterprise has completed 101 transactions, including 18 privatizations that were mostly consummated in their early funds, and 23 IPOs on the Warsaw stock exchange. Robert Manz, a Managing Partner at Enterprise, believes that improved corporate governance has been a key part of the value his firm brings to the portfolio. Of the twelve Polish companies traded on the Warsaw Stock Exchange that have received top awards from the Polish Directors Institute for best corporate governance, seven of them have come from Enterprise's portfolio.

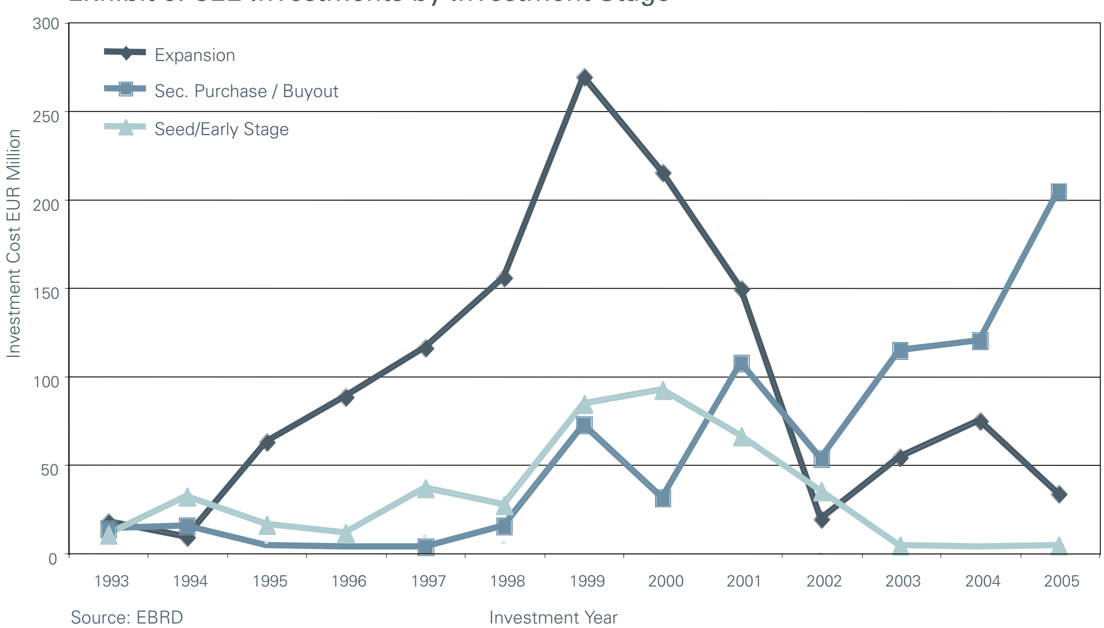
Until 1999, Enterprise invested solely in Poland, but in recent years approximately 30-40% of their activity has been outside of Poland, a telling sign for the dynamic of the regional opportunity. Manz sees parallels between Romania today and the Polish market seven years ago, but "Romania has a more compressed timeframe in which to catch up." Enterprise has just closed its fourth transaction in Romania.

In 2005, MidEuropa closed the largest fund in the region with €655 million, and invested in three transactions in the first six months of 2006, already deploying approximately one-fourth of the fund. MidEuropa plays at the higher end of the market, and, in addition to the deployment of private equity capital, investee companies in its portfolio have issued over €1 billion in bonds over the last 3 years. It has had a regional focus from the start, with its first fund investing in 11 deals spread over 9 countries.

MidEuropa's Managing Partner, Thierry Baudon, is buoyant about the change in deal flow since 2003. According to Baudon, "We mostly invested our first fund in local market leaders in sectors such as mobile and fixed telephony or cable TV. These transactions did have a very attractive risk-return profile, but were totally dependent on the growth of their national market. We are now sourcing investments in world market leaders that are based in Central Europe. They have Central European cost structures, but also worldwide sales, which gives us the potential to generate significant upside." Baudon cites a recent investment in Calucem, a leading supplier of calcium aluminate cement, which used to be part of the Heidelberger Cement Group. The company has its main production facility in Croatia, but has trading entities in Germany, the United States, and Singapore.

While Enterprise developed from a strong Polish base and MidEuropa built a proprietary regional team from its start, Advent International has used a partnership model to balance its interests across the region and maintain flexibility in the deployment of resources. Advent went into key markets by partnering with local fund managers, suchas Copernicus in Poland and a local bank in Romania.

Exhibit 5: CEE Investments by Investment Stage



Source: EBRD

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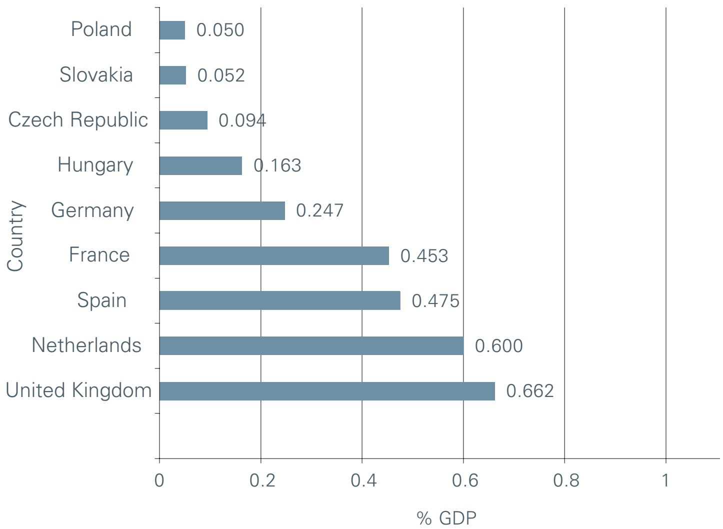
Exhibit 6: 2005 Private Equity Investment as % of GDP



Source: EVCA/ Thomson Financial/ PricewaterhouseCoopers

Joanna James, Managing Director of Advent's team in CEE, reflected on her firm's entry into the market in 1994, and stated, "We would have pictured the Czech Republic as a strong country for deal flow, but that did not materialize for another five years. Instead we have had our biggest transaction in Bulgaria, and we have put more capital and made higher returns out of Romania than any other country. In Romania, we had a bank partner that just continued to feed us good deals."

Advent is continuing its partner model as the group explores new frontiers including Turkey. Turkven, managed by Seymur Tari, is Advent's exclusive partner in Turkey. With a stabilized political situation and a government concentrated on achieving EU membership, Turkey has doubled its GDP in the last five years, and inflation has held steady in the range of 8%. Turkven did its first leveraged buyout in 2003. According to Tari, "Even with one-to-one leverage, companies growing at 15% to 20% can give us returns in excess of 30%. In a country with GDP growth in the range of 10%, finding companies with 15% growth is easy." With a population of 70 million people, Turkey could provide a market for private equity on an equal scale with Poland.

Mid-Cap Funds Finding Success

Several smaller funds have developed impressive track records through targeted approaches to the region. Nigel Williams, the Managing Partner of Royalton Partners, conducted a study of the power of accession to the EU. Williams found that in Spain and Portugal, "accession to the EU inflated prices for non-tradable goods dramatically." A study by the Czech National Bank Board found a similar dynamic. Between 1999 and 2005, the prices of most tradable goods in the Czech Republic fell by more than 5%, while the prices of non-tradable goods increased by over 35%.

Williams takes the lesson that "we should invest in businesses that are immune to international competition, and in particular focus on the service sector." Royalton has followed this strategy by investing in a series of successful service companies, including mPunkt Polska, the second largest distributor of mobile phones in Poland. The market for this independent retailer of mobile phones is currently limited by contracts between the mobile phone companies and their proprietary distributors, but Williams expects this to change as the market is forced to conform to EU rules, opening up a much larger market for the Polish retailer. According to Williams, "EU convergence is a core value to our portfolio."

While not part of the CEE region proper, some fund managers are including Ukraine in their investment strategy. SigmaBleyzer has managed three funds in the Ukraine since 1996, and its current fund is also investing in Romania and Bulgaria. According to Neal Sigda, Head of Asset Management, "In some ways Bulgaria is more similar to Ukraine than it is to Poland. We find the same level of corporate infrastructure and the same type of upside potential one can find by investing in companies that are really quite underdeveloped."

A Maturing Market

The region's private equity market appears to be reaching a level of maturity where one can now find examples of the higher and lower ends of the market coming together. In 1999, Global Finance, a successful South Eastern Europe fund manager from Greece, invested in a generic pharmaceutical company from Romania called Sicomed. Finding the right management to rouse this profitable but mostly antiquated producer was a challenge. Global Finance tried two different management teams before finding the right fit. They also strengthened the experience available to the company by bringing in two new independent board members, including a former regional head of Unilever.

"Deepening the experience available to the company was critical," said Mihalis Madianos who is a Partner with Global Finance. "The company improved its systems and dramatically improved margins in over-the-counter sales to provide cash flow to grow the prescription business." Global Finance exited its stake through a trade sale to Zentiva, the generics pharmaceutical that had been bought by Warburg Pincus. The exit was one of the best for Global Finance as they secured a return of 6.4X and achieved an IRR greater than 55%.

At the higher end of the market, there was obviously room for further growth. Warburg Pincus integrated Sicomed into Zentiva, and continued to grow the firm's exports. In March of 2006, Warburg Pincus exited Zentiva through a sale of its remaining stake to Sanofi-Aventis, achieving an IRR above 40% and a capital gain in excess of $1 billion on its investment.

Joseph Schull, a Warburg Pincus Managing Director who covers the CEE region, believes that "there was a period of time when value creation was principally found in buying something cheap, polishing it up, and then selling it on as the discount to EU15 assets decreased."

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However, Schull believes "that era is now largely over." Looking ahead, Schull offers that funds will have to bring more industry insight and operational value, but he is also quick to note that one of the key assets in the region is the management talent that can be found internally.

Schull describes Warburg's initial approach to buying Zentiva. "The reality in Eastern Europe is still quite different to what meets the Western eye. Often the most talented person in the room does not necessarily look the part or speak English very well but runs a company very effectively." Warburg Pincus retained the incumbent CEO of Leciva, Jiri Michal following its investment in 1998. Michal, who had spent his career as a manager at Leciva under Communist state ownership, continued to run the business through its IPO and Warburg's exit in 2006. "We thought Jiri Michal was a capable manager when we bought the business – he turned out to be exceptionally talented."

According to Schull, "the region has evolved in terms of the depth of management skills that can be found within companies. Previously you were lucky to find one or two high quality managers within a mid sized or even a large business. Today, you can often find a handful of strong managers, and our role is to provide capital, relationships, and skills to help them succeed in a market they already know well or, in some cases, to extend their business into new markets."

Looking Forward

There has been so much change in the market and the types of deal opportunities available that Henry Potter of the EBRD cautions LPs to study fund managers carefully. According to Potter, "LPs should be coming to the CEE region because the returns are tremendous. This should continue, but the opportunity has changed so much through each phase of development that it is tricky to examine track records that may only be partially relevant to the market that lies ahead."

According to Robert Manz of Enterprise Investors, possible pitfalls include rising acquisition multiples and the risk of over-capitalization in the region. "So far a reasonable competitive balance exists in the region, but that could be upset if managers start doing silly things in order to deploy capital." But, Joanna James of Advent believes that fund managers have only just begun to tap the region's base of

Exhibit 7: Representative Sample of CEE PE Funds

Firm Name	Primary Target Countries
Fund of Funds	
Alpha Associates	Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia, Turkey.
Upper Mid-Market Funds	
Advent International	Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Turkey
Enterprise Investors	Czech Republic, Poland, Romania , Slovakia
Mid Europa Partners	Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Poland, Romania , Slovakia, Slovenia
Mid-Market Funds	
3TS Capital Partners	Czech Republic, Hungary, Poland, Slovakia,
Argus Capital Partners	Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, and Turkey,
Askembla Asset Management	Estonia, Latvia, Lithuania
Balkan Accession Management Company	Bulgaria, Romania
Bedminster Capital Management	Bulgaria, Romania, Turkey, Serbia, Croatia
Copernicus Capital Partners	Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Poland , Serbia and Montenegro
DBG Eastern Europe	Bulgaria, Czech Republic, Hungary, Romania, Slovakia, Slovenia
EuroVentures	Ukraine
Global Finance S.A.	Bulgaria, Cyprus, Greece, Poland, Romania
Innova Capital Partners	Czech Republic, Hungary, Moldova, Poland, Romania, Slovakia
Royalton Partners	Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia, Slovakia
SigmaBlayzer	Bulgaria, Romania, Ukraine
Turkven Private Equity	Turkey
Mezzanine Funds	
Accession Mezzanine	Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia
Darby Overseas Investments	Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia
Syntaxis	Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia

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opportunities. According to James, "Some people are always saying there is too much money, but people go and create opportunities that have not until now been recognized in the market."

One interesting trend to watch will be how LPs continue to invest in the region. The EBRD is now starting to draw down its investment activity in the new EU member countries, seeing that its mission for spurring private sector investment is succeeding. Will private sector LPs continue their surge, and take up the slack left by EBRD's scaling back? If fund managers continue to deliver the returns, the appetite from the US, Europe, Asia, and the Middle East should endure.

[1] For the purposes of this article, the CEE region refers to: Bulgaria, Czech Republic, Estonia, Hungary, Poland, Romania, Slovakia, Slovenia, Turkey and the countries of the former Yugoslavia. Turkey, while a candidate country for EU accession, is not included in most regional data. This article also covers PE activity in Ukraine, although Ukraine is not typically included in the definition of the CEE region and is not included in the regional data.

[2] Performance data for CEE is based on the CEE portfolio returns from EBRD. The EBRD December 2005 horizon IRRs are preliminary and based on estimated year-end valuations prepared pursuant to the EBRD's fair valuation process. Actual December year-end financial results from the Bank's investee funds are usually received several months after year end and aggregated thereafter. Final December 2005 aggregated results, based on net asset values, will not be available until October 2006. The Cambridge Associates numbers for CEE are not included here because they include Russia, and therefore do not provide an appropriate side-by-side comparison.