Private equity/venture capital investments in CEE countries[1]

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Abstract

Private equity/venture capital (PE/VC) investments contribute to development and growth of many companies. Financing early stages of company development is very important especially for innovative companies that have to face the problem of finding additional financing sources. Financial support for young, small and innovative companies can result in future development of the economy. It is especially important for CEE countries trying to reduce the development gap to western European economies. The paper presents the condition of PE/VC market in CEE countries and perspectives for the future.

Key words: private equity, venture capital.

JEL Classification: G24

1 Introduction

Many companies, especially those just established and small ones, are facing the problem of finding the sources of finance. The market is inefficient in providing such sources for these entities. This phenomenon called as equity gap is common all over the world. Private equity and venture capital (PE/VC) funds are those whose activite should lead to reducing of this market ineffectiveness. Theirs activity involves not only funding but also contributing to the growth of the companies that are backed. PE/VC fund is not only the provider of capital. First of all, the funds offer some additional value that is an experience, knowledge and business conections that can be used to build the companies strategy. We should distinguish from private equity and venture capital investments that are very often confused. Private equity includes all stages of company development: seed, star up, growth capital, replacement capital, rescue/turnaround and buyouts. Private equity funds are pools of capital managed in general as closed-end fixed-life funds doing primarily equity capital investments into companies not quoted on a stock market. On the other hand, venture capital refers to equity investments made for the launch, early development, or expansion of a company [1].

Three main stages of investment process on private equity/venture capital (PE/VC) market are fundraising, investment and divestment. CEE region[2] is relatively small market in comparison with Europe as a whole. Fundraising in CEE countries represents only 3% of all funds raised in Europe in 2008. Similarly investment amount represents only 4.7% and

[1] Research work is co-sponsored by the European Social Fund and State budget within the framework of the Integrated Regional Operational Programme, Measure 2.6 “Regional Innovation Strategies and transfer of knowledge” of Kuyavian-Pomeranian Voivodeship “Scholarships for doctoral candidates 2008/2009 – IROP”.
[2] For the purpose of this paper, CEE Region comprises the following countries: Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia, Slovenia and Ukraine.

divestments at cost amount to 292 mln euro that accounts to 2.2% of the total exit value in European PE/VC market.

2 Fundraising

The institutions usually provide the bulk of the CEE funds. However, in 2008 the funds of funds were the largest source of capital contributing 25% of total funds raised. The other significant sources of capital are pension funds (18%) and private individuals (9%). For the entrepreneurs it is important where the funds intend to allocate their resources than the absolute amounts raised. As in previous years, the proportion of funds raised for buyouts increased to 77,4%. Encouragingly, the proportion of funds raised for total venture stages representing 8.8% of total funds raised at 217210 thousands euro in 2008, up from 128654 thousands euro in 2007. However, the proportion raised for growth stage decreased from 12.5% to 5.8% of total funds raised. This is common proportion in Europe that the largest amount is targeted to later stages like growth, buyout and mezzanine [2].

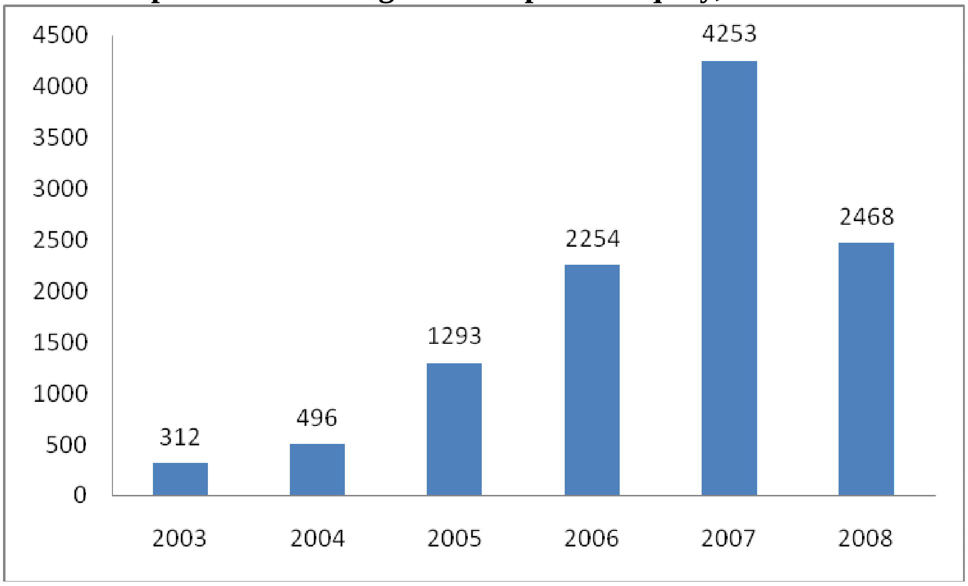
For the larger CEE countries, in terms of funds raised, there are some quite large differences between countries in the split between funds allocated to buyouts and funds allocated to earlier stages (venture capital) in 2008. Substantially more funds tend to be allocated lo later stages (buyout). For example, Poland allocated 85% to buyout. On the other hand, Hungary allocated the whole amount of funds raised to venture stages [3].

Table 1. Fund raised by fund stage focus (thousands euro)

Stage	2007		2008	
	amount	%	amount	%
Early-stage venture	0	0.0	49 010	2.0
Later-stage venture	1 054	0.0	140 000	5.7
Balanced	127 600	3.0	28 200	1.1
Total venture	**128 654**	**3.0**	**217 210**	**8.8**
Growth	531 031	12.5	141 500	5.8
Buyout	3 036 592	71.4	1 910 250	77.4
Mezzanine	473 000	11.1	161 200	6.5
Generalist	84 000	2.0	37 610	1.5
Total funds raised	**4 253 277**	**100.0**	**2 467 770**	**100.0**

Source: EVCA, *Central and Eastern Europe Statistics 2008,* An EVCA Special Paper, Brussels July 2009, p.6.

Graph 1. Fundraising for CEE private equity, 2003-2008



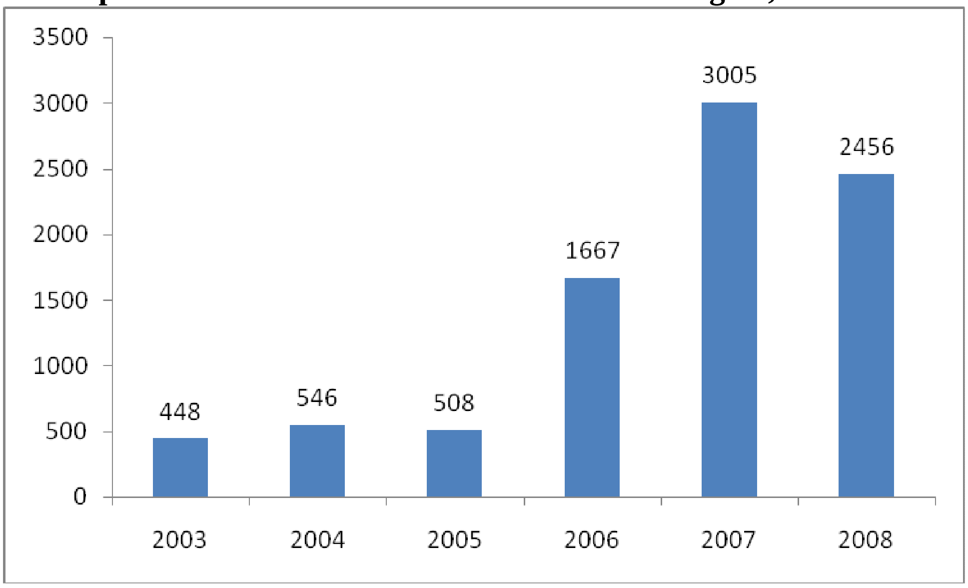
Source: EVCA, *Central and Eastern Europe Statistics 2008*, An EVCA Special Paper, Brussels July 2009, p.5.

In 2008, the share of non-European investors in the total fund raised has increased to 56%. The largest amount was raised by US investors (27%). Among European investors, the largest share in the total fundraising came from UK and Switzerland. Funds located in the CEE region raised only 3% of total funds.

3 Investment

Investments in CEE region have decreased in 2008 by 18% to 2.5 bn euro but still stay on higher level than in 2006. This data correspond with the data for the whole European market, where investment amount has decreased by 28% in 2008.

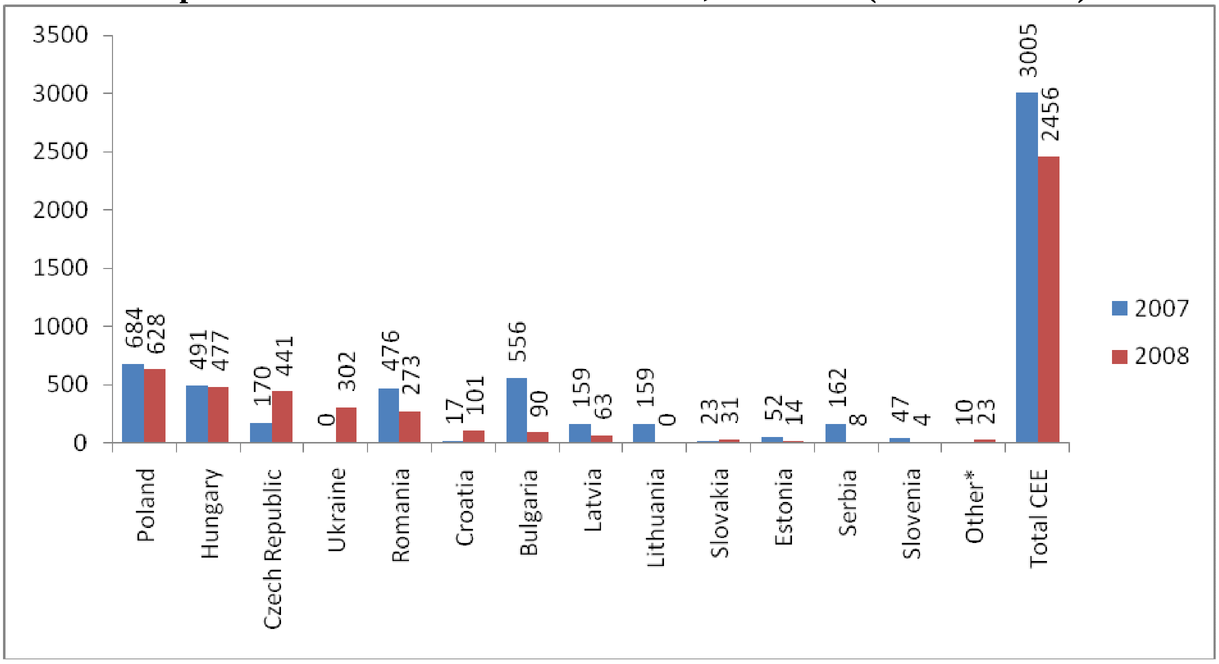
Graph 2. Annual investment value in the CEE region, 2003-2008



Source: EVCA, *Central and Eastern Europe Statistics 2008*, An EVCA Special Paper, Brussels July 2009, p.8.

The investment activity was concentrated especially in five countries of CEE region: Poland, Hungary, the Czech Republic, Ukraine and Romania. In 2008, these countries accounted for 86% of investments in the meaning of amount and 71% in the meaning of the number of PE/VC backed companies.

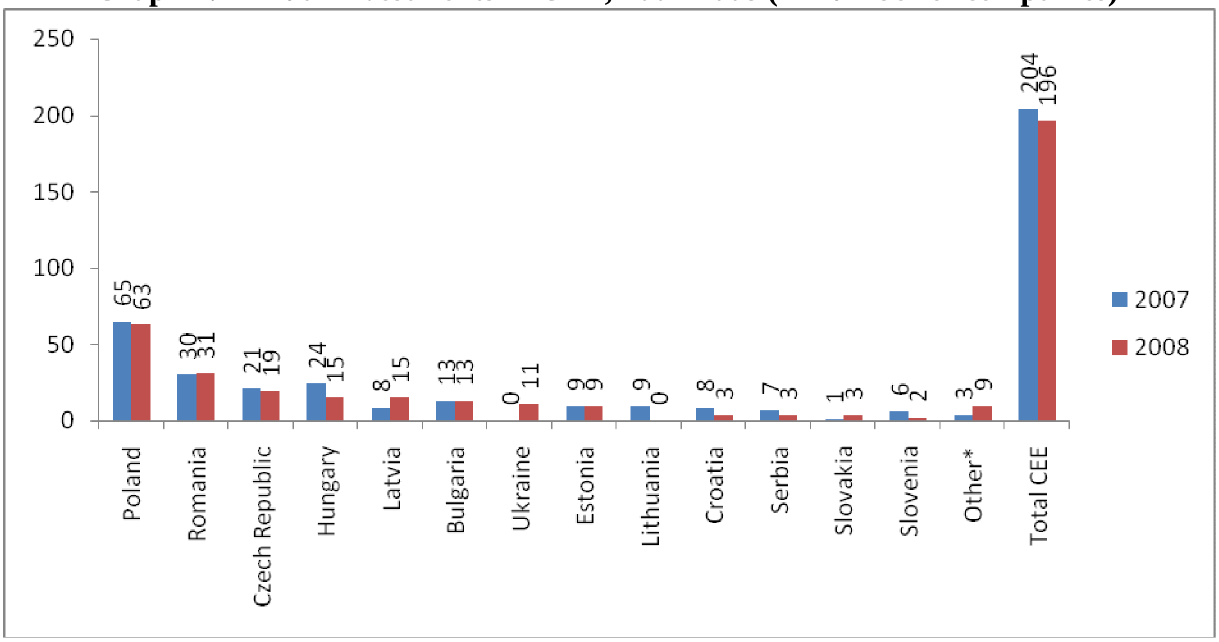
Graph 3. Annual investment value in CEE, 2007-2008 (in million euro)



*Bosnia & Herzegovina, Macedonia, Montenegro

Source: EVCA, *Central and Eastern Europe Statistics 2008*, An EVCA Special Paper, Brussels July 2009, p.9.

Graph 4. Annual investments in CEE, 2007-2008 (in number of companies)



*Bosnia & Herzegovina, Macedonia, Montenegro

Source: EVCA, *Central and Eastern Europe Statistics 2008*, An EVCA Special Paper, Brussels July 2009, p.9.

In 2008, PE/VC funds have invested in about 200 companies in CEE region. Average investment size in one company amounted to 12.5 mln euro and decreased by 15% in comparison with 2007.

As noted above, total amounts invested in CEE region reached 2,46 billion euro in 2008. Management buyouts represented 63.3% of the total amount invested in region in 2008 at 1,5 billion euro. Buyouts represented 23% of the total number of companies backed by PE/VC funds, compared to their 46% share in 2007. Venture capital investments represented 51% of total number of companies in 2008, compared to their 41% in 2007. Seed investments represented just 0.2% by amount at 4 million euro and 6% by number of companies.

Private equity investments are sometimes correlated with high tech industry sectors. That is not the rule according to investment criteria of PE/VC funds. The funds are first of all focused on sectors that are high growing. That is why, consumer goods sector is so popular for years with PE/VC funds investments. In 2008, the largest amounts were invested in life sciences (616,5 millions), communications (495.8 millions), financial services (308.4 millions) and consumer goods (258 millions). By number of companies, the most popular sectors were communications (51 companies), business and industrial products (20 companies each), life sciences (19 companies) and computer and consumer electronics (17 companies).

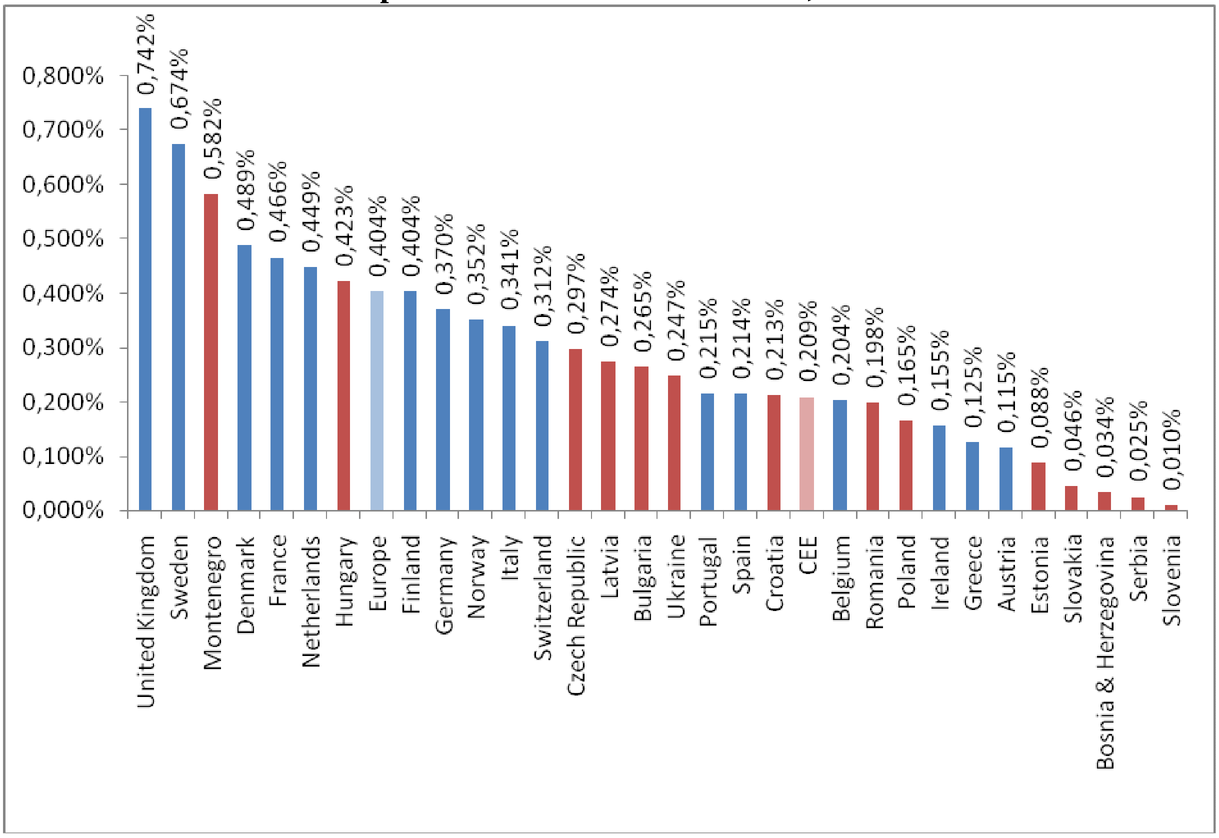
Table 2. CEE investments by sector in 2008 (in thousands euro)

Sector	Amount	%	number of companies	%
Agriculture	4 300	0.2	2	1
Business and industrial products	180 866	7.4	20	10.2
Business and industrial services	38 097	1.6	8	4.1
Chemicals and materials	53 041	2.2	5	2.6
Communications	495 803	20.1	51	26
Computer and consumer electronics	54 218	2.2	17	8.7
Construction	43 883	1.8	4	2
Consumer goods and retail	257 989	10.5	20	10.2
Consumer services	104 874	4.3	12	6.1
Energy and environment	91 106	3.7	12	6.1
Financial services	308 356	12.5	14	7.1
Life sciences	616 522	25.1	19	9.7
Real estate	5 068	0.2	1	0.5
Transportation	184 476	7.5	6	3.1
Unknown	17 011	0.7	5	2.6
Total investment in year	2 455 610	100	196	100

Source: EVCA, *Central and Eastern Europe Statistics 2008*, An EVCA Special Paper, Brussels July 2009, p.10.

One of the most significant indicators of private equity/venture capital market condition is the ratio of PE/VC investment to Gross Domestic Product. In 2008 this ratio for CEE region was 0.209%. In comparison, the investment to GDP ratio for Europe was 0.404% that is twice more than for CEE region. That relation shows that the investment activity in CEE region is still insufficient.

Graph 5. Investments as % of GDP, 2008



Source: EVCA, *Central and Eastern Europe Statistics 2008*, An EVCA Special Paper, Brussels July 2009, p.11.

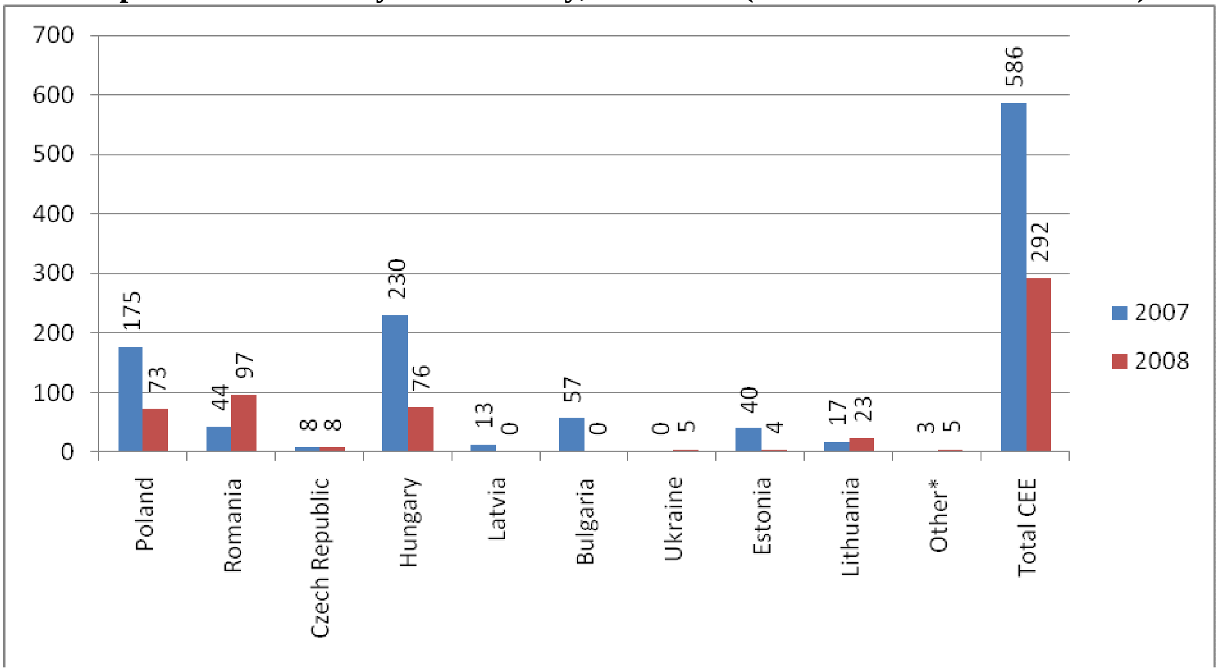
What is also interesting, the CEE region is more growth-capital oriented than Europe as a whole. In 2008, 28.9% of invested amount was spent for growth stage, 7.6% on early stages (seed, startup, later-stage venture) and 63.3% on buyout transactions. In Europe as a whole it was: 13.5%, 13.1% and 70.1% respectively. These data show, that PE/VC funds are much more interested to invest in later stages, like buyout transactions. Usually it means also that the target company for PE/VC funds is rather larger one and matured than small one or just seeded.

4 Divestment

The financial crisis and the poor condition of capital markets in Europe have resulted in decrease in the value of exits. One of the ways of exiting from PE/VC investment is public offering. While the condition of capital market is unfavourable, the companies are delaying the time when they get public. That result, that many funds prefer to wait for better condition on capital market aiming to get the better valuation of their investments. In case of PE/VC funds, that investment horizon is relatively longer and such a delay is not a problem. Funds can continue creating the value of the portfolio companies and wait for better conditions for an exit. On the other hand, the funds find the crisis like an occasion to invest in public companies. That is a kind of denial because according to definition, PE/VC funds don't invest in public companies. It is an exception, because can invest in public company with the aim to make it private. After withdrawal, investment process and building the value, such a company can be again public offered.

The most common ways of exit from PE/VC investment are still trade sale (43% of amount divested and 40% of total number of companies exited) and sales to other private equity house (37% of amount divested and 15% of total number of companies exited). The most divested sectors in 2008 were life sciences (51 mln euro), financial services (45 mln euro) and energy and environment (38 mln euro). These sectors accounted for nearly 60% of total amount divested. In the meaning of the number of companies exited, the most divested sectors were communications (10 companies) and consumer goods and retail (6 companies). Comparing the all CEE countries only Romania and Lithuania have significantly increased the value of exits.

Graph 6. Divestment by CEE country, 2007-2008 (exit value at investment cost)



*Bosnia & Herzegovina, Croatia, Serbia, Slovenia
EVCA, *Central and Eastern Europe Statistics 2008*, An EVCA Special Paper, Brussels July 2009, p.16.

5 Some perspectives for future development of PE/VC market in CEE countries

The CEE private equity and venture capital market will develop depending on some conditions that should be improved. First of all there is a lack of one core financial center in the CEE region. However in September 2009, four stock exchanges form Vienna, Prague, Budapest and Ljubljana announced the merger. New market – CEE Exchange Group will be the biggest in the region. Joint capitalization of these four markets amounts to 140 bn euro and 265 companies are listed. In comparison, Warsaw Stock Exchange capitalization amounts to 88 bn euro and 471 companies are listed.[3] Future consolidations including Warsaw Stock Exchange should lead to create one common market for whole CEE countries. The same problem face the Europe as a whole. The European Union has more than 20 stock markets many of which are very small in the meaning of capitalization. An efficient high-growth stock market would improve the ability of young companies to raise capital. On the other hand there is a need for creation of alternative markets such as AIM (Alternative Investment Market)

[3] Data at the end of August 2009.

developed by London Stock Exchange. In CEE region, such a market was organized by Warsaw Stock Exchange. NewConnect is the platform that has started in August 2007 with an aim to finance small and fast growing companies. These markets are recognized as a good way for exiting by PE/VC backed companies. Companies listed on alternative markets have reduced requirements in comparison with regulated markets that is significant for small and innovative companies. For example in case of NewConnect, there is no obligation for quarterly reports. The companies have also an option of non-audited semi-annual reports including only selected information. The costs of public offering are also reduced in comparison with regulated market [4].

The next aspect facing PE/VC sector in CEE region is the legal, tax and operating environment that is very based at the local and country level. The current fund structuring environment does not support cross-border investing not only for CEE region but for whole Europe. The problem covers mainly taxation issues, where the capital gains are taxed twice (in country of investee company and in the country of PE/VC fund). There is a need for changes to be made so that, capital gains on cross-border investments are taxed in the country of investor. That could increase the transparency of PE/VC investments. Nowadays many PE/VC have their headquarters in tax havens opening only branch office in the country of investee company.

There is also a need of supporting small and national PE/VC funds focused on early stages of company development. Such funds that are providing smaller amounts of capital (up to 5-10 mln euro) are considered as those who influence the most the entrepreneurship and development of young and innovative companies. A tendency is to support such a funds from public sources by creating public funds that could cooperate with smaller and private ones as a fund-of-funds structure. These kinds of incentives should result in creating smaller, national funds focused on core venture capital investments and increasing the proportion of amount invested in early stages of company development.

6 Conclusion

CEE region is relatively small market for PE/VC investment. There is still a lot to do to support the development of PE/VC market that is recognized by many advanced countries as a good catalyst of economic growth and innovation. In fact, PE/VC funds have contributed to establishing hundreds companies providing them billions euro, knowledge and experience. Many PE/VC funds find a great opportunity in investing in CEE region. The companies of the region can be a good way for diversification of investment portfolio.

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[2] EVCA, *Central and Eastern Europe Statistics 2008*, An EVCA Special Paper, Brussels, July 2009, pp.5-6.
[3] EVCA Yearbook 2009, pp. 29-30.
[4] NEW CONNECT, http://www.newconnect.pl