THE BLEYZER FOUNDATION

SigmaBleyzer

The Role and Benefits of Private Equity in Emerging Market Economies

Halyna Herasym, Edilberto L. Segura

April 04, 2006

TABLE OF CONTENTS

Page

Executive Summary……………………………………………………………… 3

I. What is Private Equity?... 5

II. Private Equity in the World…………………………………………………. 16

III. Economic and Social Benefits of Private Equity to Emerging Markets…….. 22

IV. Investment Opportunities in CEE Emerging Markets……………………… 31

V. Main Determinants of Private Equity Investment and
Policy Implications………………………………………………………. 37

Annex: Private Equity Glossary………………………………………………… 48

Executive Summary

It is now well documented that private equity is an important contributor to economic development, technological progress and employment in the developed world. But in emerging countries, private equity is a new asset class that faces little public understanding. In these countries, the benefits that private equity can generate for the economy are often not well understood by local businesses and state authorities, given the limited presence of private equity financiers.

In fact, in emerging markets private equity is often confused with short-term portfolio flows, which proved to be highly volatile in recent years and posed a threat to the external stability of these countries. As a result, private equity operations are not getting the support that they truly deserve and this may further restrain expansion of private equity in emerging countries.

In this report, we show that by its nature, private equity stands very close to foreign direct investment or strategic investment, as opposed to portfolio flows. Like FDI, private equity is a longer-term and transformational investment strategy. Broadly speaking, it may be defined as investment in equity through direct negotiations. The majority of private equity investments are made in unquoted companies. Investors make a return on their investment by enhancing and then realizing the value they build in an acquired company over the investment horizon. For this reason, private equity investors thoroughly examine the companies in which to invest, and choose the ones with high value growth prospects. They often seek to invest at least in controlling stakes to be able to influence the development of acquired companies.

To build value, private equity investors take board positions in invested companies and actively involve themselves in an ongoing process of close monitoring and assistance to the companies. They offer management support on a wide range of business issues—advice on strategy, hiring experts, adoption of new technologies and best working practices, development of new products, improving marketing policy, making new acquisitions, etc. A pro-active approach and the private equity managers’ business expertise help troubled companies revive and grow and eventually become attractive investment destinations for strategic investors.

Given its transformational and value-adding nature, private equity has an important role to play in emerging markets. The high need for extensive economic restructuring and transformation creates an environment where the potential benefits of private equity may be particularly valuable. The major gains that private equity flows are likely to generate to emerging markets are the following:

- Accumulation of private equity is likely to contribute to entrepreneurship development and private sector growth in a recipient economy through strong support provided to underperforming companies.
- The most successful private equity investors contribute to enhanced efficiency and profitability of invested enterprises. These investors are highly appreciated for the non-financial input they make to acquired businesses, in particular the transfer of best practices in doing business, strategic advice, business connections, etc. Efficiency gains achieved by invested enterprises may then spillover to other companies in the same industry and to related and unrelated firms.
- Private equity contributes to increased competitiveness of targeted businesses at domestic and local markets.

- By improving the financial standing of invested companies and enhancing their position on the market, private equity may stimulate (and most often does) strategic investors to take over the companies, when the private equity investor decides to exit from the investment.
- Private equity is likely to play a positive social role in a recipient economy, which is reflected in the contribution made to employment, human capital formation and greater tax and social payments to public coffers by private equity-backed companies.

A separate section of this report is devoted to Central and Eastern European (CEE) countries, which have received increased attention from western private equity investors following the EU enlargement in 2004 and a number of exceptionally successful exits in recent years. We believe that this attention will continue to grow, and the resulting greater presence of private equity financiers in the region will be beneficial to both providers and users of private equity capital.

CEE countries possess a number of features that make them a particularly attractive destination for private equity investments. These fast-growing economies have made substantial progress in economic restructuring, deregulation of the business environment, and market liberalization. Governments of CEE countries have made major steps towards harmonizing their legal, regulatory and fiscal frameworks with EU standards. In addition, these countries possess a highly educated and skilled labor force that demands relatively low wages. Finally, the existence of inefficiently run companies provides significant opportunity for value creation through improved operations, marketing, finance, customer and quality focus – bottom line growth. Although the reform agenda in Eastern Europe is still largely unfinished, the overall risks and costs of doing business in the region have been substantially reduced. All of these positive factors, combined with the growth and value adding opportunities available in CEE economies make the region a particularly promising place for private equity.

The West should also be quite interested in larger private equity investments in the CEE economies since their higher economic growth and their closer integration to the West will contribute to enhanced political and economic stability in Eastern Europe. This will increase the security of all of Europe.

I. What is Private Equity?

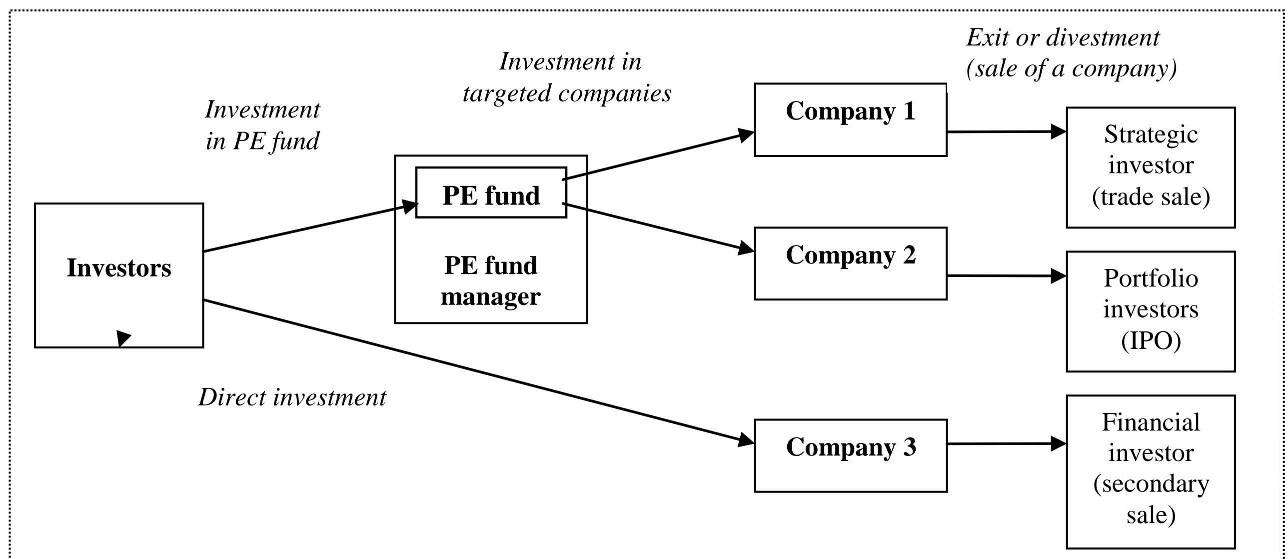
Definition

In broad terms, private equity refers to equity investments in companies not listed on a public stock market. In other words, private equity investors target **unquoted, privately-held companies** and provide capital to their owners in exchange for a controlling equity stake in the company. As opposed to "portfolio" investors, whose strategies are "buy cheap and sell expensive," private equity financiers seek to produce high returns within a specified period of time by implementing well-defined actions that will generate substantial growth in the value of the invested company. According to this "value-adding" strategy, private equity investors pick their targets among companies that are projected to show high growth rates and performance improvements, should they obtain the right management and financial support and assistance. Therefore, a distinctive feature of private equity investors is that they usually choose to take an active role in business development and provide both financial and various non-financial input for the development of the acquired enterprises.

How Does Private Equity Work?

Institutional and individual investors intending to invest in private equity can choose between investing directly in targeted companies (with no intermediary involved) or alternatively, co-investing via a special collective vehicle – i.e., a **private equity (PE) fund**. It is now common among investors to use the second route. A **PE fund** constitutes a professionally managed pool of capital that is raised for the sole purpose of investing in equity of unlisted companies.

Private Equity Investment Cycle



Source: European Private Equity and Venture Capital Association (EVCA), The Bleyzer Foundation

To better understand how private equity works, one needs to look at those who are involved in this activity. Three market players participate in the investment cycle:

- ***Private equity investors*** provide the capital to the private equity fund. In recent years, the range of investors in private equity has expanded rapidly. In addition to traditional financial institutions, they include various types of institutional investors (such as pension funds, endowments, foundations, insurers, investment firms, funds of funds) and high net worth individuals (normally through private/investment banks acting as their family offices.)
- The ***private equity fund manager*** (or private equity firm) acts on behalf of the private equity investors in accordance with an investment strategy agreed upon by the investors and the fund manager when the PE fund was established. The PE fund manager is responsible for identifying, structuring and managing investments in targeted enterprises and creating successful exit opportunities.
- ***Targeted companies*** are the invested companies acquired by the PE fund manager.

Direct Investment in Private Equity versus Investment in a PE Fund

Investors in private equity do not usually invest directly, but rather via a PE fund for a number of reasons. First, direct investment often requires far larger amounts of committed capital from investors and extra expenses to complete all stages of the investment. In contrast, the required capital in a PE fund is shared by a number of investors, though a minimum level of committed capital is needed.

Secondly, the success of private equity deals crucially depends on specific skills and experience in managing investments, which is different from those skills required to make investments on a public securities market. In particular, along with extensive investment analysis, private equity investments require extensive management skills and experience in business strategy, accounting, and tax and legal issues. In other words, successful private equity investors should be able to act as both financial and operating management advisors. However, very few financial investors possess this appropriate knowledge or can use it efficiently. On the other hand, private equity firms are more likely to possess the necessary skills in the field, as many of them specialize in this type of investment. In fact, most investors in private equity now consider the professionalism of PE fund managers as one of the major reasons of why they invest in PE funds, and not directly.

Finally, the overall risk of total loss of capital while investing in a PE fund is recognized to be much lower than direct investment, due to both diversification and the proven expertise of the PE fund manager.

Table 1. Direct Investment in PE vs Investment in PE Fund

Indicator	Direct investment	via PE Fund
Invested funds	Requires substantial amounts of funds for investment	Minimum level of investment may apply
Expertise and good management	Control and management over investment is concentrated in investors' hands Direct investment may require from investors considerable expertise and management skills. This may lead to higher operational expenses and may also require hiring professionals to successfully implement investments	Control and management over investment is delegated to PE fund manager. Established PE fund managers usually have a high level of expertise in private equity as they participate in a large number of investment opportunities and may specialize in the private equity field

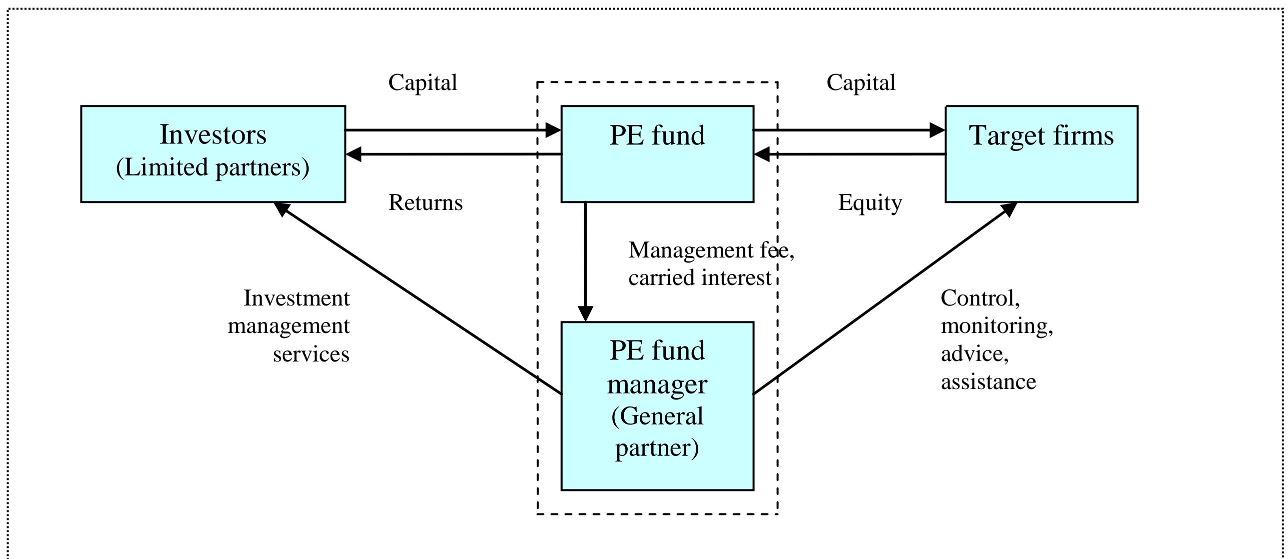
Risk	Higher risk	Lower risk

Potential Principal-Agent Problem and PE Fund Manager Remuneration

Investing through a PE fund implies delegation of control and management of the investment to a PE fund manager. Such delegation of responsibility potentially generates a negative incentive problem, also known as a principal-agent problem. That is, there is the risk that the PE fund manager may not act according to the best interest of the PE investor. The wide recognition of the possibility of this negative incentive problem has led to adoption of **a special remuneration scheme designed** for PE fund managers, which aims at aligning the interests of PE investors and the PE manager. According to this remuneration scheme, the PE fund manager participates in profit sharing and receives typically up to 20% of the profits of the fund, known as a carried interest. Carried interest becomes payable once the investors have achieved repayment of their original investment in the fund plus a defined hurdle rate[1]. To further align the interest of PE investors and PE managers, the PE fund manager is often expected to invest a significant amount of its own money in the fund, along with the other PE investors.

The PE fund manager is also entitled to a management fee that traditionally amounts to between 1.5 and 2.5 percent annually of the committed capital, according to the EVCA, but can also take other values. The management fee is used to cover the fund's operating costs.

Interrelations Between the Private Equity Industry Players



Typical Legal and Organizational Arrangements

In the private equity business, the **limited partnership** is the dominant legal form of organization. The popularity of this arrangement is mainly driven by two reasons: first, a limited liability partnership allows for limitations on the liability of investors in private equity; second, it provides tax advantages, particularly the avoidance double taxation of capital gains once the fund exits from an investment ('divestment' transaction) and once the fund returns cash to investors. Alternative forms to limited partnerships, like unit trusts and

[1] European Private Equity and Venture Capital Association (EVCA)

investment trusts, are rarely used in private equity. According to the limited partnership contract, the PE investors act as the "limited partners" (LP) providing the capital available for investments. Their liabilities are limited to the amount of their commitments. This means the LP cannot be held liable for additional damages that may be incurred at the investee company level. The PE fund manager acts as the "general partner" (GP) and is obliged to provide investment expertise and asset management services in exchange for a management fee and profit participation. The general partners of a limited partnership may be individuals, but are usually corporations or limited liability companies (LLCs), both of which limit the liability of the GPs to their invested capital. The legal responsibilities of the GP with the LPs are set forth in the limited partnership agreement or based on statute requirements. Normally, these responsibilities include the duties of loyalty, care, good faith, and fair dealing. Loyalty involves refraining from adverse dealings and from competing with the fund.

The limited partnership agreement normally provides not only for capital distributions, gains, fees and profit sharing, but also specifies the authority and discretion of the GP regarding investment decisions, including size of investments, countries and sectors eligible for investments, etc. Other provisions in typical limited partnership agreements include limitations of the liability of the GP against events such as disappointing returns for the investments, failure of the GP to invest committed funds, and mismanagement.

A PE fund limited partnership is usually formed for a contractually fixed period, most often 10 years, with a provision to be extended if necessary from 1 to 3 years.

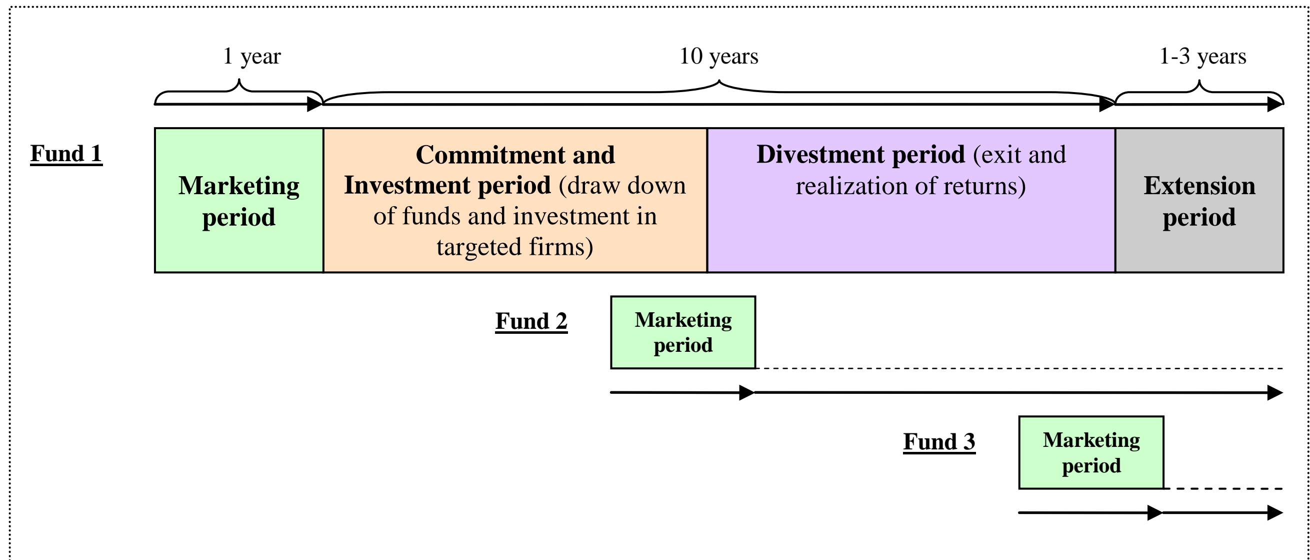
PE funds are **closed-end structures**. This structure implies that once the fund is created, it is closed to further investments from new investors or to exits by current investors. In this way, a fixed capital pool is established for investing, paying management fees and covering operational expenses.

The major characteristics of private equity funds are listed in the table below.

Features of Typical Private Equity Funds
• Collective investment vehicles. • Legal form: limited liability partnerships. • Closed-end structure. • Typically a 10-year duration, with a two-year possible extension. • Management fee to cover operational costs. • Additional incentive for fund manager: carried interest of 20% of profits realized once investors are repaid their original investments and returns at a defined hurdle rate.

Stages of a Private Equity Investment

Private equity investment is usually structured in the five main stages:



1) The "marketing period" lasts one year on average and involves identification and preliminary assessment of investment targets to develop a pipeline of projects as well as marketing efforts, including "road shows" to attract interest from limited partners.

2) The next five years is the "commitment and investment period". At the early stages of this period, the limited partners commit to invest a specified sum of money over a specified period of time. The commitment period may be comprised of one or several closings, in which investors agree to participate in the fund. When a private equity firm has decided where it would like to invest, it approaches investors to "draw down" the money already pledged to the fund. Draw downs, also known as "capital calls", are actual transfers of money to the fund. As soon as the money is transferred, the private equity firm completes negotiating, structuring and signing an investment agreement. Deal structuring involves setting forth the financial and governance aspects of investment. In particular, at this stage both sides of the deal agree on the amount of ownership acquired by partnership, the scope of the partnership's control over the enterprise, and on incentives provided to the portfolio company's management team. Once the targeted company has been acquired, the PE fund manager will normally start its active involvement in the management and control of the acquired company with the goal of increasing the company's value and preparing grounds for a successful exit from the investment.

3) The "divestment period" is normally five years, when the acquired companies are sold to third parties (exit) and returns are distributed among limited partners. Successful exits from the investments are critical to the realization of the benefits from private equity investing. The main types of divestment are: (i) trade sales, which involve selling the company to strategic investors; and (ii) initial public offerings (IPO), which involve the stock registration and sale of equity to public investors. There is also an alternative way – a secondary sale, which involves the sale of the company to financial investors, including other private equity funds. Companies that still have growth potential but are not yet ready to be sold to strategic investors or listed publicly, are usually divested via secondary sales. At present, a trade sale is regarded

as the most certain liquidation route, as it guarantees a sale of a complete stake to a recognized buyer at a negotiated fixed price. In this case, there is no concern for investors that private equity will not be realized completely or the sale will take a longer than expected time period, as might be the case with an IPO. Overall, the evidence shows that IPOs are still rare in emerging markets.

Forms of Private Equity Investments[2]

Private equity is typically segmented into two categories – "venture capital" and "buyouts" – according to the maturity of the acquired company. Often, an intermediate class of "development capital" is introduced in between these classifications.

According to the EVCA, venture capital investment can be defined as the "business of building businesses." It is investment in companies that have undeveloped or developing products or revenue. Venture capital has a particular emphasis on entrepreneurial undertakings and less mature businesses. It is normally provided for the launch, early development or expansion of a young company. In many countries, it is recognized to be an important driver of technological progress, as it is often the new companies that launch the latest products and new technology on the market.

Venture capital investment is divided into several sub-classes, according to the stage at which investment is made:

Seed stage is financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.

Start-up stage is financing for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially and will not yet be generating a profit.

Development capital involves investment in companies already in operation, with a proven product and operating cash flows.

Expansion capital is financing for growth and expansion of a company that is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital.

Replacement capital financing is purchase of shares from another investor or to reduce gearing via the refinancing of debt.

Buyouts refer to equity capital provided to more mature companies with established business plans and a proven product or service offering. According to the EVCA, a buyout fund typically targets the acquisition of a significant portion or majority control of businesses, which normally entails a change of ownership. Capital is provided to finance expansions, consolidations, turnarounds and sales, or spinouts of divisions or subsidiaries. Financing expansion through multiple acquisitions is often referred to as a "buy and build" strategy. Investment styles can vary widely, ranging from growth to value and early to late stage.

Buyouts are now the major segment in the private equity industry, by both value of invested funds and number of investment deals. In addition to straight-forward buyouts, other sub-classes include:

Management buyout is acquisition of a company by its current management team and private equity investors.

---

[2] In this section, we follow definitions provided by the EVCA.

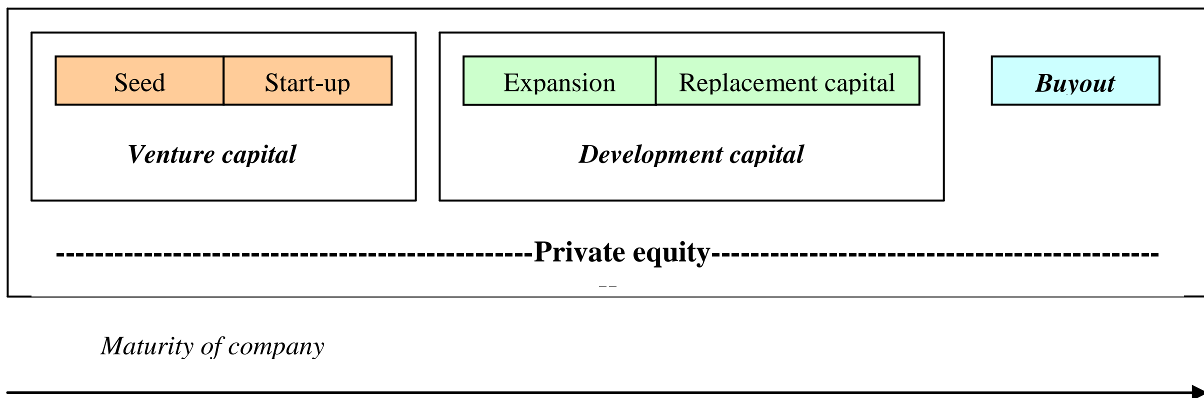
Management buy-in is very similar to a management buyout with the difference that the management team will be new to the targeted company.

Institutional buyout is the purchase of a company by private equity investors with no or very limited participation of the PE fund in the management of the company. In these transactions, senior managers are usually hired by investors to run the business on their behalf.

Leveraged buyout (LBO) is the acquisition of a company using equity as well as a significant amount of debt and/or mezzanine financing (securities with provisions in-between debt and equity, such as subordinated debt with warrants, preferred shares, etc.)

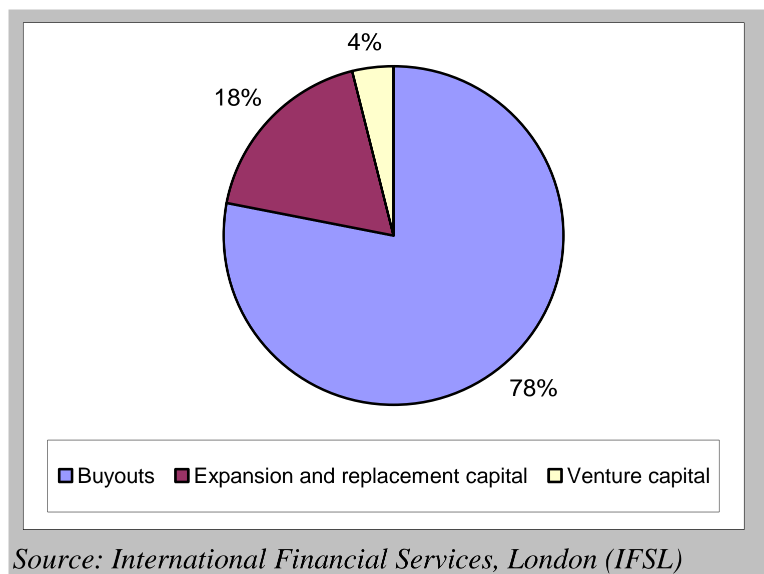
The following chart illustrates the above classification of Private Equity:

Maturity of Targeted Company and PE Financing



The chart below shows that globally, buyouts now represent about 72% of PE investments. Development capital adds another 18% of the total, with venture capital representing only 4% of the total.

Distribution of Global PE Investment by Maturity of Invested Company



Source: International Financial Services, London (IFSL)

Characteristics of Private Equity Investments

Private equity has several characteristics that are unique to this investment class. Its main characteristics are as follows:

1) Private aspect of investment deal.

Investing in private equity is executed through direct negotiations between the fund manager and the targeted company's owners. This private aspect of the deal has a number of positive implications. Unlike public securities trading, private negotiations allow the sides to reach a more flexible arrangement, with investment terms more precisely specified to satisfy the needs of both company and investors. Second, private equity investment managers are usually exposed to wider and more detailed information on a targeted company's performance (including 'insider information'), as opposed to the information available to stock market players. This greater level of data disclosure enables investors to learn more about the company they intend to invest in and helps better evaluate investment risks.

2) Low liquidity.

Liquidation or divestment of each portfolio company is dependent on the success of the fund manager in creating a sale or initial public offering (IPO) opportunity. In fact, investors in private equity are locked in to their stakes until a potential private or other financial buyer is identified or the company is floated on a stock exchange.

3) Long-term commitment required.

Private equity requires investors' long-term commitment of capital because of the lack of liquidity. Institutional and individual investors with longer than average time horizons (pension funds, insurance companies, foundations, etc) can thus expect a liquidity risk premium. This low liquidity discourages investors who search for quick profits.

4) Difficulty in determining current market value.

Because there is neither stock exchange listing nor continuous trading of the investments within a private equity portfolio, there is no direct way of determining the current market value of the portfolio. Valuations must be based on cash flow forecasts or industry rations of value to earnings or assets. The EVCA has worked out the valuation guidelines that many investors follow[3].

5) Active investor involvement in the company's development.

Extensive performance analysis and operational and financial advice to the acquired businesses are often required in order to raise the value of the acquired business and create an opportunity for profitable exit from the investment.

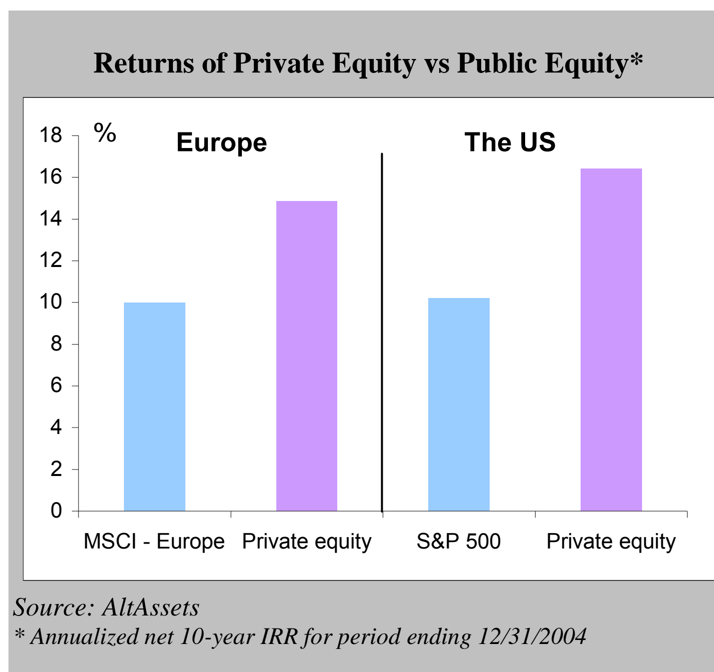
[3] http://www.evca.com/pdf/international_valutation_guidelines.pdf

Characteristics of Private Equity
• Investment in unquoted companies
• Private aspect of a deal
• Medium to long-term commitment
• Illiquid nature of investment
• Targeted at companies with high growth potential or inefficiency opportunities
• Investment in majority of shares to obtain control of the enterprise
• Finance is accompanied by extensive management, close monitoring and operating changes
• A "value-adding" investment strategy

Returns of Private Equity versus Public Equity Investments

Though a private equity investment belongs to the investment class of alternative assets, many investors choose to add it to a traditional portfolio of stocks and bonds because of the advantages private equity offers. The first advantage is the potential to enhance long-term returns. Over the medium to long term, returns from private equity have outperformed returns from publicly traded securities. However, for some short-term periods public equity performance was superior to that of private equity, which in some cases registered even negative short-term returns. Since the normal life cycle of private equity funds requires a significant time horizon to deliver returns, it is more appropriate to look at the long term when measuring private equity performance. According to calculations carried out by Alternative Assets, over the 10-year period ending December 2004, private equity investments outperformed stock indexes by about 50% both in the Europe and the USA as noted in the chart below:

Returns of Private Equity vs Public Equity*



Source: AltAssets
** Annualized net 10-year IRR for period ending 12/31/2004*

The second advantage is that private equity investments improve risk diversification, given their low price correlation with the major public stock exchange indices. Thus, adding private equity to a diversified portfolio, *ceteris paribus*, can increase returns for the same level of risk or reduce the overall portfolio risk for the same level of expected returns. It should be also noted that private equity helps secure returns over the long term, which is critical to investors with a longer than average investment horizon (like pension funds, university endowments, etc.)

It is now widely evident that private equity performance is largely influenced by the PE fund managers' performance and investment strategies pursued. Returns from private equity can be quite impressive, but not just because investors buy undervalued assets. In particular, after reviewing the performance of PE funds, Paul Rogers et al (2002)[4] of Harvard Business School reached the conclusion that the top performers' success stems chiefly from the rigor with which private equity firms manage their businesses. For each business, the top private equity performers define an investment thesis of how to make the business more valuable within three to five years. This thesis, which then guides the company's actions, most often focuses on growth and business transformations. He also concluded that successful PE fund managers are actively engaged in managing the assets of the invested companies – including mining undervalued assets, managing their fixed capital, etc. In a similar study focused on emerging markets, Roger Leeds (2000)[5] points to key value accelerating drivers that are likely to enhance private equity returns in emerging markets. These key drivers are the following:

- **The PE fund should "go local." A** greater local presence in virtually every aspect of the business is likely to reduce costs and enhance operating performance. Local market intelligence, from deal origination to exit, is likely to improve performance, as well as effective post-investment involvement.
- **The PE fund should mobilize local government support.** More effective and closer collaboration with local government and business leaders may foster changes that would enhance industry performance, such as corporate governance reform, minority shareholders rights protection, tax treatment, etc.
- **The PE fund should think about exit strategies before investing.** The issue of exit must be realistically assessed in detail before investing. If an IPO is not realistic, prospective strategic buyers must be identified, along with the auction potential.

Private equity vs Public equity

Private equity investment	Public equity investment
Investment in privately-held companies	Investment in companies listed on a stock exchange
Illiquid investment	Liquid investment
Concentrated ownership	Dispersed ownership among outside investors
Valuation is difficult	Valuation is relatively easy
Intermediaries tend to be small	Intermediaries are large
Financing is accompanied by control, monitoring	Financing is often divorced from control and

[4] Paul Rogers, Thomas P. Holland, Dan Haas. Value Acceleration: Lessons from Private Equity Masters at Harvard Business Review (2002).
[5] Roger Leeds. Private Equity in Emerging Markets. John Hopkins University (2000).

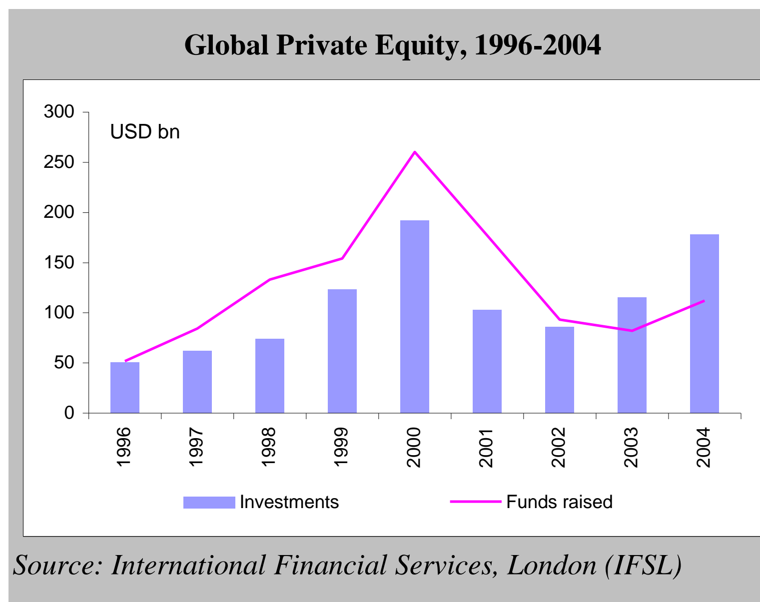
and consulting	monitoring
Close involvement of private equity investors in company's development	No inside involvement in company's development

II. Private Equity in the World

Private equity is now a well-established asset class for alternative investments in many countries. Its roots go back to the early 1940s, when the first companies providing private financing for newly-created and mature businesses were established in the US and Europe. For quite a long time, private equity firms primarily managed the funds of wealthy families and directed committed financial resources mostly to early stage companies. By the late 1980s, the industry had grown big enough to become noticeable, with institutional investors being the major players on the market. Life insurance companies, pension funds and other investors that disposed of long-term financial resources and aimed at securing returns over the longer term horizon had acknowledged the attractiveness of private equity if added to a traditional portfolio of publicly traded stocks and bonds.

Over the 1990s, the global private equity industry experienced substantial growth up to and including 2000, when a historical peak of $260 billion was raised and about $200 billion was invested. Afterwards, a decline in private equity activity occurred in 2001 and 2002, driven largely by the global economic slowdown, financial market declines, and decelerating privatization and mergers and acquisitions transactions. In 2003, a positive trend was re-established as market confidence was restored. The table below shows the evolution of private equity investments from 1996 to 2004:

Global Private Equity, 1996-2004



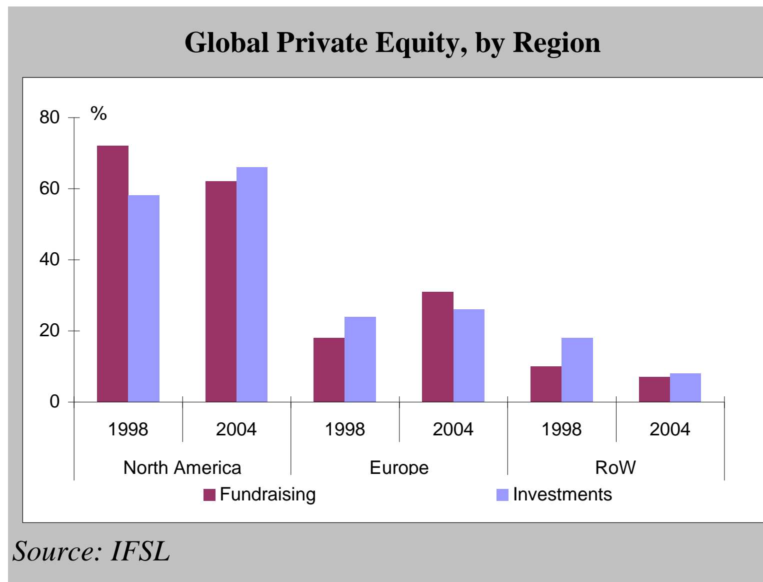
Source: International Financial Services, London (IFSL)

Private Equity Intelligence (PEI) reports that private equity funds' investments broke the 2000 record and raised about $261 billion in 2005. PEI forecasts that 2006 will remain exceptionally strong in terms of fundraising, which is expected to reach $280 billion.

By regional breakdown, North America (primarily the US) has traditionally accounted for the lion's share of all new funds raised and invested. In 2004, it contributed almost two-thirds of the global total and nearly the same share was attributable for investments in this country alone.

Europe comes next with a 26% share of global investments and a 31% share of global funds raised by the end of 2004, as reported by IFSL. The chart below shows the breakdown of private equity investments by region, both in 1998 and 2004.

Global Private Equity, by Region



Source: IFSL

In terms of relative size of private equity investments in relation to GDP, the table below shows that North America also exhibits the largest share of private equity, at 9.1% of GDP. Western Europe has almost matched the US at 7.8% of GDP. By contrast, the penetration of private equity fundraising in the emerging markets of Asia, Eastern Europe, South America and Africa is only about one-tenth of that in Europe and North America, showing the large potential for the private equity market that exists in these regions.

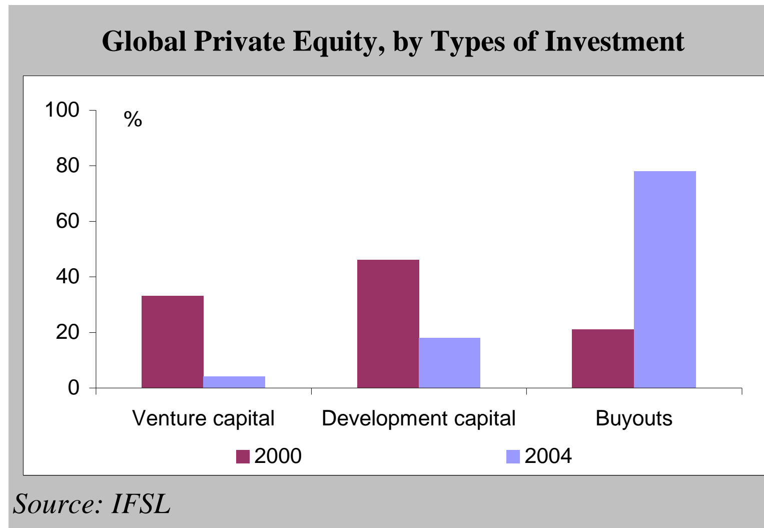
Global Private Equity as a Percentage of GDP, by Region

Region	*Private equity funds raised in 2005, $ billion*	*$ billion of PE funds raised per $ trillion of GDP*
North America	111.1	9.1
Europe	76.9	7.8
Australasia	2.1	3.5
Asia	20.5	1.2
Eastern Europe	2.7	0.9
South America	0.7	0.2
Africa	0.1	0.1

Source: PEI

As noted in Chapter I, by type of investment, buyouts represent the bulk of private equity investments globally, both by number and value of deals. Moreover, the amount of funds raised for buyouts has been constantly increasing since 2000 to account for 78% of total investments in 2004, up from 21% in 2000. Venture investments declined and constituted 18% by value of total investments for expansion stage financing and 4% for seed and start-up financing. It is expected that in the coming years buyouts will continue to prevail, as most of

the private equity funds currently in operation have reported that they target considerable fractions of attracted resources exactly to buyout deals (according to surveys carried out by PEI).

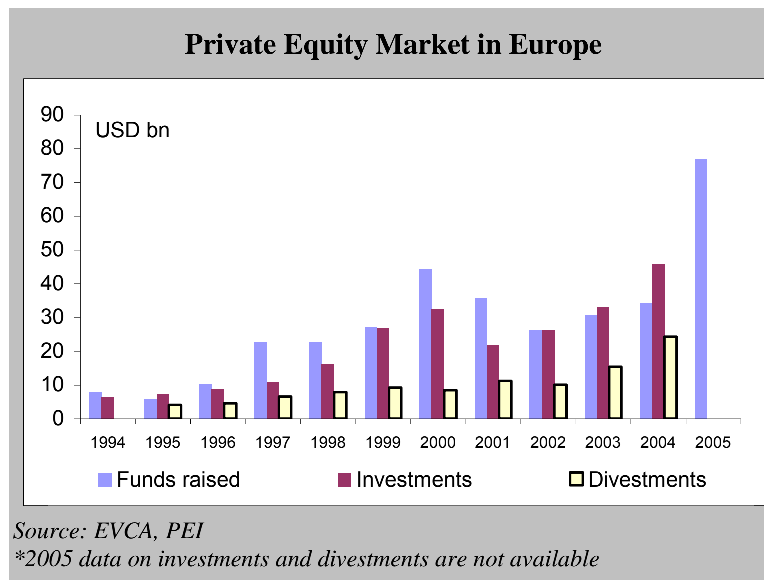


Global Private Equity, by Types of Investment

Source: IFSL

Private Equity in Western Europe

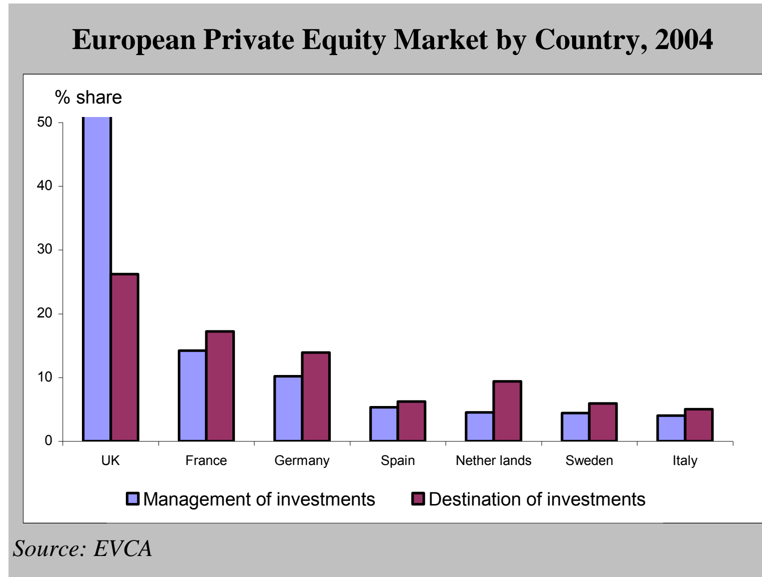
Following the global trend, private equity fundraising in Western Europe intensified in 2005, as noted in the chart below. Fund raising reported a record high of $76.9 billion last year, up from $34.2 billion in 2004.



Private Equity Market in Europe

Source: EVCA, PEI
**2005 data on investments and divestments are not available*

By country breakdown, the UK is the most important private equity market in Europe, both by volumes of fundraising and investments. In 2004, it accounted for almost one-third of total European fundraising and half of private equity investments. Sweden and the Netherlands were next in the ranking with a 13% and a 12% share in total fundraising, respectively. France, Germany, Italy and Spain together accounted for 28% of total European funds raised, whereas the rest of the countries made minor contributions.



European Private Equity Market by Country, 2004

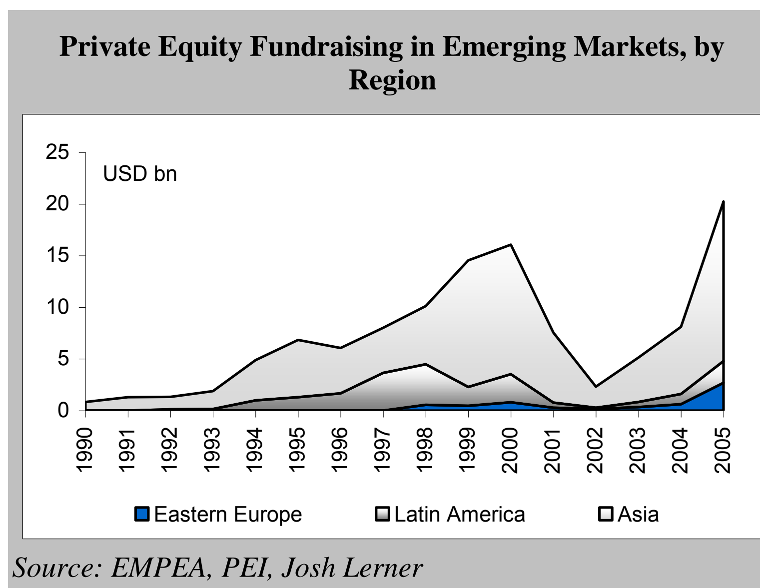
Source: EVCA

During the last five years, the structure of European fundraising by type of investor has not undergone significant changes. Banks have traditionally been the largest source of capital, contributing about one-fifth of total funds raised. Pension funds and funds of funds were next in the ranking, with respective shares in total fundraising of 20% and 14%. Capital received from insurance companies amounted to 12% of the total, while that from private individuals was only 8%.

The bulk of invested funds (70%) in Western Europe took the form of buyouts, whereas investments in expansion and early stage financing constituted 21% and 6.4% of the total, respectively. Consumer-related and high technology industries have typically received most of the private equity investments in Europe. In particular, consumer industries accounted for nearly a fifth of total investments in 2004, followed by communications (13%) and a heterogeneous 'other services' category, including engineering, consulting, distribution, retail and wholesale services (14%). The subtotal for high-tech sectors constituted 20% of the total amount invested, virtually the same level maintained over the previous 5-year period.

Emerging Market Economies

Even though private equity investments in emerging markets are relatively low, they have received increased interest from investors in recent years, as noted in the chart below:



Private Equity Fundraising in Emerging Markets, by Region

Source: EMPEA, PEI, Josh Lerner

Following a decline in 2001 and 2002, the flows of private equity to emerging countries rebounded in 2003 and continued accelerating at a high rate in the next two years, gaining primarily from a stable financing environment and improved domestic environments in many emerging countries. The pickup in private equity has also coincided with the higher-than-world-average GDP growth rates in these countries, combined with credit ratings upgrades and relieved barriers for foreign capital flows. Low interest rates and tough competition for access to leading European and North American funds have also encouraged investors to turn more attention to emerging markets private equity.

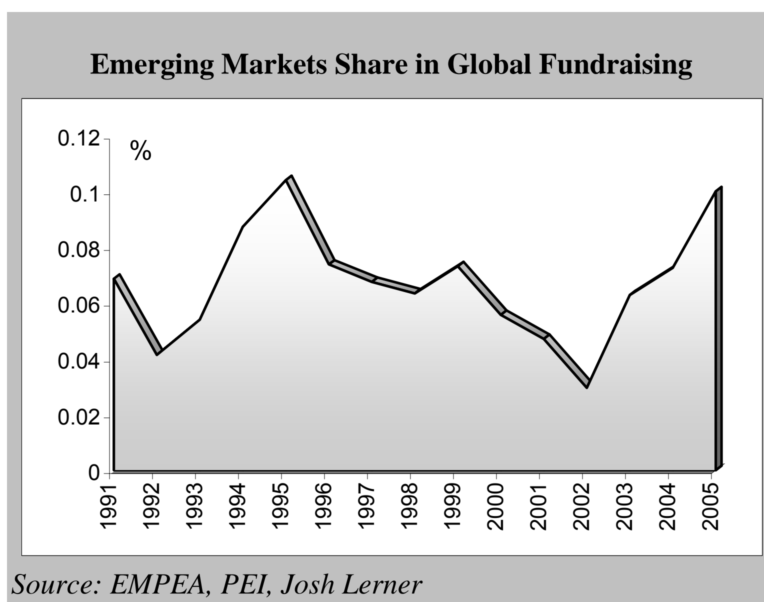
According to the Emerging Markets Private Equity Association (EMPEA), most emerging market economies reported a 50 to 100% increase in funds raised for private equity in 2004. 2005 broke the prior records and reported a preliminary 245% increase in emerging markets PE fundraising compared to the 2004 level. Both the supply of, and demand for, emerging markets private equity funds is growing strongly. The countries that have benefited the most from increased private equity flows are China, Brazil, India, Russia, and Mexico.

By regional breakdown, Asia has traditionally accounted for the bulk of private equity in emerging markets. In 2004 and 2005, it received more than 70% of total funds raised for emerging markets. Fundraising for Central and Eastern Europe and Russia picked up considerably in 2005, up to $2.7 billion from the previously reported level of $1.8 billion in 2004 (a 53% increase), and held a 13% share of total funds raised in emerging markets. Latin America followed next, with approximately $2.1 billion collected, or a 10% share.

In terms of the sources of PE financing, according to PEI, approximately two-thirds of capital being invested in emerging markets funds is coming from US and European investors.

The improvement in exit possibilities in emerging markets has also positively affected western investors' attitudes towards investing in private equity in these countries. Though the vast majority of exits are accomplished via a trade sale, IPOs and secondary sales (a sale to a private equity fund or other financial investor) are gradually becoming more viable options for investment liquidation, principally in Asia. Deepening domestic financial markets and the appearance of local institutional investors provide much stimulus for this trend. Further developments in this direction should lead to shorter holding periods and higher market valuations for investments, contributing to a more positive investor view on doing business in this part of the world.

Emerging Markets Share in Global Fundraising



Source: EMPEA, PEI, Josh Lerner

Though private equity in emerging markets experienced substantial acceleration in the last three years, the industry remains rather small. When compared to mature markets, emerging market private equity, if measured as a proportion of GDP, is only one-tenth as much as in Europe and North America. This suggests that there is large room for growth in the industry in emerging markets. Some industry surveys have indeed confirmed that an increasing number of Western private equity funds expect to increase commitments to emerging markets in the coming years. Therefore, one may expect that emerging markets will continue to grow in importance to private equity investors, providing benefits for both suppliers and users of committed capital in the asset class.

III. Economic and Social Benefits of Private Equity to Emerging Markets

Private Equity, Portfolio Investments and Foreign Direct Investments

In many emerging countries, there is poor public understanding of private equity investments and the benefits that this asset class can bring to their economies. In fact, private equity investors are often improperly blamed for seeking short-term profits and fleeing the country when difficulties arise. This is because in many countries, private equity is often confused with short-term portfolio investments.

It is true that portfolio investments have proved to be highly volatile, with large capital inflows followed by large capital outflows. These volatile flows have posed a financial threat to the external stability of many emerging countries. The relative ease with which portfolio investment can enter the country and exit, should investor perception change, has contributed to a growing instability all over the world. Following negative experiences with portfolio capital flows during the Mexico crisis in 1994, the East Asian crisis in 1997, and the Russian crisis of 1998, many emerging countries have imposed some restraints on portfolio flows.

On the other hand, most nations do welcome Foreign Direct Investment (FDI) flows, which are considered long term and stable sources of finance. More importantly, FDI is highly valued for its positive non-financial input provided to a recipient country in the form of enhanced corporate governance, new technologies and western standards. FDI is carried out by "strategic investors," since it involves financing of local productive enterprises of which they have management control. However, it is also evident that flows of foreign direct investments have been highly concentrated in a limited number of countries in Asia and Latin America. In fact, in 2005 four countries (China, Mexico, Brazil, and Chile) together accounted for about 60% of the total net FDI to the developing world. China alone accounted for one-third of the total net flows. This conclusion remains true if estimates are further adjusted by the size of the economy of these countries. The uneven distribution of FDI across regions and countries may indicate that strategic investors may be in a "wait-and-see" position towards investing in countries that are less advanced or less familiar to them, or that have a difficult business and legal environment. It is in this latter group of companies that private equity investments can be very beneficial.

By its very nature, private equity stands much closer to foreign direct investment than to portfolio capital. Like foreign direct investments, private equity is a medium to long-term strategy-oriented investment that aims to transform underperforming companies into growing and profitable businesses. Upon exit, these transformed and more profitable enterprises could be of interest to strategic investors. Therefore, private equity investment acts as a bridge between portfolio investors and strategic investors.

Benefits of Private Equity

There is ample evidence that private equity investments have yielded substantial benefits to developed countries. In these developed countries, private equity has been well-recognized as a source of economic growth, technological progress and employment. Europe in particular has been encouraging these investments, as they have seen the benefits that private equity has generated in the US and the UK. In contrast, in developing countries and emerging market

economies, gains provided by private equity are less understood. However, the ultimate benefits of private equity investments may be even more profound in developing economies, as the positive impact on invested enterprises may have a spillover and demonstration effect on other firms in the same industry, as well as on companies in related and unrelated sectors.

The major benefits private equity investment is likely to bring to a recipient country are the following:

- Private equity investments provide solid support to **entrepreneurship and private sector development** in a recipient country. They help to illustrate techniques that can be used to restore the health of businesses. They may also help in encouraging the government to undertake reforms that would improve the country's investment climate. They help newly created firms to start up and grow and more mature companies to develop into profitable and highly-competitive businesses.
- To raise the value of targeted companies and create favorable exit opportunities, private equity investors implement value creating strategies, which usually focus on improving the financial results of these companies. Investors in private equity provide both financial and various non-financial input, thereby contributing to **enhanced efficiency and higher profitability** of invested firms.
- Private equity **improves the competitiveness** of companies both on domestic and international markets, which is reflected in higher exports and sales revenues reported by private equity-backed firms.
- When private equity firms look for exit opportunities, they often attract **a strategic investor** to take over a divested enterprise. Indeed, private equity-backed companies are regarded as much more attractive destinations for strategic investment than they were prior to private equity investors' involvement.
- **Social benefits** of private equity investment to recipient states relate to job creation, human capital enhancement and the higher tax and social contributions allocated to public coffers by private equity-backed companies.

I. Private equity spurs entrepreneurship development

> "In times when it becomes more and more complicated to get bank loans, private equity turns out to be the essential if not even saving alternative. Many companies would not have been founded or reorganized or have found successors if it had not been for private equity"[6]

It is now well documented that a strong private sector is conducive to job creation and economic growth. Governments in many countries have undertaken major efforts to create an enabling business environment and encourage creation of new enterprises and growth of existing businesses. In emerging market economies, strong private sectors are likely to help to successfully complete economic restructuring and transition to market economies. However, opportunities for private sector expansion in developing countries are limited,

[6] "German Companies Widely Benefit from Private Equity" in German Private Equity and Venture Capital Association e.V. (BVK) and PricewaterhouseCoopers common study on The Economic Impact of Private Equity Firms on Portfolio Companies and the German Economy

given underdevelopment of capital markets and restricted access to financial resources. Hence, state authorities that aim to promote private sector growth and economic restructuring should be interested in attracting alternative sources of stable financing and entrepreneurial ability.

The most obvious positive effect of private equity to recipient countries is the strong support it provides to invested enterprises at different stages of development. Although involvement of private equity investors usually implies loss of (or partial loss of) ownership and/or control over the enterprise by its current owners, sometimes it may turn out to be the only viable option to secure business operations and preserve jobs. In fact, owners of poorly run and underperforming businesses often seek to attract private equity investors to take part in ownership and provide their expertise and assistance to enhance performance of these companies. According to results of pan-European surveys[7], managers of private equity-backed companies usually respond that without the contribution of private equity, their companies would either have never come into existence, would have failed to survive, or would have limited growth prospects.

The case study below on Sevastopol Shipyard provides a good example of how private equity contributed to a company's development, as well as to the local community.

Case Study: Sevastopol Shipyard (Ukraine)

PE Investor:
SigmaBleyzer
Sector:
Shipbuilding
Portfolio company:
Sevastopol Shipyard (SSY)
Investment type:
Buyout

Following comprehensive restructuring, SSY developed into a highly-efficient and profitable business, oriented at customers' needs.

SigmaBleyzer acquired relative control (and the largest stake) of SSY in 1998, when it increased its previous holding to 47.4 percent. It acquired an additional 2.8 percent the following year, bringing its total to 50.2 percent. Prior to this, the Ukrainian government was the majority owner and manager of the company, which for most of its pre-privatization history catered mainly to the military, producing and repairing military vessels. At that time, SSY was comprised of 39 separate companies and was a highly inefficient structure, which led to misallocation and misuse of resources, an extra value-added tax (VAT) burden, and general chaos. When military ship-repair contracts were suspended, since both Russia and Ukraine lacked sufficient resources to pay for such repairs, SSY failed to find commercial orders. The company was in crisis and desperately needed restructuring.

After the company was acquired, a team of western experts was invited to provide recommendations on how to improve and restructure the company. A business plan was developed to reorganize the company into five key profit centers. New controls were put into place to gain a handle on the business. A strategic decision was made to focus on ship repair and the port, and to abandon floating cranes (because of high capital outlays and low demand). The company began to focus on customer needs – pricing, delivery time, quality, and services – which it had previously ignored. With the help

[7] See results of the pan-European Surveys of the Economic and Social Impact of Venture Capital in Europe (2002), and of Management Buyouts and Buyins in Europe (2001) performed on behalf of the European Private Equity and Venture Capital Association (EVCA).

of international experts, best practices of Western shipyards were adopted for use at SSY. As a result, revenues had increased 98% by 2001, net income reached $1.7 million, port volumes increased over 400%, the number of commercial ships grew from 7 to 47, and debts (salary, payments to the government, and social insurance) decreased from $7.91 million to $1.44 million (table A below). Without these changes, the company would most likely have gone bankrupt.

These changes not only improved the overall condition of the company, they also helped city employees and residents. The city and central government received nearly $6.5 million in back payments, and profit tax payments increased by about 75%. From 1997 to 2001, average salaries doubled, exceeding the average for the city of Sevastopol by more than 50%. Also, the existence of about 350 small and medium-sized businesses is now directly linked to SSY's success and improvement, as these companies can now serve other companies too (in Sevastopol or shipyards elsewhere). They provide products or services that the Shipyard uses to meet its clients' needs. This generates a greater tax base for the city, more employed citizens, less expenditure on social services, and an overall increase in consumer spending.

Table A. Ukraine: Key data for Sevastopol Shipyard, 1996-2004

Item	1996	1997	1998	1999	2000	2001	2002	2003	2004
Net sales (millions of dollars)	9.40	12.70	12.81	11.28	14.62	18.06	23.15	27.87	33.48
Net income (millions of dollars)	-1.50	-0.80	0.80	0.76	0.52	1.70	0.55	1.65	2.29
Port Cargo Loaded (tons)	n.a.	176	146	263	705	790	n/a	n/a	n/a
Ships Repaired	n.a.	7	8	25	44	47	43	59	42[8]

Source: Sevastopol Shipyard Company

II. Private equity enhances efficiency of invested companies and creates a platform for them to grow

The entire private equity business is about securing profitable exits from the fund's investments by enhancing the growth of the values of the acquired companies. Private equity firms invest in enterprises in order to sell them in five to seven years for a multiple of what they initially paid for them. The search for "value-adding" opportunities by private equity firms influences their two major decisions made at the pre-investment stage.

The first is the identification of appropriate investment target – a company in which to invest. The targets are normally chosen among firms with high growth prospects. These may include newly-created companies lacking clear development strategies or appropriate means for growth, or firms already in operation, whose development is hampered by operational inefficiencies, lack of finance or poor management. The private equity targets may be profitable and well-performing businesses that look for possibilities to launch new products or service lines, enter new markets or make new acquisitions.

The second decision made by private equity investors relates to the size of the share to be acquired. Private equity firms normally seek to invest in at least a controlling equity stake to be able to control and influence the development of a business.

The strong willingness and ability of private equity investors to add value to the acquired companies make them good partners for the acquired businesses; this is a major characteristic distinguishing this type of financier from portfolio investors. Private equity investors direct their efforts toward identifying and eliminating inefficiencies in a company's performance,

[8] Though the number of ships repaired was 42 in 2004, which is less compared to the previous year, the volume of orders increased significantly.

expanding current business activities, developing new products, or making acquisitions. Along with financial advice and additional capital, private equity investors are prepared to commit valuable non-financial input, which supports the growth of the company. This non-financial input generally takes different forms, depending on the "growth" strategy developed for company:

- strategic advice, including advice on restructuring, new product and service development, further acquisitions, re-orientation, etc.
- endowment with new and more efficient technologies and transfer of innovations and know-how in different areas, including production, marketing, management, etc.
- assistance in entering new markets
- networking opportunities and business connections
- providing credibility, support in acquiring bank loans
- search for skilled professional staff
- improved organization and management policy
- enhanced corporate governance
- access to key market information

Therefore, aimed at raising the invested company's value, private equity investors provide extensive assistance to management in various areas. Ultimately, they contribute to greater efficiency and improved financial standing of acquired businesses. Efficiency gains achieved at private equity-backed enterprises may then spillover to other firms in the same industry, related and unrelated firms, via transfer of more efficient technologies and business practices.

The case study below on Romania's Brewery Holdings illustrates this role by private equity.

Case Study: Brewery Holdings (Romania)

PE Investor:
Brewery Holdings Limited (controlled by Advent International and Jupiter Asset Management)
Sector:
Brewing
Portfolio company:
Brewery Holdings Group (original investment in Miercurea Ciuc)
Investment type:
Development capital
Exit way:
Trade sale to BBAG (Austria)
Holding period:
5 years

With private equity funding and outside investors' hands-on assistance, this regional brewery was able to develop into a fast-growing and highly competitive market-leader. Its two brands entered the list of the top five beer brands in Romania.

In 1996, Advent International and Jupiter Asset Management set up Brewery Holdings to acquire Miercurea Ciuc, a regional Romanian beer producer and distributor, which was originally privatized via the sale of the

business to its employees and management. At that time, the Romanian brewery industry was highly fragmented, with a large number of beer producers operating on a regional level. Private equity investors identified prospects to develop a company with then less than 5% market share into a leader on the Romanian beer market.

Following the acquisition, Ciuc's production facilities were upgraded and expanded. Also, a new marketing program was put in place and distribution capabilities were expanded to create a national presence. In 1998, Brewery Holdings Group acquired two more breweries and increased its market share to 14%. On the management side, private equity investors invited a group of western CEOs to work with the existing management team, which contributed to knowledge transfer and adoption of western working standards. Overall investment in the operations of the group during these years exceeded $35 million.

By 2000, Brewery Holdings was comprised of three breweries and controlled 20% of the market, while its two brands, Ciuc and Gambrinus, achieved national recognition and entered the list of top five beer brands in Romania. In 2000, Brewery Holdings Group was acquired in an auction by a strategic investor, BBAG AG of Austria, itself the number two player in the market.

Source: Advent International (www.adventinternational.ro)

III. Private equity raises competitiveness

Private equity investors' efforts to raise efficiency and reduce costs in targeted enterprises, as well as their extensive assistance in developing new products and expanding business activity contribute to a strengthened position of the companies on domestic and external markets. This translates into the above-average growth rates of exports and sales revenues typically reported by private equity-backed companies.

According to EVCA pan-European surveys (footnote 2), the companies in the survey usually report an improved competitive position in terms of both market share and generated profits, following the involvement of private equity.

Case Study: Poltava Confectionary (Ukraine)

PE Investor:
SigmaBleyzer
Sector:
Confectionary/Candy
Portfolio company:
Poltava Confectionary
Investment type:
Buyout

Following comprehensive restructuring and expansion, Poltava Confectionary developed into a highly-efficient and profitable business, with significant export revenues.

Poltava Confectionery was established in 1924 and was privatized in the early 1990's. In 1999, SigmaBleyzer originally purchased a 26% stake from the company's largest private shareholder. SigmaBleyzer then invested additional funds to build a new factory. This additional investment provided the PE fund with a controlling interest of 76%. This investment allowed the company to

increase its production capacity from 23,000 tons/year to 110,000 tons/year. It also enabled it to produce over 400 types of candy and sweets. The new investment allowed the company to expand its sales network and to seek export markets. In fact, SigmaBleyzer steered the company into exporting a larger share of its production. Export now accounts for about 40% of total sales, principally to Russia, Estonia, Moldova, and Kazakhstan.

The new investments allowed the company to improve its competitive market positioning. The company had initially focused on providing products to the lower income segment of the local market, which was largely hard biscuits. The new investment gave an additional opportunity to diversify to higher end products such as chocolate, as well as to modernize facilities to produce better quality cheaper products. The growth rate that the company demonstrated since 1999 was due, among other factors, to the company's new focus. The company also established a new brand, Dominik, which helped drive up sales. Consultants were brought in from Switzerland and Italy to help improve recipes and the overall quality of chocolate and biscuits. The increased quality has since further improved the perception of the company's products in the market place. These factors were also critical to expanding export sales.

SigmaBleyzer's participation in the activities of Poltava Confectionery allowed the company to start widening its production capacities, refocus its product lines, and build one of the most modern confectionery factories in Eastern Europe, which meets all European quality standards.

Annual company sales increased by over 400% since 1999 to US$60 million at present, converting Poltava Confectionery to one of the largest confectionery companies in Ukraine by sales volume. Poltava has outperformed the largest Ukrainian confectionery companies in profitability in relative terms. Currently, there are several exit opportunities to either Western or Russian strategic investors.

IV. Private equity stimulates entry of strategic investors

A private equity fund may play an important role in stimulating entry of strategic investors to the sectors and economies that beforehand were not treated as attractive investment destinations. In these particular sectors and economies, **private equity could come first and, by restructuring poorly run and underperforming enterprises, make them more desirable for industrial owners** when private equity investors decide to exit. PE is also better at consolidating a fragmented industry to create one attractive player.

In fact, a trade sale or a sale to an industrial owner is the most popular and the most viable exit route in emerging markets. As opposed to public trading, a sale to a strategic investor is also regarded as one of the most certain routes among investors, as it allows selling a complete equity stake to an identified buyer at a predetermined price.

On the other hand, strategic investors consider possibilities for increasing the market shares of their businesses through making acquisitions. Often, they target competing firms or firms supplying complementary products or service lines. They may also look for acquisitions of companies producing inputs that are used in the course of their core businesses. Companies at early stages of development and underperforming firms may be of no interest to strategic investors, yet they may appear to be good candidates for private equity investment.

Case Study: Comp Rzeszow (Poland)

PE Investor:
Enterprise Investors
Sector:
Software development
Portfolio company:
Comp Rzeszow S.A.
Investment type:
Expansion capital
Exit way:
Public offering
Holding period:
6 years

By focusing on new product development and market share expansion, a private equity investor helped a small IT Polish company become the number two player on the local market.

At the pre-investment stage, Comp Rzeszow S.A. was a small but already growing provider of banking software in Poland. It was 50% owned by Comp S. A., a leading Unix-based IT systems integrator, which became interested in the extensive experience of Polish private equity firm, Enterprise Investors, in IT and company development know-how. In 1999, the Polish Enterprise Fund LP, managed by Enterprise Investors, provided $5.2 million in expansion capital to acquire a 55% stake in the company. Additional capital was then provided to develop new products (transactions systems, electronic banking, data warehousing, and outsourcing) and make new acquisitions (a stake in Asset Soft, the largest software producer in Slovakia). As a result, Comp Rzeszow started to develop rapidly and substantially improved its financial results. From 1998 to 2003, its sales and net profit increased dramatically – almost fourfold. Its market shares increased to 17% of the total banking sector, 35% of cooperative banks, and 45% of small and medium-sized banks.

In 2004, Enterprise Investors fully exited its 55% stake in Comp Rzeszow, at that time the number two domestic software producer for the Polish banking sector, in an IPO on the Warsaw Stock Exchange (WSE). The exit was very successful, with 10 times oversubscribed offerings, a 7.3x investment multiple and net proceeds of $37.7 million. Comp Rzeszow attracted the interest of a strategic investor, Softbank, which acquired a 17% stake in the company.

Source: Enterprise Investors (www.ei.com.pl)

V. Social role of private equity

Overall, private equity investment is now widely recognized to generate a positive effect on employment in recipient economies. In particular, by reanimating companies that face financial difficulties and underperforming firms, private equity investors play an important role in **job preservation**. At the same time, private equity (particularly venture capital) has proved to be an important source of **job creation**. In the EU-25, the rate of employment growth in private equity-backed companies exceeded the average annual growth rate of total European employment from 1997 to 2004 by forty times (30.5% against 0.7%)[9]. Overall,

[9] Research Paper on Employment Contribution of Private Equity and Venture Capital in Europe performed on behalf of the European Private Equity and Venture Capital Association (EVCA) (November 2005).

private equity-backed companies in Europe employed close to 6 million people in 2004, which is 3% of the whole economically active population. Out of these, 5 million people worked for buyout companies, while the rest for venture-backed enterprises.

It should also be noted that private equity-backed firms tend to **increase the level of qualification of their employees.** According to EVCA data, 92% of the private-equity backed companies in its sample are committed to training and on-the-job education of their employees, which is significantly above the EU-25 average estimated at 61%.

Apart from encouraging employment effects, private equity contributes to larger profit tax payments and social contributions made by portfolio companies to local and state budgets and social funds.

IV. Investment Opportunities in CEE Emerging Markets

A good number of successful exits from private equity deals achieved in Central and Eastern Europe (CEE) over recent years and the 2004 EU enlargement have contributed significantly to increased investor interest in doing business in the region. As reported by the European Private Equity and Venture Capital Association (EVCA), both fundraising for PE deals and investment levels picked up dramatically in CEE countries over the past few years.

The CEE Private Equity Market

Private equity is becoming an important part of capital markets in Central and Eastern Europe, though it constitutes a relatively new asset class and source of financing in the region. The first fundraising and investment activity in CEE countries took place in the early 1990s, following the fall of communism and the beginning of the transition from planned to market economies. At that time, private equity investment in the region was regarded by western investors as a particularly risky business, due to the unstable political and economic situation in these states and lack of investor confidence in the coming turnaround. Most deals that were completed in the early 1990s were privatizations of state-owned enterprises – inefficient and undervalued assets. Following a decade of economic and regulatory reforms and industrial restructuring, only the late 1990s and 2004 and 2005 saw intensification of private equity flows to the region.

According to the Emerging Markets Private Equity Association (EMPEA), between 1990 and 2005 about $11.7 billion was raised for private equity investments in Eastern European countries. Since 1996, about $9.5 billion was raised by PE funds in about 170 separate operations.

Fundraising for Private Equity Investments in Eastern Europe, $ billion (1996-2005)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Funds raised	0.57	0.38	0.96	1.1	0.7	0.37	0.6	0.35	1.78	2.71

Source: EMPEA

A dramatic pick up in fundraising for Eastern Europe was reported in 2004, when eight countries[10] in the region joined the European Union. The EU accession process and related obligations of candidate countries to harmonize their legal, regulatory, administrative and economic policies with EU standards contributed to a growing interest by foreign investors in doing business in the region. Macroeconomic stabilization, market liberalization and an improving business environment – all were conducive to increased flows of private capital to these economies.

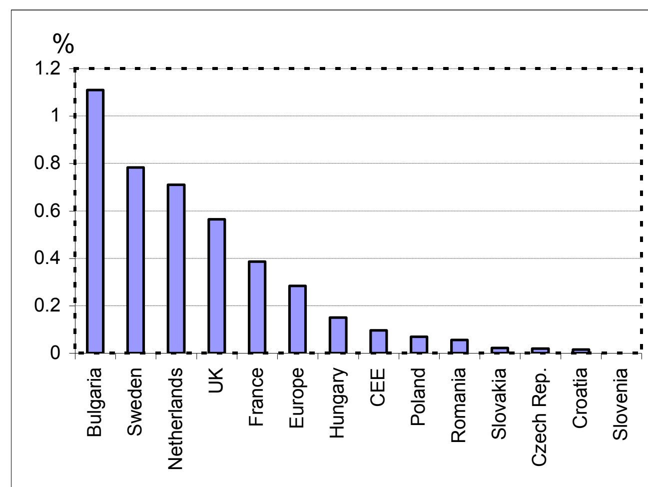
With regard to capital origin, institutional investors from North America and Western Europe were the major sources of private equity to CEE countries. In 2004, they contributed more than 85% of total annual fundraising volumes in the region. In contrast, 50% of capital is financed from domestic sources in Western Europe. Domestic financiers are expected to gradually strengthen their role on the CEE private equity market, since the continued financial sector development and pension system reforms in these countries will help local investors.

[10] The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia

On the investment side, the EVCA reports that investments in private equity of CEE companies totaled about Euro 5 billion over the past 15 years. These funds have been targeted to more than 900 companies in the region. Relative to GDP, the volume of total investments in the region is modest, about 0.09% of total GDP, which is meager compared to indicators for European countries with developed private equity markets (0.56% for the UK, 0.78% for Sweden, 0.71% for the Netherlands.)

Private equity investments in the region have been largely concentrated in several core countries – Poland, Hungary, the Czech Republic, Slovakia, Romania, and Bulgaria, as noted in the chart below.

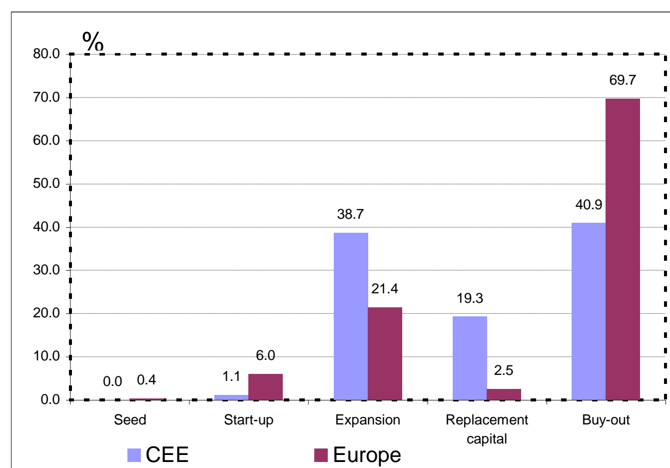
Private Equity Investment in 2004, % GDP



Source: EVCA

By maturity of invested companies, the bulk of investments in CEE countries typically goes to buyouts, expansion and replacement capital. In 2004, these types of private equity together accounted for more than 95% of total investments in the region. The reason behind this striking prevalence of later-stage investment is obvious – the availability of large stock of underperforming and inefficient companies with high growth prospects in CEE countries. Start-up and seed financing is insignificant in the region both by volume of invested capital and number of deals completed.

Forms of Private Equity Investment in 2004, % total



Source: EVCA

The major recipient industries of private equity in CEE states are the ones with the following characteristics:

- industries that are expected to experience rapid growth based on increasing consumer demand (consumer businesses, such as food and beverages, services, etc.)
- industries with non-satiated markets (financial sector)
- industries that launch new types of products (telecommunications, media, pharmaceuticals, etc.)
- highly-fragmented industries, which provide opportunities for consolidation.

By 2005, approximately 400 exits were completed in Central and Eastern Europe. The major exit routes were trade sales (sale to industrial owner) and sales to management. IPOs remain a limited divestment opportunity in most CEE countries. The majority of IPOs took place in Poland, where listing on the Warsaw Stock Exchange proved to be a viable option for private equity investors to sell their portfolio businesses. The EVCA reports that a number of exits were achieved on international stock exchanges, including Prague, NASDAQ and the Vienna Stock Exchange.

According to the EBRD and Cambridge Associates, CEE has become one of the best performing private equity regions in the world over recent years. Following an average 40% net return reported in 2004, the EBRD declared an estimated 55% net 1-year IRR from its private equity fund investments in 2005.

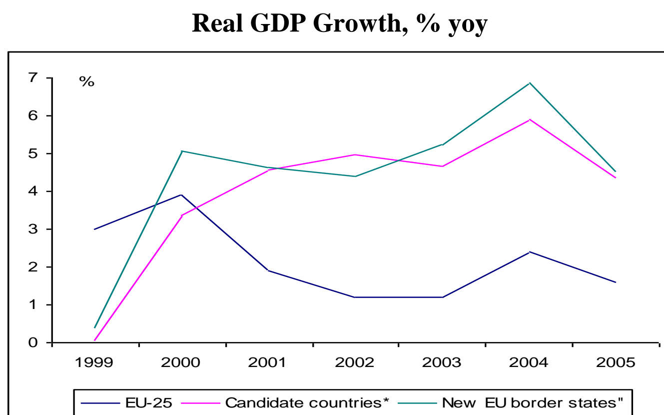
Prospects for future growth of PE investments in EEC

On the eve of the second wave of EU enlargement in 2007 and 2008, three candidate countries (Romania, Bulgaria and Croatia) and the new European Union border countries (Ukraine, Albania, Bosnia and Herzegovina, Macedonia, Moldova, Serbia and Montenegro) should be of particular interest to financial institutions and investors in Europe. The reasons for this greater interest stem from the characteristics of these countries, which are discussed below:

1. High Macroeconomic Growth Prospects

In the last few years, the EU border countries to the east have been among the fastest-growing economies in Europe, despite political turmoil in some of them. Over 2004-2005, the average annual growth rate in these economies exceeded 5%, compared to 2% recorded for EU-25. Growing private consumption (driven by rising incomes and strengthening banking systems) was the main contributor to GDP growth in the region. In the coming years, economic growth is expected to maintain these high rates and investment should play a stronger role. The recent significant inflows of long-term foreign direct investment should start translating into growing

Real GDP Growth, % yoy

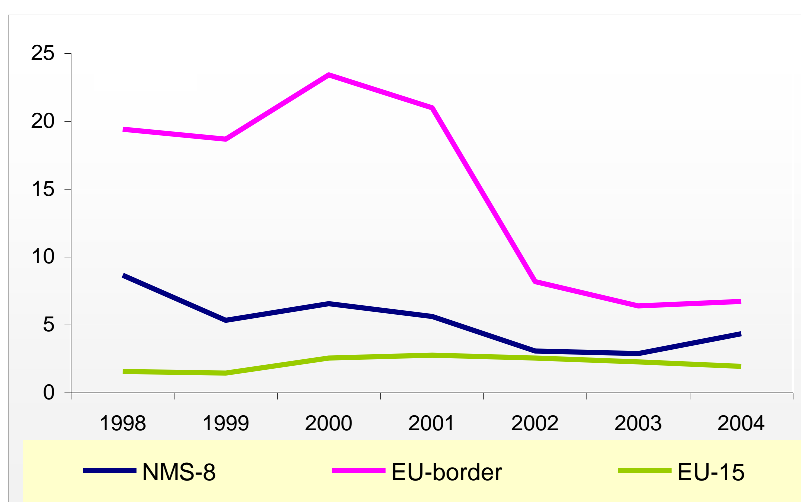


Source: Eurostat, IMF, The Bleyzer Foundation
* Bulgaria, Croatia, Romania
“ Albania, Bosnia and Herzegovina, Macedonia, Moldova, Serbia and Montenegro, Ukraine

industrial production and should therefore contribute to sustainable economic development in the coming years.

2. Good Macroeconomic Stability

Over the past few years, macroeconomic conditions in Eastern Europe have generally been stable. More importantly, the expectation of continued macroeconomic stability in the region is steadily improving, which is reflected in rising investment inflows. Most CEE countries featured relative price stability in 2004-2005 (except for Ukraine, Moldova and Serbia). In some economies, inflation accelerated slightly, driven primarily by administrative price adjustments and rising energy prices, but still remained below 5% yoy in 2005. In fact, over the last few years, the average annual inflation in the eight EU New Member States (NMS-8) and the EU Border Countries has been going down to EU levels, as noted in the chart below.



Source: Eurostat, IMF, The Bleyzer Foundation

Most countries in the region have succeeded in fiscal consolidation and posted balanced or near-balanced budgets last year. Some of the states, in particular Romania and Bulgaria, have lowered their corporate tax rates and have in this way demonstrated their willingness to stimulate business activity and attract more investments.

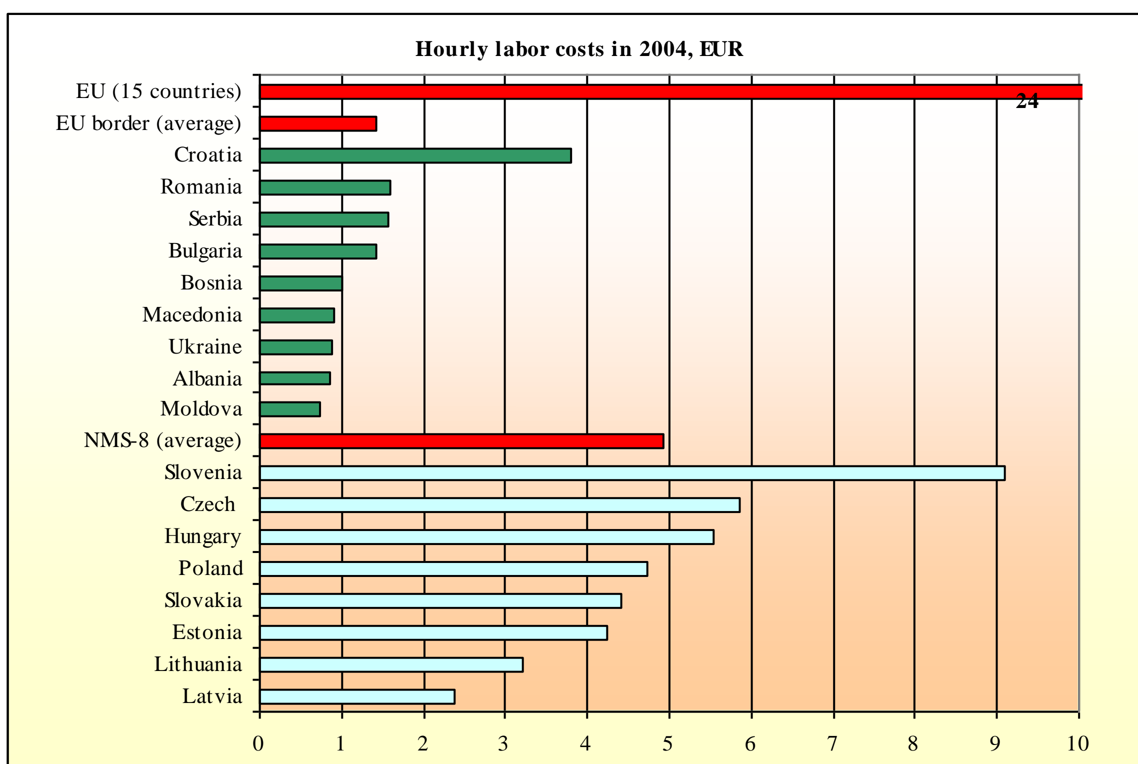
Economic developments, 2003-2005

	Consumer prices, % yoy aop			Fiscal balance, % GDP			Current account balance, % GDP		
	2003	2004	2005	2003	2004	2005	2003	2004	2005
EU-25	1.9	2.1	2.2	-2.9	-2.6	-	0.0	0.3	-0.3
Bulgaria	2.3	6.1	4.2	-0.4	1.8	1.0	-9.3	-7.5	-7.5
Croatia	1.8	2.1	2.9	-6.3	-4.9	-4.5	-7.2	-4.8	-5.0
Romania	15.4	12.0	9.2	-2.0	-1.4	-1.0	-6.1	-7.5	-8.7
*Candidate countries**	6.5	6.7	5.4	-2.9	-1.5	-1.5	-7.5	-6.6	-7.1
Albania	2.4	2.9	2.1	-4.4	-5.0	-4.5	-8.2	-6.1	-7.2
Bosnia and Herzegovina	0.1	0.7	2.9	-1.7	-1.9	-1.3	-21.8	-24.7	-18.6
Macedonia	1.1	-0.3	0.0	-0.1	0.7	-0.8	-3.5	-8.2	-6.5
Moldova	11.6	12.4	12.0	1.1	0.4	-1.6	-6.6	-4.4	-4.5
Serbia and Montenegro	11.3	9.5	16.2	-3.4	-0.3	1.2	-9.7	-13.1	-9.8
Ukraine	5.2	9.0	13.5	-0.2	-4.6	-2.0	5.8	10.5	2.7
New EU border states"	5.3	5.7	7.8	-1.5	-1.7	-1.5	-7.3	-7.7	-7.3

Source: Eurostat, IMF, The Bleyzer Foundation
* Bulgaria, Croatia, Romania
“ Albania, Bosnia and Herzegovina, Macedonia, Moldova, Serbia and Montenegro, Ukraine

3. Highly Educated Labor Force with Low Labor Costs

The countries of Eastern Europe possess a highly educated labor force. In fact, according to UNESCO statistics, the university enrollments in the region are quite high even when compared with developed countries (59% in Ukraine, 44% in Hungary, 34% in Czech, 32% in Slovenia, 29% in Moldova). In the former Soviet countries (like Ukraine), there is a significant endowment of engineering and science specialists. From this point of view, Eastern Europe should be considered an attractive place for investments particularly in high technology investment projects. Furthermore, as noted in the table below, labor costs in Eastern Europe are still quite low.



Source: Eurostat, ILO, National Statistical Offices

4. Good Endowment of Attractive Target Companies for PE

On the endowment side, Eastern Europe should be regarded as a particularly attractive destination for private equity investments. The region provides splendid “growth” and “removing inefficiencies” opportunities to be exploited by investors in the private equity asset class. Rapidly growing and transforming CEE economies still have large stocks of inefficient but promising firms. Many of them are already privatized, but some of them remain in state ownership. Inefficiencies of these companies generally come from different sources:

-market/pricing inefficiencies, when assets are not priced adequately, but the prices are expected to rise, should other investors recognize the true value of these assets;

-*economic inefficiencies*, when inadequate plant size and technologies are utilized or inefficient production links are maintained;

-*enterprise inefficiencies*, when companies are poorly managed.

A number of successful takeovers in the region have shown that major improvements in management, marketing and production organization can achieve a lot. Indeed, most investors now prefer to make buyout deals in CEE countries, and not early-stage investments, as the latter have proved to be a much riskier alternative compared to opportunities that already exist.

5. Debt and stock market development

Generally, private equity is not an exclusive source of funds. Private equity investors invest in business plans, which may require additional resources to finance new projects or modernization and expansion of existing projects. Sometimes, generated cash flows may not be enough to re-invest, and then other financial instruments should be involved. Therefore, access to debt and equity financing may be a critical issue in making an investment decision by a private equity investor. A functioning financial sector should thus only stimulate private equity activities in the region.

Despite remaining weaknesses, financial intermediation in CEE countries has generally improved. A growing number of foreign-owned banks in the region are contributing to more active corporate lending activity and increased provisioning of senior and subordinated debt products. Also, local commercial banks are becoming more willing to support investments with the provision of debt. This gives companies greater financial flexibility and room to maneuver in their expansion plans.

Improvements in local stock exchanges will also help CEE prospects for private equity. One of the main determinants of private equity investment is the opportunity to exit from the investment within several years. In developed markets, listing divested companies on a stock exchange is a well established way to exit. In CEE countries, however, only a small share of exits are currently made via public offering, while most portfolio businesses are divested through private sales to industrial or financial investors. This is because the liquidity and size of capital markets in CEE, though constantly increasing, remain inadequate compared to the needs of growing businesses. However, exit prospects in CEE countries are expected to improve in the coming years due to constantly increasing liquidity of local capital markets, greater presence of foreign investors in the region, and appearance of local institutional investors.

Other Factors Affecting PE Investments

Along with the favorable factors mentioned above, clear progress in deregulating and liberalizing the business environment and improving the legal environment are evident in Eastern European countries. Candidate states have already benefited from the EU accession process, as their policies are directed towards harmonizing their legal, regulatory and administrative frameworks to EU-created criteria, which contributes to enhancing the business environment and investment climate. The overall costs and risks of doing business in the region have been substantially reduced.

The countries on the border of the newly enlarged Europe also progressed in this direction, driven by the desire to gain accession to the EU and also competing for inflows of foreign investments. However, their reform agenda, just as with the candidate countries, still remains unfinished. This is discussed in the next chapter.

V. Main Determinants of Private Equity Investment and Policy Implications

As explained in the previous sections, private equity can have a positive financial and strategic impact on targeted firms and generate extensive benefits to recipient economies. However, the availability of private equity in emerging markets remains extremely limited. Most countries compete for foreign direct investment and adopt policies to create an enabling environment for the private sector. It is widely agreed that conditions for doing business in a country have a major impact on investment decisions made by foreign investors. Private equity investors, like strategic investors, evaluate the whole array of factors when they decide on whether to invest or not. Along with the expected profitability of individual projects, they thoroughly assess the investment and business climate in a country. Below we present some key factors that may help to increase the availability of private equity financing in a country. These are the nine investment drivers identified by SigmaBleyzer in a comprehensive research effort. They determine the attractiveness of a country's investment climate and help determine the most important measures that a government can take to improve the business environment and attract foreign direct investments.

The key investment drivers are the following:

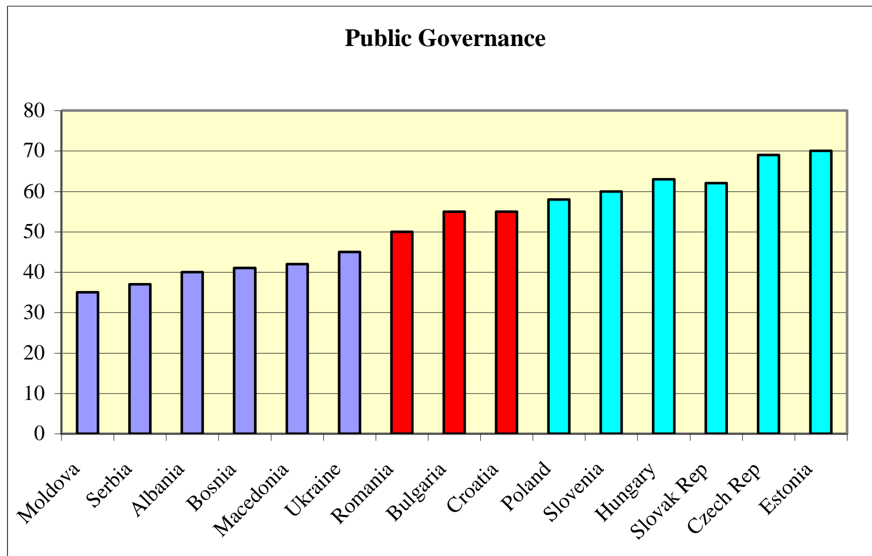
Driver 1. Public Governance

This driver includes policies and actions to increase the capacity of public administration to implement economic reforms, to improve efficiency of the public administration system, and to transfer the revenue generating activities that do not involve a "public good" to the private sector. Public administration reform is the key reform to facilitate the implementation of all other reforms. If well done, this reform will put the country on a different path, on an accelerated course to faster development and growth.

The objective of public administration policies is to redefine the role of the government to support the private sector and secure the provision of sound and efficient government services without corruption. Progress in this area is achieved through implementation of transparent public administration procedures, sound procurement policies, and redefining the roles of government agencies.

The objective of privatization-related policies is to improve the efficiency of resource use through private ownership, minimize the possibilities of undue market power by the authorities, and concentrate government resources on public goods. Key elements here include sound legislation to ensure competitive privatization process, an independent agency in charge of privatization, along with private ownership of land.

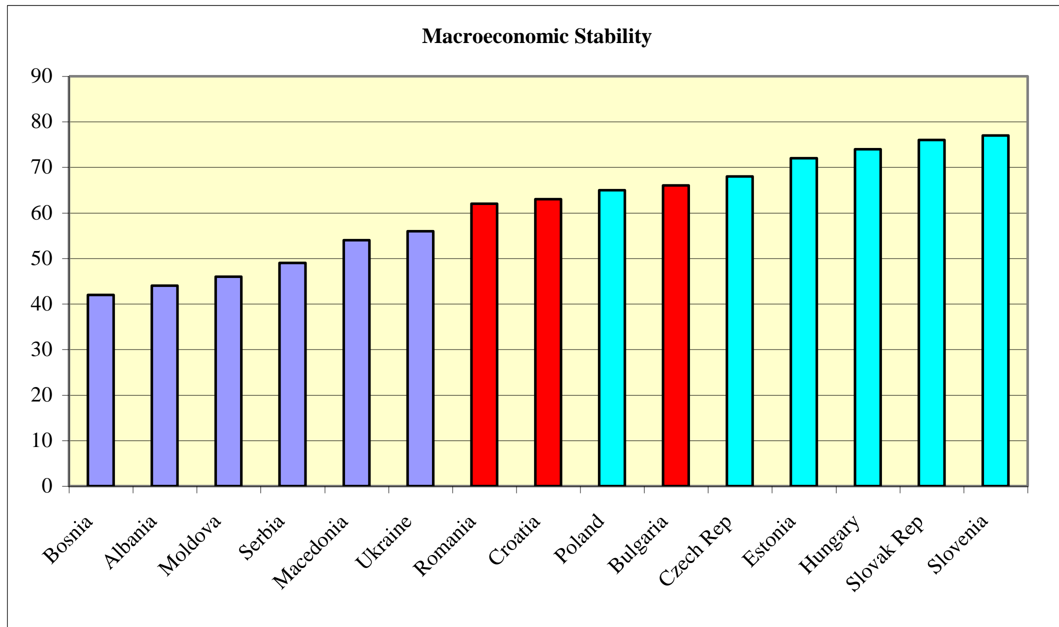
The countries of Eastern Europe show the following ratings on public governance (on the graphs below, the countries in focus have been divided into three major groups with a separate color assigned to each group: EU border countries – in violet, acceding countries – in red, EU new member states – in light blue):



Driver 2. Macroeconomic Stability

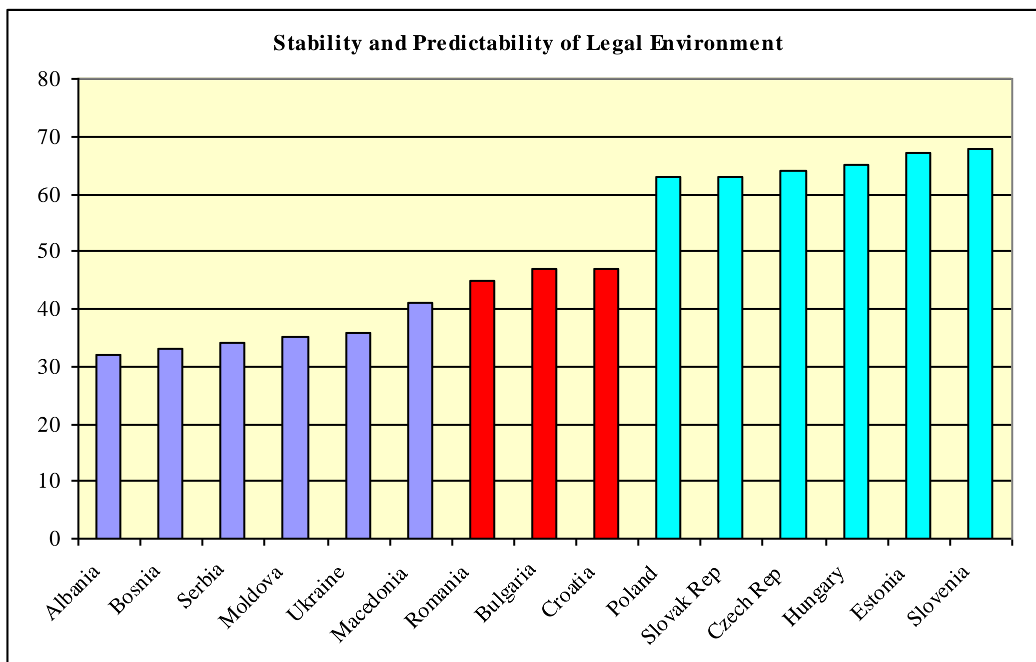
This driver includes policies and actions to ensure economic stability over the medium term. Macroeconomic stability is defined as long-term stability in prices with low inflation (internal stability) and a stable foreign exchange rate (external stability). Volatility in prices and exchange rates increases the risk of doing business in the country and induces investors to charge a higher risk premium to compensate for these risks of instability. As a result, fewer investment projects would qualify for investments and the overall flow of invested capital to a country would drop. In order to achieve internal and external stability, two sets of government policies are necessary: sound fiscal and monetary policies, which are attained by maintaining control over the fiscal budget balance and money supply.

The countries of Eastern Europe show the following ratings on macroeconomic stability:



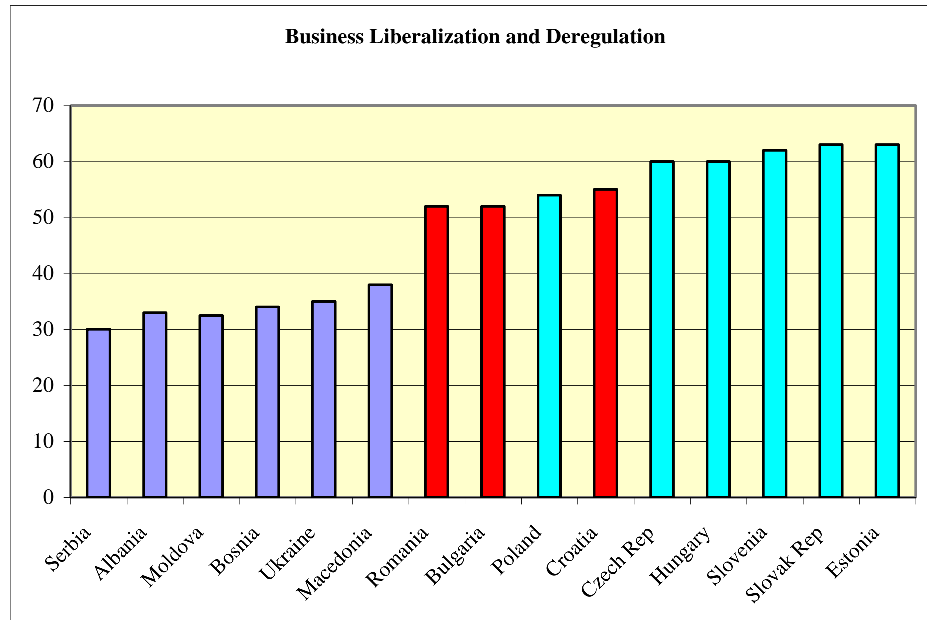
Driver 3. Stability and Predictability of the Legal Environment

This driver includes policies and actions to enact and implement stable and predictable laws and regulations that would support and encourage private sector businesses in a free market. To attract investments, it is not enough to create an enabling environment and provide the right incentives, it is also essential to ensure stability and predictability of adopted rules. Regulatory stability is a key issue for private equity investors, who usually invest in long-term investment "growth" projects. This driver also calls for a transparent judiciary and recognition of international contracts and agreements.



Driver 4. Liberalization and Deregulation of Business Activities

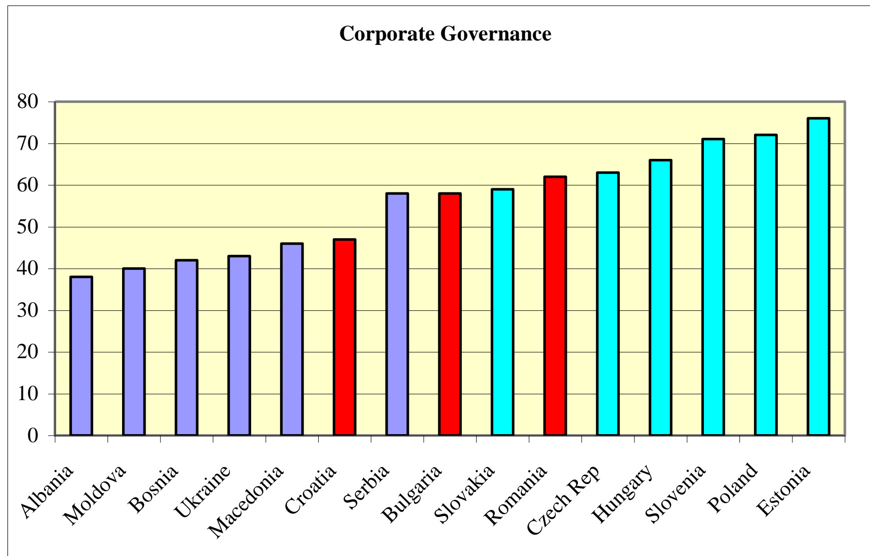
This driver includes government policies and actions that reduce government interventions, enabling private businesses to operate freely and make profits in a competitive environment. Major efforts must be directed towards removing barriers to entry, operations and exit.



Driver 5. Corporate Governance

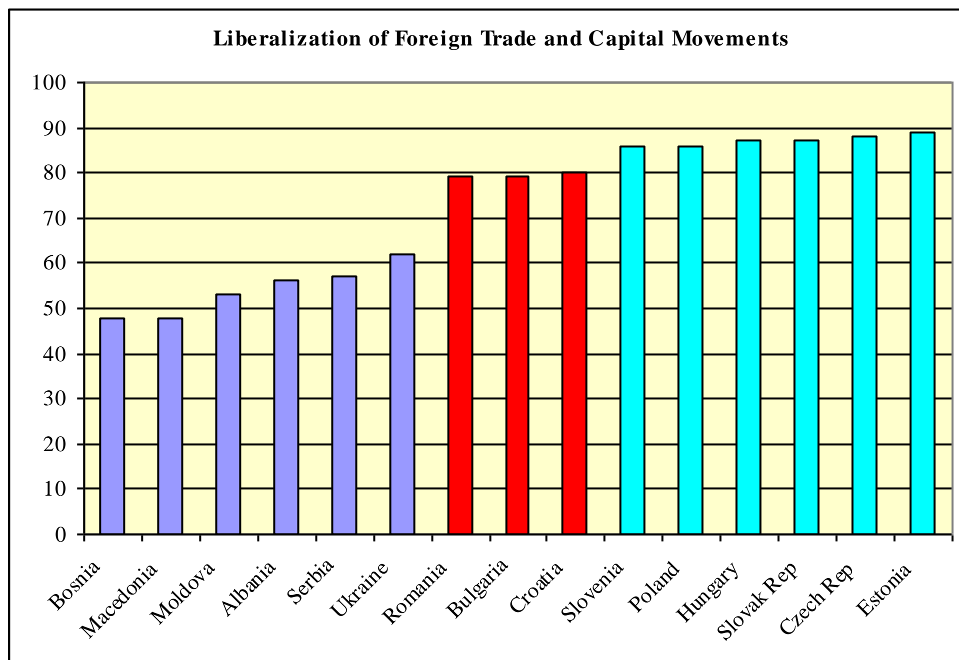
This driver includes policies and actions aimed at improving the governance of private companies to support private sector activities in a free market economy.

The objective of corporate governance policies is to establish appropriate rules that would guide the activities of businesses in the best interest of their shareholders, protecting ownership rights, including those of minority shareholders. Key elements here include disclosure of information about corporations, shareholders' rights protection, public reporting requirements, and use of transparent accounting practices.



Driver 6. Liberalization of Foreign Trade and International Capital

This driver includes policies and actions to facilitate exports and imports of goods and transfer of capital internationally. This includes the following actions: removal of restrictions to both exports and imports, including non-tariff restrictions, streamlining customs procedures and certification requirements, and liberalizing the foreign exchange regime.

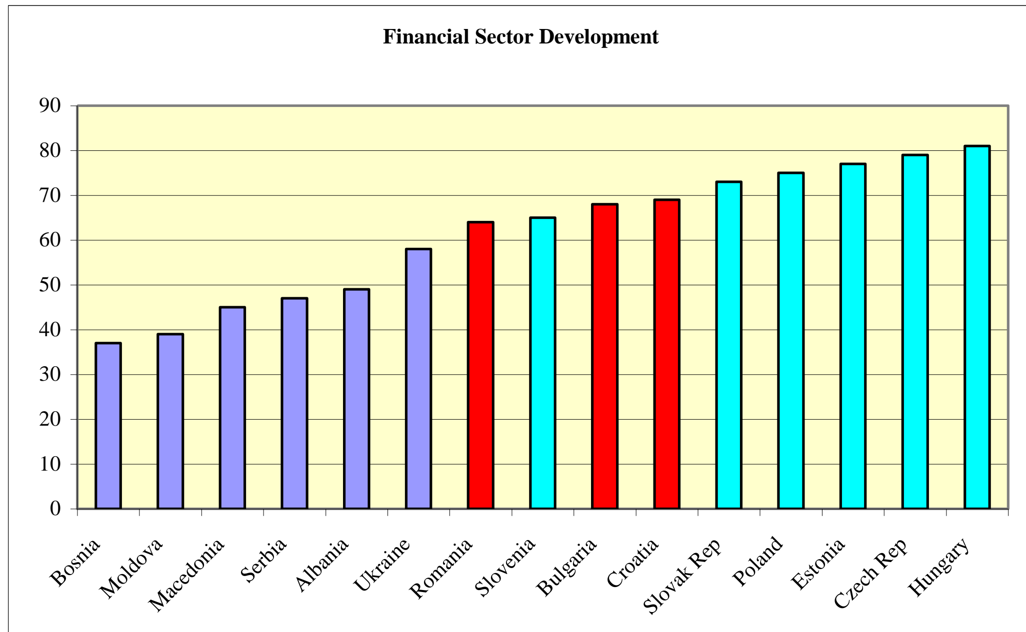


Driver 7. Financial Sector Development

For private equity investors, the availability of debt financing and a functioning and well-capitalized stock market may be a critical issue in making an investment decision in favor of a particular project. Private equity investors invest in companies with high

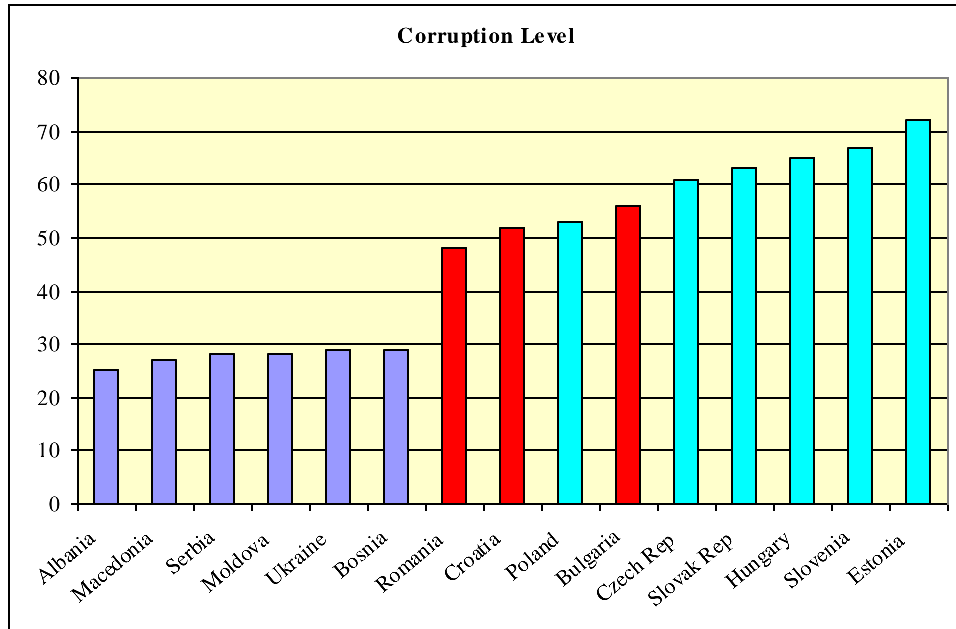
growth potential, which may require additional capital from outside sources for realization of their growth plans. A functioning and well-capitalized stock market provides an opportunity for private equity investor to exit from the investment through public offering of the portfolio company.

To develop its financial sector, a country needs an independent central bank capable of effective bank supervision, a large number of private commercial banks, including foreign banks, functioning lending and deposit markets with liberalized interest rates, along with an appropriate capital market infrastructure and effective insurance system in place.



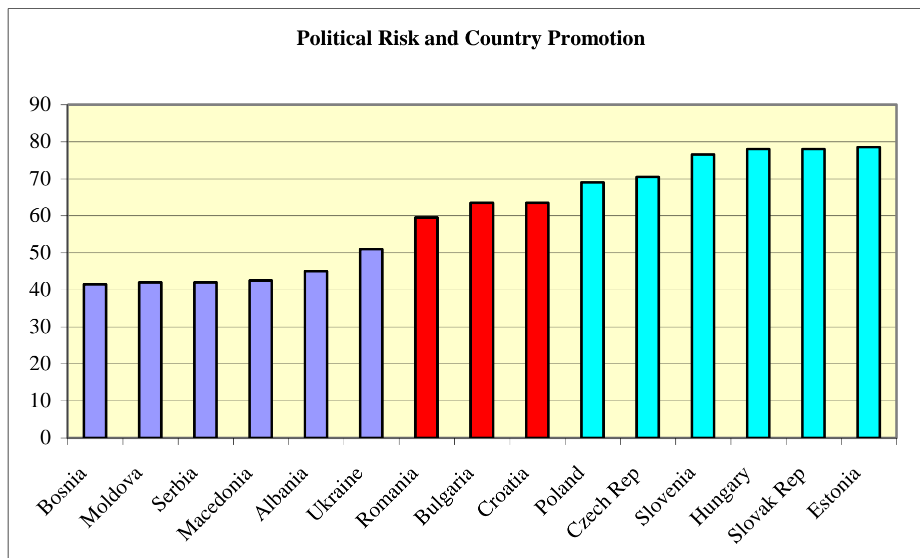
Driver 8. Corruption

This driver includes policies and actions to minimize corruption and protect businesses from abuse of power by government officials. Key measures here include developing a legal framework to ensure better enforcement of anticorruption and corruption-preventive measures, and raising public awareness of the problem.



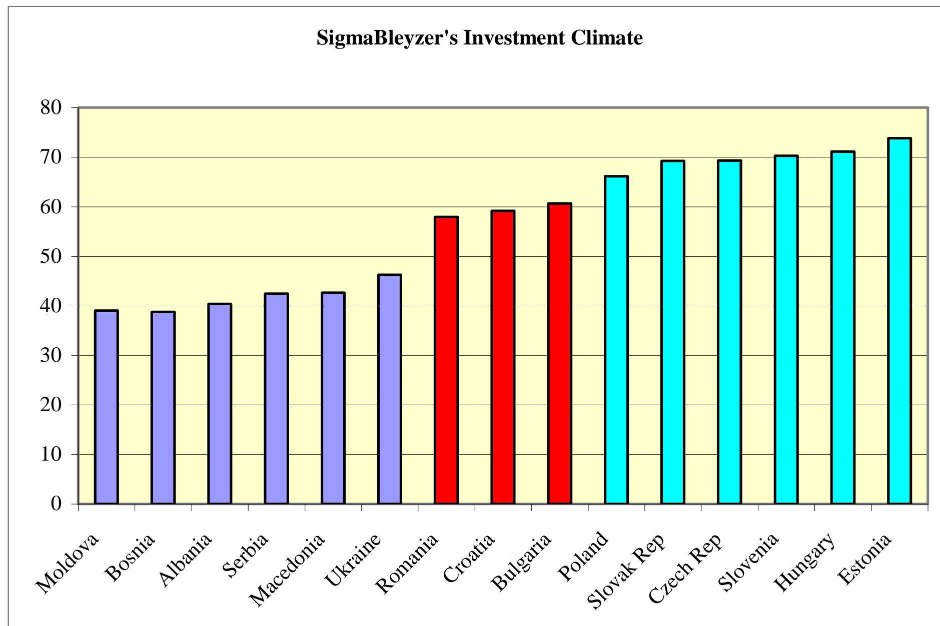
Driver 9. Political Risks and Country Image

This driver includes policies and actions to minimize the effects of political uncertainties on business activities and to promote the country and improve its image as perceived by foreign and domestic investors. This is achieved through effective functioning of the authorities unimpeded by vested interests, elimination of power abuses by the authorities, and minimizing the risks of civil disturbances that may affect businesses. Key measures to improve the country's image include consistent and detailed government action plans on country promotion, support to current investors in resolving problem issues, and the country's active position internationally.



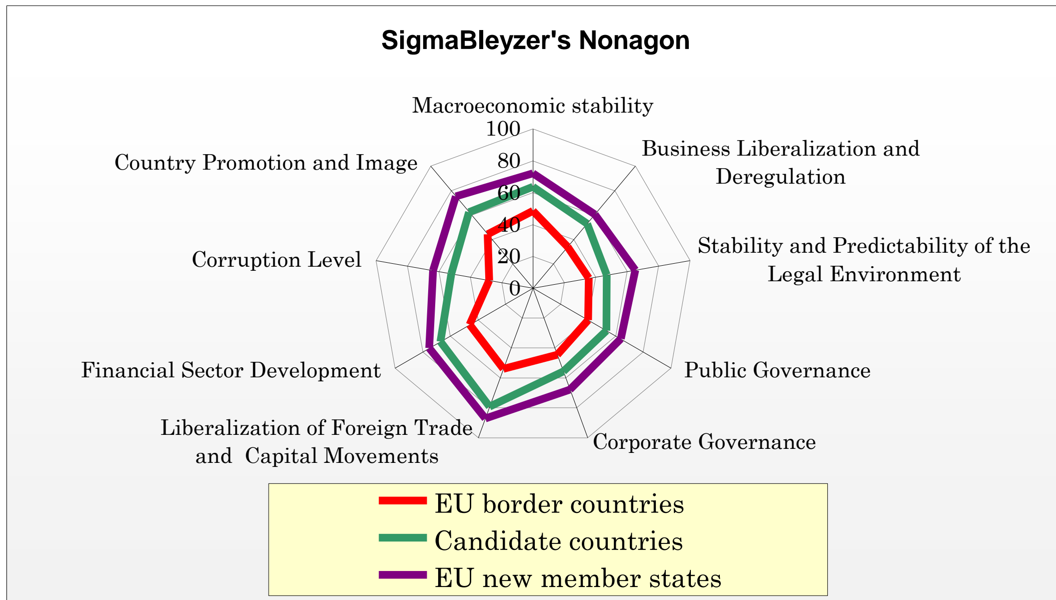
Aggregate Investment Attractiveness Index

The chart below shows the overall aggregate investment attractiveness ratings for these countries.



It is clear from the previous charts and the nonagon chart below that new EU member states have made more progress in improving their business environment than those countries that are still outside the EU (the new EU border countries). In fact, it is now well-recognized that the possibility of joining the EU has been a very important "beacon" to lead Eastern Europe to undertake deep economic and social reforms that have led to dramatic improvements in their investment climates.

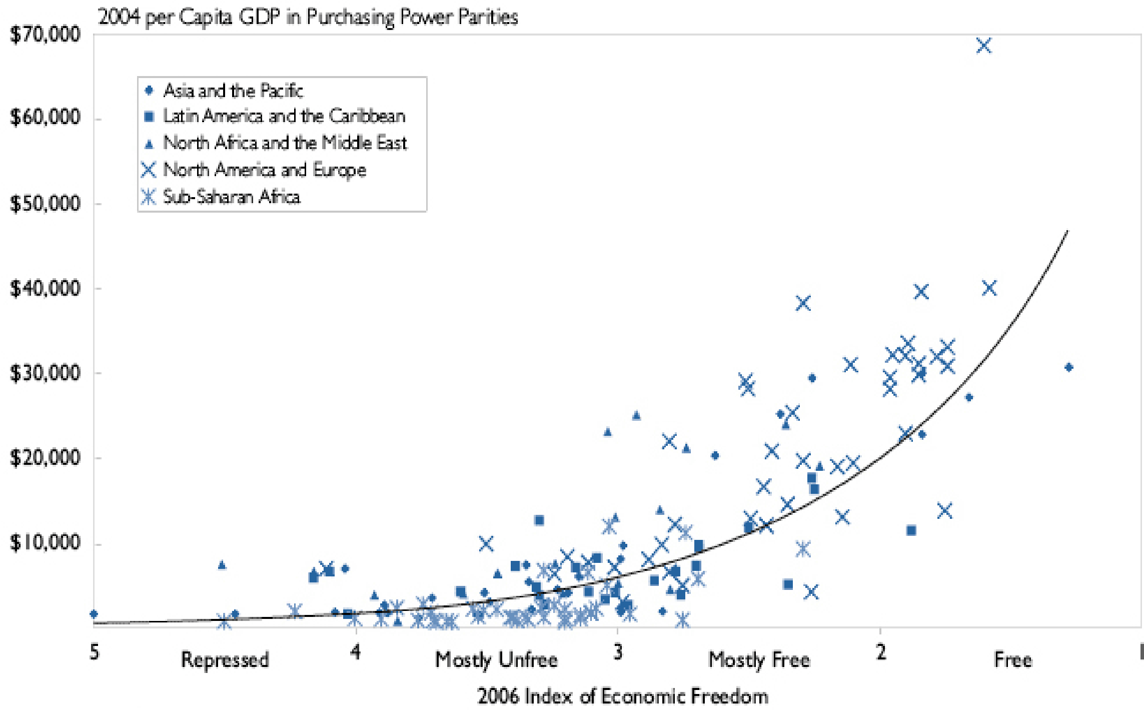
SigmaBleyzer's Nonagon for EEC



These improvements in the investment climate of Eastern Europe, together with the larger private equity investments that will follow, will also help to enhance the political stability in the entire region. This will increase the security of the whole of Europe.

Other studies have also shown that it pays to be economically free. The Heritage Foundation defines economic freedom as "liberalized" economic policies regarding business regulations, government interventions in the economy, the tax burden, international trade and capital, monetary policies, banking and finance, wages, and property rights. As noted below, the Heritage Foundation Economic Freedom index indicates that those countries with more economic freedom enjoy higher per capita income.

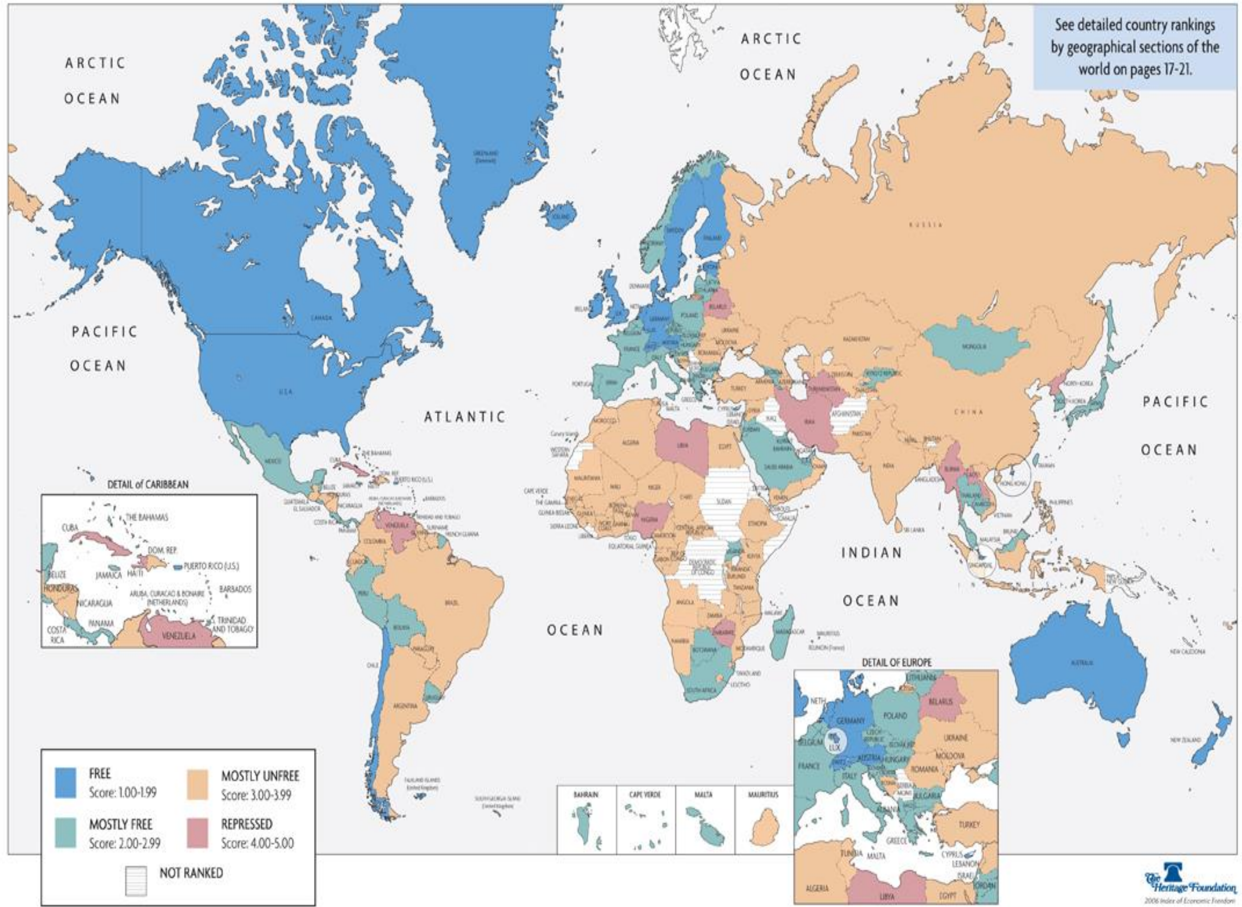
Economic Freedom and Per Capita Income



Sources: World Bank, *World Development Indicators Online*, available by subscription at *www.worldbank.org/data;* Central Intelligence Agency, *The World Factbook 2005*, available at *www.cia.gov/cia/publications/factbook/index.html*, for the following countries: Bahamas, Bahrain, Barbados, Burma, Cuba, Equatorial Guinea, Iraq, Kuwait, North Korea, Libya, Qatar, Suriname, Taiwan, United Arab Emirates, Zimbabwe; Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), at *www.heritage.org/index.*

On the other hand, as noted in the following chart, the same Heritage Foundation study shows that most of the world is still largely economically un-free:

DISTRIBUTION OF ECONOMIC FREEDOM



Annex -- Private Equity Glossary

Alternative Asset Investments — Complementary investments to traditional bond and stock investments. These are investments in private equity, hedge funds, and real estate. Alternative investments are generally more risky than traditional assets and should in principal generate higher returns for investors.

Buyout — A sector of the private equity industry. Also, the purchase of a stake of a more mature private company by an outside investor (with or without borrowed funds in a leveraged buyout) or by a management team (in a management buyout).

Capital call — Also known as a draw down. A demand by a private equity firm (a private equity fund manager) to an investor to provide capital to a fund. Usually an investor agrees to a maximum investment amount and the fund manager then makes a series of capital calls as opportunities arise to invest in start-ups and buyouts.

Carried interest (carry) — A manager's share of a fund's net profits generated by investments made out of the fund.

Capital commitment — An obligation of an investor to invest a certain amount of capital in a private equity fund for a specific period of time.

Capital distribution — Allocation of investment returns among investors and a private equity fund manager. It is the income and capital realized from investments less expenses and liabilities.

Divestment (exit) — A sale of shares of a portfolio company. Divestment is generally performed via a private sale to an industrial or a financial owner or via a public offering.

Due diligence — Detailed examination of the books and records of potential target companies, an assessment of a potential investment project for making an investment decision.

Early stage — The state of a company after it has been created but not yet generating profits. Typically, a company in early stage will have a management team and a proven business concept or product.

Exit strategy — The plan for generating profits for owners and investors of a company. Typically, the ways are to merge, be acquired, or make an initial public offering.

Expansion capital — Investment in companies already in operation, with a proven product and operating cash flows. It is provided for various types of growth and expansion, including physical plant expansion, product improvement, marketing campaign, etc.

Fundraising — The process of identification and solicitation of investors to commit capital to a private equity fund.

General partner — A class of partner in a partnership. The general partner retains authority for the actions of the partnership. In the private equity industry, a firm that manages a private equity fund.

Initial public offering — A process of "going public". When a privately-held company lists a proportion of its shares on a stock exchange for the first time. IPOs are an exit route for private equity firms.

Leveraged buyout — A purchase of a stake of a more mature private company by an outside

investor with heavy use of borrowed money.

Limited partner An investor in a limited partnership. The limited partners are generally protected from legal actions and any losses beyond their original investment.

Limited partnership A legal entity composed of a general partner and limited partners. The general partner manages the investments for a fee and profit share while the limited partners provide the funds and are generally protected from obligations and losses beyond their investments.

Management buy-in Acquisition of a company by private equity investors with subsequent substitution of current management by a new team.

Management buyout Acquisition of a company by a combination of its current management team and private equity investors.

Management fee A fee charged to the limited partners in a fund by the general partner. Management fees in a private equity fund typically range from 1 to 3 percent of capital under management. Management fees are paid to cover the overhead costs and any other expenses that arise in the course of the fund’s investment activity.

Private equity Investment in equity of non-public companies.

Seed financing Capital invested in equity of companies at the “idea” stage, when initial business concept has not yet been developed and assessed. Seed capital generally supports product development and market research.

Start-up financing Capital provided for companies moving into operation but before commercial manufacturing and sales occur.

Strategic investor A corporation that invests in a company that is sold, expecting that this investment can add value to the corporation itself. The aim of strategic investment may be to gain access to a particular product or technology that the company is developing, or to support the companies that could become customers for the corporation's products.

Takeover Transfer of control over a company.

Venture capital A sector of the private equity industry that focuses on investments in new companies with high growth prospects.