Private Equity in CEE: Creating Value and Continued Growth

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Speakers:

- **Thierry Baudon**, Chair, Invest Europe & Founder, Mid Europa Partners
- **Anne Fossemalle**, Chair-Elect, Invest Europe & Director, Private Equity Funds, European Bank for Reconstruction and Development (EBRD)
- **William Watson**, Head of the Invest Europe CEE Taskforce & Managing Partner, Value4Capital

Moderator:

- **Eric Drosin**, Communications Director, Invest Europe

Discussion on investment in the CEE region and themes that are expected to dominate for the years to come.

1. How does the Private Equity and Venture Capital ecosystem look like in CEE today?
2. What are the key investment and value creation strategies in the CEE region?
3. What is the economic and social impact of the industry in CEE today?
4. What do you think the future holds for Private Equity and Venture Capital in CEE?

AF – First, I would like to say that I am really happy to be here, presenting at this webinar. I just wish we were all in the same room. So, I would like to say hello to those of you I know and all those of you I don't know. And I hope we will meet one day.

Many people in the audience know that EBRD has been investing in funds in Central and Eastern Europe for close to 30 years. Over this time, we have invested into about 50 fund managers in Central and Eastern Europe, themselves [investing] through about 100 funds. And these funds have invested in about 800 portfolio companies. So, it's a sizeable portfolio. We have had an important role seeding the funds in that region.

I would like to start with an important figure, which is the returns that we have achieved through this portfolio. So if I take the funds that have raised more than one fund, and I look at the pooled IRR of all these funds, I get an IRR of 12% on liquidated funds. That's a very good number.

[That figure is] close to 17% if we look at the growth returns – looking at the underlying invested companies. So, we are very proud of these returns and everybody who isn't familiar with the region should take comfort that it's a good idea to look at it. And those of you already in it, we can congratulate ourselves.

These numbers are without survivor bias – we don't pick and choose or edit what we don't like. So, we know this region and our portfolio shows that it is possible to make money.

Why is that and how does it happen? We see that CEE markets are quite often overlooked as emerging markets when compared with Asian markets. Yes, it is true that growth rates are lower than in other emerging markets, but then so are the risks. The growth rates have been higher in CEE than in Western Europe and we feel there is really a place in the portfolio for Central European funds somewhere between developed and emerging markets.

Why is that and what underpins this? We see that the themes of convergence with the rest of Europe and the increasingly wealthy middle class underpin econ growth and underpin the investment themes for our fund managers.

Central Europe also has a number of fund managers that have raised a succession of funds. You can see several fund managers that have raised a number of funds and have a proven track record over a number of funds. They have also, over the years, a broader and deeper offering across a number of strategies that have come through.

In particular on this point on strategies, I would like to mention that Central and Eastern Europe is becoming increasingly recognised for its strength as a tech hub. And we see this with the calibre of the tech talent that is there, some of the investment companies, some of success stories, and some of the GPS who have some through.

The private equity market in CEE is also a less saturated private equity market. We see the stories in Western Europe with dry powder, pressure on pricing. But with the market penetration in CEE about 20-

30% of what there is in western Europe, there is really less pressure on pricing. GPs face less competition and, as a result, have access to proprietary deal flow. It's not uncommon for them to reach out to first generation owners.

Another aspect of that market is that with harder fundraising, we see GPs with better alignment of interest with their LPs which is also a positive. And we see fund managers that are really focusing on their own strategies and are driven by getting a carry from their funds, rather than raising multiple funds and just focusing on management fees. That is why there are so many compelling stories.

One point that Thierry just touched upon is that we are looking at a number of years in the report, but that 2020 is a year when very important things happened with the COVID crisis. And what we have seen is that our portfolio has been resilient through the COVID crisis. That is because there is a lower use of leverage than in some other markets, the GPs are focusing on operational improvement and not so much on fancy financial engineering – they roll up their sleeves and add value to the companies. These GPs really are focused on definite strategies, and the GPS in the region have experience of dealing with crises. It's not the first one and it's not the last. You have resilient GPs who know how to handle this and we saw that through our portfolio.

It's not the first time. It's another crisis where they react really quickly, support their companies, put in place whatever contingency plans are needed, communicate with LPs appropriately. As a result, we saw deal-making quickly resuming. There was a bit of a lull in the first half, but then in Q3 and Q4 we saw new transactions and also exits, which we felt was very encouraging.

So, in summary for investors listening, if you can overcome that risk perception gap and appreciate the value that is created by the managers and the GPs, our experience shows that there are great opportunities, as well opportunities for allocation and opportunities for returns.

ED – Thierry, would you like to add Anne's remarks about how the ecosystem is looking today?

TB - First thing I would say is that I fully concur with Anne's assessment. Our industry in Central and Eastern Europe today compared with 10 years ago is bigger, deeper, wiser, more institutionalised, and more integrated.

Bigger – the numbers are in the report – I won't expand on that.

Deeper – all stages are thriving form early-stage VC to large buyouts. There is actually remarkable growth in the VC segment recently.

Wiser – Anne mentioned it – there are several GPs that have gone through multiple fund cycles and learnt as a result.

More institutionalised – succession has been completed at a number of firms and that tends to add to institutionalisation. And we see can more and more blue-chip LPs joining the party.

And it’s more integrated because we have an increasing number – very noticeable now – of secondary exits to other CEE players which at some point will create almost a seamless food chain.

ED – Thank you Thierry. I think the audience really wants to hear now about the report and the case studies themselves and the dots that connect them and what separates them. So over to Bill, who has led the Task Force in producing this report, to explain what really were the key investment value creation strategies that you found for the region for as a whole.

WW - I essentially had the job of taking the environment and saying what are you going to do with it? It’s great to be on a sunny, windswept, attractive beach, but what do you actually do when you go into the water?

In central Europe, we have a very large number of GPs who have been very successful in investing, and in the publication released today, we have identified 22 of those stories.

When you look across those stories, there are some things that come out. The first thing is that the CEE GPs – like GPs everywhere – are very good at spotting an opportunity. They are very good at identifying a specific advantage or an idea that a company has, and turning that into a great business and ultimately great returns for investors.

The book looks at Bitdefender, which was an deal for Axxess in Romania, as well as Eutecus, a Hungarian deal from Euroventures, both of which took their opportunities and the good ideas for their business founders and turned them into success for their LPs.

But Central Europe is not only about making that investment in a good idea or opportunity, Central Europe is also supercharged in terms of growth and that gives us a tremendous advantage to do other things. One of those things we can do is take advantage of what we call “catch-up”, others call it convergence – the idea that a business in CEE can follow the path of existing businesses in Western Europe, and catch up in areas such as digitalisation, the introduction of market trends or other opportunities.

The publication highlights a number of these successes – Dino and Profi from Enterprise Investors – both situations where the GP was able to create a new market segment and new opportunity for their businesses. Also a business called Famicord – that took the revolution in stem cell technology and brought it to Central Europe. And Rankomat, a deal from 3TS that introduce one of the first online car insurance marketplaces to the region.

Again, these companies were a successful partly because they were able to benefit from that fundamental growth. One of the other themes that is talked a lot about when investing in CEE is ownership transition. I’ve said at a number of conferences myself that the family business does not really exist in Central Europe because most of these businesses are first generation – they haven’t had the chance to transition yet. And GPs in the region are very good at identifying and managing these situations to unlock the potential of someone’s business and turn it into a company.

There are a large number of examples of this in the publication – deals such as Anwis from ARX, AZ Klima from Genesis and our own Home.pl in Poland. Abris was also able to make a strong return with their Novago investment in a waste recycling business, capturing the professionalisation and institutionalisation of that industry, as well as Swell and Velvet Care, both of which managed the transition.

Velvet Care is an interesting case because that was a corporate orphan that was turned into 13x return for Avallon Partners.

The other trend we see a lot of Central Europe is consolidation. The markets in our region remain fragmented, they are relatively young. There are still a lot of growth companies. But 30 years on from the fall of the wall, you are starting to see the winner emerge.

Private equity has become very good in central Europe at identifying the winning platforms around which they can build even bigger businesses. The success storybook highlights Wirtualna Polksa. Innova, the lead GP and the founders, managed to do some 15 add-ons, creating one of the leading web portals in Poland and generate almost 3x for their investors.

Urgent Cargus – a deal in Romania – put together two large courier companies to catch the wave of final mile delivery and digitalisation of commerce in the region. KVK holdings, a construction business from ARX followed a similar path, as did Dotcard when they put together two businesses to create one of the leading omnichannel payments system business in Poland.

But our GPs also have an ability to create some of their own opportunities. And the last theme we see emerging is what we call being a catalyst. We, I think, have all seen good businesses that just lack something. They lack the management capability, they lack the capital to expand, sometimes they just lack the vision and drive to make them a success. And we were able to identify a number of these deals as well.

Bambi and Knjaz Miloš in Serbia from Thierry's MEP, Magnetic MRO from BaltCap, Duetek and Fitek are all examples of how GPs were able to take a good business and turn it into a great company.

These are the main themes we identify and I think it's important when we look at the region to recognise that this range of themes also reflects the heterogeneity of our region. It's not only about doing one thing in one place. Central Europe is a diverse market and offers diverse opportunities. And our GPs – from the venture space, through to the more mature buyout areas – all have their specialisations and focus. And that allows us to capture that opportunity, capture that growth and very much capture that dynamic that Anne was talking about in her remarks.

ED – Thank you Bill. That was nicely captured – forgive the pun. Anne, moving on from Bill's very pointed observations about the themes, the heterogeneity and the performance of the case studies, we are also having to ask what are the economic and social impacts of the industry in the region today? From your perspective, please?

AF – It's a good question. Because I think this is a question of growing importance to LPs globally. And I would say to that point, CEE does extremely well. That was a market that was seeded initially by DFIs – ourselves, our colleagues at the EIF and some others – as a result of which, all the ESG considerations were integrated into the GP investment mandate right from the start. It isn't something that is being added on now. It is something that was part of the investment thesis for the GPs right from the beginning, with focus on governance initially, then on environmental and then social. And I think on that I would like to cite another figure that comes out of another excellent Invest Europe report – the PE at Work paper published last year - CEE had the highest job growth of 11% in 2018 among European PE-backed businesses and that was followed by the Nordics.

These companies mentioned in the report we are launching today created a total of 25,000 jobs, and we can say that this trend is continuing. And the same with tax contributions, training, diversification, etc. I would say that GPs in the region are doing very well on this front. It's just part of them and the numbers are there to prove it.

ED – Bill did you want to add anything?

WW – Yes, I think when I first started investing in Central Europe in 1991, you were more concerned about environment. I can remember being taken to some horrendous sites, factories and so on. But we are now 30 years on and that has largely been dealt with and ESG remains part of our blood.

Certainly, at our firm, one of the things that we focus on now is the G part. Every portfolio company that private equity goes into essentially gets a lesson in what correct governance is. They move away from the idea that one person can make a decision. We create boards and we create teams.

In our first fund that we managed you would come to our investment committee and say: "I found a guy with a great idea, he's going to make me money." Today, the investment committee discussions are about the team – they are about the President, the CFO, his marketing direction, his HR director and all the other functions that come together. And I think that has been one of the big contributions of CEE private equity to the ecosystem. Setting those good examples, showing not only the president what it's like to have a board, but showing all the employees in those businesses what governance and correct governance is all about.

ED - We are going to move to our final question. And I will ask all our wonderful panel participants to try and keep it brief. Maybe the highlight for the audience: what do they really think the future holds for this region?

And then we will leave five minutes at the end for questions from the floor, which we strongly urge participants to submit.

Perhaps Thierry, I can ask you to kick off with what you see the future holding for the region?

TB – Well, I have a clear conviction that the future is bright. The PE and VC ecosystem in our region is poised to grow and prosper as the region is very well placed to take advantage of some very long-term structural trends, which may sound obvious to you but it's worth remembering.

The first one is digitalisation. It will be a boost not only to the VC/tech segment, but also to the growth capital and buyout players as the traditional industries move through modernisation and adjustment.

Deglobalisation will also be a big booster. With the near-shoring and shortening of supply chains, there will be lots of investment opportunities coming to our region. And the third key trend I would identify as supportive of PE and VC in the region is obviously the accelerating economic integration of Europe. Central Europe has the human talent pool, the geographical proximity, and the cost advantage – it should benefit.

Now more specifically, I would also expect VC/tech to outperform as this segment is not really dependent on market size or country conditions. It's really an easily scalable global game. The example of the Baltics is really a preview of what's going to happen next.

I would also expect increased blurring of the boundaries between late-stage venture growth capital and buyout. As I mentioned earlier, I can see an integrated food chain developing with lots of exits being provided by lots of participants in the system. And hopefully, we will see the emergence of local LPs on a significant scale and that would greatly help the resilience of the industry in our region.

ED – Anne would you like to give a final bullet point?

AF - I think Thierry has made the case extremely well. The only thing I would like to add to that is that the returns that are generated by the region will continue, and will continue to prove that this undercapitalised part of Europe can add value to LPs portfolios.

ED – Bill with your understanding, I am going to hand over to my colleague Maria who very kindly has been vetting questions from the floor, for which we hope there has been a deluge given the over 100 years of experience on the panel today. But Maria over to you for the questions.

MN – The first question for the panel is – which countries in your view of the CEE region offer the most opportunities for private equity and venture capital in the coming years?

WW – Those from the region know that my fund is called Poland Plus, so I have to stay loyal to the name and, as they say, "we do what it says on the can".

I think Poland does offer tremendous opportunities. It is a large economy. It does offer – as Thierry was saying – all of the layers where you can play from big buyouts to growth capital and down increasingly to venture, which has been one of the focuses for development of the Polish government, and there has been a lot of capital available to seed ideas. So, I would still go with Poland.

I think, though, you can find opportunities throughout the region, and I think what is encouraging, if I take a CEE taskforce perspective, we have very active associations, composed of very active GPs throughout. So, I come back to the prior question, I am expecting a lot more of the same – but from increasingly experienced players.

TB – My answer would be, it depends. Because the five investment themes which Bill very accurately described, are going to play differentially, depending on geographies and levels of development. So depending on the sort of strategy and investment focus that one is comfortable with, you are likely to go into certain geographies and certain sectors more than others. So, I can see opportunities across the region.

Now volume wise – Bill is absolutely correct – Poland will continue to dominate. It has the deeper ecosystem from VC all the way to big buyout. But there are ops in some of the underserved markets as well.

MN – [Next question] You mentioned tech talent being present in the CEE region. Which tech domains do you see strengths in?

WW – I would make a distinction between pure tech, which is grab something like cybersecurity where you are developing a software, you are developing the vision analysis or vision technology that underlies certain developments. You have those in all the countries, and you have smart people in all.

What's really interesting to me, though, are the opportunities to apply tech and the increasing adoption of tech by businesses throughout the spectrum.

One of the things we have done at V4C is really focus on how small and medium-sized enterprises are getting tech delivered, through software as a subscription [Software as a Service], through various marketplaces, through various platforms. And I think you will find tremendous opportunities throughout the region to invest in areas that are delivering and accelerating the ongoing digitalisation that has only become that much more in the last nine months of COVID.

ED - Thank you very much everyone. Thank you, ladies and gentlemen. Have a lovely evening.

For more information and to access the report, please click here.

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