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Development of Private Equity Funds in the Czech Republic

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Prohlášení

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V Praze dne 19. května 2008 Petra Sedláková

Poděkování

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Téma: Předpokládaný budoucí vývoj akvizičních aktivit finančních investorů a českém trhu

Charakteristika tématu

Přelom tisíciletí byl v České republice ve znamení fúzí a akvizicí. Zatímco předchozím rokům dominovaly tzv. strategické akvizice, tedy převzetí podniku za účelem jeho rozvoje a využití růstových příležitostí, v současné době se začínají dostávat do popředí akvizice finanční neboli spekulativní. Při nich se tuzemští finanční investoři zaměřují na střednědobé projekty s jasnými kritérii, tj. stávají se standardními *private equity* fondy. Tyto fondy postupují tak, že podnik koupí, restrukturalizují a v horizontu 3–7 let opětně za účelem dosažení zisku prodají. Neuvažují dlouhodobě, ale spekulativně. Proto jsou schopné akceptovat vyšší rizika, a tudíž nabídnout vyšší cenu než strategický investor.

Ve své diplomové práci bych se chtěla zaměřit právě na *private equity* fondy v České republice, a to od počátku jejich působení na našem trhu, přes současnost, až k možným scénářům budoucího vývoje. Budu se zabývat akvizičními aktivitami prováděnými prostřednictvím těchto fondů a jejich závislostí na makroekonomických ukazatelích, institucionálním a právním prostředí a také na struktuře podnikatelské sféry. Dále hodlám zmapovat současné postavení těchto fondů na českém trhu ve vazbě na situaci na trhu bankovním. Tyto fondy mohou zřejmě v oblasti financování menších projektů konkurovat bankám, protože na rozdíl od nich jsou zpravidla ochotny nést vyšší riziko výměnou za možnost vyšších zisků. V případě velkých projektů tyto fondy naopak využívají bankovních služeb ve formě půjček. Pokusím se najít odpověď také na otázku, do jaké míry jsou pro banky tyto půjčky bezpečné. Závěr práce věnuji posouzení budoucnosti *private equity* fondů v České republice a jejich roli v příštích akvizičních projektech.

Osnova:

1. Úvod do problematiky tzv. *private equity* fondů a jejich role ve financování akvizic
2. Vývoj akvizičních aktivit v ČR v závislosti na makroekonomických ukazatelích dané ekonomiky
3. Vliv právního a institucionálního prostředí na akviziční aktivity v ČR
4. Závislost vývoje akvizičních aktivit na struktuře české podnikatelské sféry
5. Současný stav akvizičních aktivit na českém trhu
6. Budoucí vývoj akvizičních aktivit v ČR
7. Závěr

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ABSTRACT

Private equity has played an important role in financing of non-publicly traded companies since its appearance in the 1950's. Private equity funds were first focused on providing capital for start-up especially technological projects and have later reoriented towards buyouts with high level of leverage thanks to favorable economic situation. Private equity is no longer aimed to support and promote the latest technological innovations, but it rather serves as a tool to improve company's efficiency in the more competitive environment.

Thanks to the oversupply of liquidity on the world markets, low interest rates and the potential of the region, the number of financial investors willing to invest in Central and Eastern Europe kept growing in the recent years together with the number of the local private equity funds and private equity focused financial groups.

In this thesis, we analyze the development of private equity funds and the overall private equity market in the Czech Republic since 1990 until now within the European context. We will outline the main determinants of private equity activity, trends and obstacles that inhibit further private equity market development in the Czech Republic. In the last part of the thesis, we will focus on the liquidity crisis and its impact on the European versus the Czech private equity market.

ABSTRAKT

Private equity fondy hrají významnou roli ve financování společností, které nejsou veřejně obchodované, již od svého počátku v 50. letech. Tyto fondy se nejprve zaměřovaly na transakce do začínajících společností, převážně technologického zaměření. Poté se díky příznivé ekonomické situaci přeorientovaly na odkupy *(buyouts)* a již se nezabývají propagací technologických inovací, ale zefektivněním fungování společností, které se stále více potýkají s rostoucí konkurencí.

V posledních několika letech se ve středních a východní Evropě výrazně zvyšoval počet private equity fondů a finančních skupin působících v oblasti private equity, a to díky několika faktorům: přebytku likvidity na světových trzích, nízkým úrokovým sazbám a potenciálu firem v této oblasti.

Tato diplomová práce analyzuje vývoj private equity fondů a celého trhu private equity v České republice od roku 1990 až po současnost, a to v evropském kontextu. Je zaměřena na hlavní determinanty aktivity v oblasti private equity, na trendy a na překážky, které brání dalšímu rozvoji tohoto trhu v České republice. V poslední části

této práce se soustředíme na krizi likvidity a její dopady na evropský a Český trh private equity.

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1 Introduction

Private equity has played an important role in financing of non-publicly traded companies since its appearance in the 1950’s in the United States. However, it was not until the middle of 1970’s that it became widespread in the United States and Western Europe thanks to the legislative changes in the tax area. Since then, we can officially start to record private equity funds’ history.

At the beginning, private equity funds were focused on providing capital for start-up projects, especially technological projects, which would be hardly able to reach other forms of financing. Today’s technological giants like Apple, Microsoft, Oracle or Sun Microsystems were once financed by venture capital, a part of private equity investments specialized in start-up projects. Private equity funds have later reoriented towards buyouts with high level of leverage thanks to favorable economic situation. Private equity is no longer aimed to support and promote the latest technological innovations, but it rather serves as a tool to improve company’s efficiency in the more competitive environment. More industries were also added to the private equity funds’ portfolios. Nowadays, there are funds specialized in either particular types of investments or so called generalist funds, which are focused on all stages of private equity investments.

In the Czech Republic and other Central and Eastern European countries, private equity emerged in early 1990’s, after the change of the political regime. Thanks to the oversupply of liquidity on the world markets, low interest rates and the potential of the region, the number of financial investors willing to invest in Central and Eastern Europe kept growing together with the number of the local private equity funds and private equity–focused financial groups. Unfortunately, there are still numerous obstacles represented especially by the legal environment that obstruct further private equity market development in the Czech Republic.

In this thesis, we would like to analyze the development of private equity funds and the overall private equity market in the Czech Republic since 1990 until now within the European context. We will outline the main determinants of private equity activity as observed in the empirical studies and confront them with development of the Central and Eastern European region. This will serve us as a basis for detailed analysis of the Czech Republic focused on the development of the private equity market and existence of obstacles that inhibit further market development, which we expect

to find. Finally, we will examine whether our assumption that the Czech Republic has been converging to the European private equity market model in the past few years holds and whether the liquidity crisis will have a different impact on the European and on the Czech market as we anticipate.

In the first part of the thesis, Chapter 2, we will provide an overview of sources of the data used in this thesis. The two main sources – Czech Private Equity and Venture Capital Association and European Private Equity and Venture Capital Association provide the most complex data; however, they are allowed to publish only the aggregated data for the country or the region. Therefore other sources of information were used to find out the details of transactions. The major ones are also described in this chapter.

In the third chapter, we will describe the business model and the basic conception of functioning of a private equity fund: the legal form, lifecycle, investors and types of investments. A special focus will be dedicated to leveraged buyouts as they currently represent a prevailing form of private equity investments in Europe as well as in the United States. In the last part of the chapter we will introduce forms of exits from an acquired company and methods of measuring the overall return on the investment.

The fourth chapter concerns private equity development in the Central and Eastern European region, which has experienced a significant boom after the 1990's. Firstly, a literature survey will be performed to show determinants of private equity activity and their significance examined in various studies in the USA and Europe. Secondly, private equity market development and trends in Central and Eastern European countries will be analyzed within the frame of these determinants.

The fifth chapter is dedicated solely to the Czech Republic. We will first describe the mergers and acquisitions market development as it is tightly connected to the private equity market. Thanks to popularity of leveraged buyouts, private equity funds belong among the major players on the M&A market. Subsequently, a development of private equity market in the Czech Republic will be analyzed, based on the evolution of number and volume of fundraising, investments and divestments. Great attention will be dedicated to the analysis of drivers of the activity and the market trends. We will also devote one part of the chapter to the description of financial groups operating on the private equity market in the Czech Republic. The last part of the chapter contains

an analysis of the drawbacks of the Czech market that inhibit the further private equity market activity expansion.

We devote the last chapter to the ongoing mortgage, later liquidity crisis that started in summer 2007. This is the only chapter, in which we will treat the year 2007, as all the previous chapters basically analyze the situation until 2006. We will describe the main factors, which triggered the crisis, and analyze its impact on private equity markets both in the Czech Republic and in Europe regarding the major trends of the past few years and new trends that may emerge as a consequence of the crisis. The Czech Republic is analyzed in detail to see, whether or not there has been direct or indirect influence of the financial crisis on the private equity market and the overall economy.

2 Methodology

The private equity (PE) market is quite specific. When we want to assemble data for market description, we necessarily have to face the general reluctance of participants to reveal information about transactions[1], or the fact that it is not publicly available, which makes the research more complicated. The information from one source is rather fragmentary and we have to use several different sources to be able to receive more precise information on the market performance. Unfortunately, combination of more sources does not always have to mean reception of a better picture of the market as the existence of two non-corresponding data sets from two different sources for the same period of time is not exceptional.

In the thesis, we will use several basic sources of information about the market activity; therefore it is desirable to provide a general overview including description of the assumptions they come out of and particular understanding of private equity deals, to be able to better interpret the results and be aware of their limitation. There are five major sources of data in this thesis:

1. *European Private Equity and Venture Capital Association (EVCA)*
    a. Central and Eastern European Statistics: data concerning Central and Eastern European (CEE) countries published by EVCA since 2004. The statistics are based on the "market" approach (also being called the country of destination approach), when EVCA assembles information to show activity in a particular country irrespective of the European country the PE house was located in. EVCA chose this approach because of prevailing presence of regional-based funds and fund managers.
    b. EVCA Yearbook: statistics published on a yearly basis concerning activity of all European countries, which are based on the "office" approach (also being called the country of management approach). Concerning the fundraising, the funds are recorded in the home country of the management company that raised them, while allocation of investments depends on the local office structure.

[1] The clause is often incorporated already in the contract between the target company and the PE fund.

2. *Czech Private Equity and Venture Capital Association (CVCA)*

   CVCA assembles data for eleven PE funds' management companies, which are currently full members of the association. A PE firm can become a full member of the association only if it has a representation in the Czech Republic and raises its funds publicly. This approach basically corresponds to the "office" approach of EVCA's statistics. The members are the following ones: Advent International, 3TS Capital Partners, Argus Capital Group, CRG, Czech Venture Partners, ARX Equity Partners (formerly DBG Eastern Europe), SGrow Venture Partners, Genesis Capital, KBC Private Equity, MCI Management and Riverside. CVCA sends it members a questionnaire on a yearly basis to find out details about transactions; however, provides only aggregated statistics on a request.

3. *Deloitte*

   a. Central European Private Equity Confidence Survey: A survey providing an overview of selected important events concerning fundraising, investments and divestments, and expectations of PE professionals in the CEE region. The survey has been carried out twice a year since March 2003 based on questionnaires sent to professionals in private equity firms covering the following Central and Eastern European countries: Estonia, Lithuania, Latvia, Poland, the Czech Republic, Slovakia, Hungary, Romania, Moldova, Bulgaria, Macedonia, Slovenia, Croatia, Bosnia & Herzegovina, Serbia, Montenegro, and Albania.

4. *PricewaterhouseCoopers (PwC)*

   a. Central & Eastern European Mergers & Acquisitions Survey: PwC yearly publishes aggregated data concerning number and volume of mergers and acquisitions (M&A) deals completed by a list of the few largest deals of the particular year. The research is based on the publicly disclosed, private-sector deals carried out in ten CEE countries: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia, and Ukraine. Transactions are classified on the basis of the nationality of the target. Public offerings of private companies are excluded. Privatizations are included separately.

b. Central & Eastern European Mergers & Acquisitions Survey – the Czech Republic: A survey tracking deals connected to the Czech Republic; Czech companies figure either as targets or bidders. The general assumptions are as above.

5. *Mergermarket:*

   Mergermarket provides a list of particular transactions carried out in the region. It has several limitations: the database includes only transactions, whose price was disclosed or estimated to over EUR 5 million. If the price was not publicly disclosed, the database comprises only the acquisitions, where the target company's turnover was over EUR 10 million. Where only a stake has been purchased, the value attributed to the stake will be its purchase price. Mostly transfers of majority or significant stakes are included, if a minority stake (less than 30%) is concerned, the database includes it in case its value reaches at least EUR 100m. If debt will be consolidated as a result of the purchase then that will be included as well. Deal prices stated in the database express the total value of a deal.

3 Private Equity Introduction

3.1 Private Equity and Venture Capital Definition

In Continental Europe, the term private equity is synonymous with the term venture capital. Both terms stand for a medium or a long term financing provided in order to gain a part of equity of a company, shares of which are not publicly traded and that have a potential to generate wealth in the future. The investment period is usually between 4 to 7 years.

In the USA, private equity has always been divided in two subgroups:

- venture capital (used for financing of small companies in the initial phase of growth)
- buyout and buy-in transactions (taking over control of companies in a later stage of development)

As the majority of documents published by EVCA inclines to the American comprehension of the term private equity, we shall do the same or mention if not.

3.1.1 The Business Model

What is the purpose of the private equity? The financial investor's business model is basically divided into three parts: financial engineering using leverage effect, operational increase of value through growth and profitability enhancement and exit strategies.

Financial engineering

Financial engineering represents a basis for every transaction. It consists in using significant amount of loan capital to acquire a company, which guarantees the investor much higher interest on equity used in the transaction. Nevertheless, financial engineering can no longer serve sufficiently well to ensure required profitability due to increasing competition. On average, prices of companies went up forcing financial investors to find other ways to distinguish themselves from their competitors.

This differentiation is done through financial instruments aimed for debt financing, which are available on the market. Apart from common senior debt offered by banks or direct investors, a PE investor can choose between secondary instruments such as mezzanine financing or junior loans, which enables him better harmonization of

risk and return. A PE investor can partially win the competitors' fight by choosing a good debt structure for the transaction.

Strategies to increase value during the investment period

While the financing and exit strategies are rather similar among investors, what can really distinguish successful investors from losers is the ability to increase value during the investment period and reach the required return. Compared to the past, when financial investors were not interfering in the company's management, nowadays it is common that they discuss operational and strategic issues with managers.

The operational increase of company's value heavily relies on investor's ability to motivate the management. As the operational management usually partially owns the company, they are more motivated to undertake unpopular measures in order to increase the value. Therefore they do not have to face the so called "principal-agent problem" to such extent. The management is immediately concerned with financial success of the investment. Investors have also recently started to specialize in certain sectors in order to bring in not only the financial and managerial know how but also the specific knowledge of the sector to be able to keep up with the strategic investors.

Exit strategies

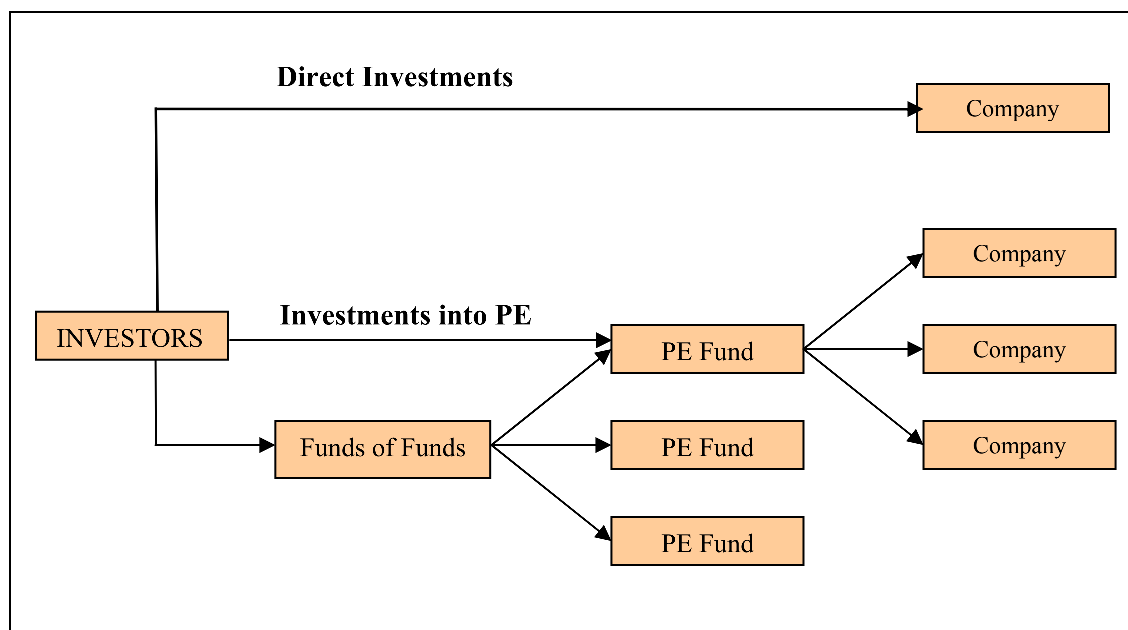
Exit closes the investment and finally decides about its failure or success. In the past, the prevailing strategy was a sale to a strategic investor. Since the second half of the 90's a new exit channel has appeared: the initial public offering (IPO). Its appearance was made through creation of special segments for smaller enterprises on the capital markets. Today there are also other strategies than those two; one of them is a so called "dual track" describing a situation when an investor is preparing a company for an IPO and a sale to a strategic investor at the same time (Ecker, 2006), and a secondary buyout, a transaction when a PE fund exits the project by a sale to another PE fund.

Investment decision depends on the prospectus of the project, not the guarantee. As the risk of the project is high, the investor requires high return in exchange, usually between 20 – 30% p.a. Compared to a loan which enters the balance sheet of the company as a debt item and requires regular payments of the interest; the financial investor invests directly into equity. Therefore he makes profit only when the company makes profit.

There are basically three types of private equity investments as it is suggested in the following scheme: investors may invest directly into a target company, investors may entrust their sources to a PE fund that gathers sources from several different investors and invests in a target company, and the last form consists in investing sources into the so called "fund of funds[2]".

Investing directly into a company requires good knowledge of the sector concerned and therefore is more risky. Clients investing through a PE fund deposit money in it, which the fund manages (and makes investment decisions for them), and then repays them back the money invested plus the profit earned at the end of the investment period. The third possibility, which is becoming more and more popular, consists in placing investments into a fund, which manages up to 25 other PE funds. This structure appears advantageous as it enables better diversification of the risk.

Scheme 3.1: Forms of PE Investments



Source: Penta Investments, 2007

In Chapter 4 and 5 of this thesis, we will focus on the investments through PE funds; however, direct private equity investments play an important role on the private equity markets as well. Therefore all private equity investors will be concerned in Chapter 6.

[2] So called fund of funds invest in other private equity funds in order to provide investors with a lower risk through exposure to a large number of vehicles often of different type and regional focus. Fund of funds accounted for 14% of global commitments made to private equity funds in 2006.

3.1.2 Business Criteria and Strategies

We already know the business model of private equity funds. But what are the criteria that a target firm must satisfy to be attractive for a PE fund? They are the following ones:

- industry with low cyclicality
- unique business idea
- growth perspective
- expected return around 30%
- management with incentives tied up to the company's performance
- thorough due diligence

PE funds prefer companies from industries with low cyclicality to ensure the stability of profits the target company generates, which serve to repay the loans in case of a leveraged buyout (LBO) or generally contribute to high returns for investors at the end of the investment period. The returns that the PE funds expect range between 20 – 30% to cover all the expenses connected to the investment and divestment and at the same time to ensure sufficient returns for PE funds' investors. PE fund managers usually participate on the management of the target company with the current managers, and it is very important to set up the remuneration scheme so that the current management is immediately concerned with the performance of the company. PE funds choose companies with unique business ideas that have a growth perspective with a specified growth plan. A thorough due diligence is part of each transaction in order to minimize the probability of a wrong choice, which would cause a failure.

Regarding buyouts, the PE funds use basically two strategies to generate profits. They either buy companies that are undervalued by the market or that are performing below their potential, so they buy companies to improve their performance by e.g. the buy & build strategy, which allows them to profit from synergies.

3.2 Private Equity Fund Foundation and its Lifecycle

Private equity investments are quite risky; therefore financial investors need to be well organized to control the risk. They establish private equity funds. PE funds are special purpose companies intended to collect sources from investors to invest them in a target company or in other private equity funds.

3.2.1 PE Fund Foundation

How is a private equity fund founded and how is the fund organized internally? Private equity funds are generally structured as limited partnership, which is controlled by a private equity firm that acts as the general partner[3]. The limited partnership is often called the "Fund", and the general partners are designated as the "Management Company".

The management company cooperates with the fund on the contractual basis and is in charge of searching investment opportunities, carries out the evaluation of profitability, realizes the projects, monitors them and then resells the purchased companies. Even though it is the management company that stands behind the selecting process, it is upon the fund to decide in the end. Therefore each fund has an investor committee composed of investors and often also of representatives of the management company, which pronounces the final decision about a project.

The reason for choosing the limited partnership form stems from the fact that the limited partnership form is usually defined quite vaguely in the national legislation, which enables the founder to make particular specification on behalf of different types of investors in the partnership agreement.

3.2.2 PE Fund Lifecycle

Most PE funds are founded for a limited period of time, usually 8 or 10 years (so called “closed-end” funds) when they typically make about 20 separate investments with usually no single investment exceeding 10% of the total commitments. At the end of their life, they are obliged to liquidate all the investments. Existence of the fund is divided into three overlapping stages:

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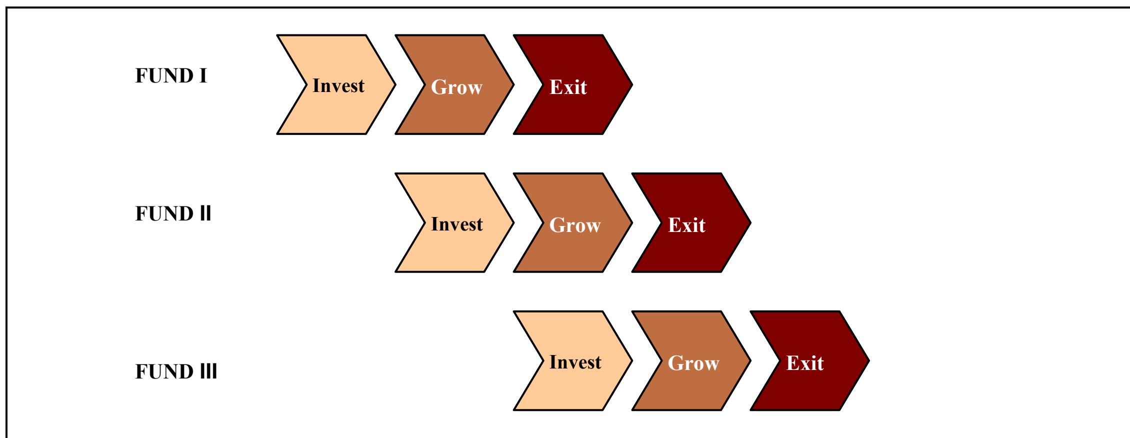
[3] For more detailed information about Limited Partnership Company, see Chapter 5.4.

1. Investment stage – this stage usually lasts for about three years and is dedicated to capital collection, to the search for target companies and finally to the investment itself. Concerning the collection of capital from investors, a PE fund prefers several subsequent drawdowns to collecting the whole amount at once. This requires the investor to hold sufficiently liquid assets to be able to satisfy the call immediately as it occurs, only two or three weeks in advance. If he is not able to comply with the requirement, he is exposed to a penalty. In the EVCA terminology, this technique is called the "just-in-time drawdowns". It is used to minimize the amount of cash that remains in the fund without being invested. The more uninvested cash the fund holds, the lower the internal rate of return (IRR) which measures its performance; therefore the less profitable the fund appears;
2. Maturity stage – maturity stage is in the name of growth and expansion of the invested capital, monitoring the cash flows, management of the company and control of the risk and strategy. This stage usually lasts for 4–7 years, during which it becomes evident, which projects were good investments and which were the loss-making ones;
3. Exit stage – this is the final stage which shows the real profits for investors as well as for the management company of the fund. There is no optimal duration of the third stage as the best moment to resell a company is strictly individual.

Every management company usually manages a few funds at the moment, each of them in a different stage. Therefore whenever one fund reaches the "harvest period", the profits are distributed among investors and the fund is closed, there is another fund that is entering the exit stage and the management company usually establishes a new fund soon after.

Scheme 3.2: Funds' Management Structure



Source: Petra Sedláková

3.3 Private Equity Investors

In general, there are a few types of investors involved in the private equity investments. They differ in their management strategy, ownership structure or form of raising of capital; nevertheless the criteria for choosing a project are similar.

3.3.1 Private Equity Investors

According to Dvořák (1998), common division of private equity investors is the following one:

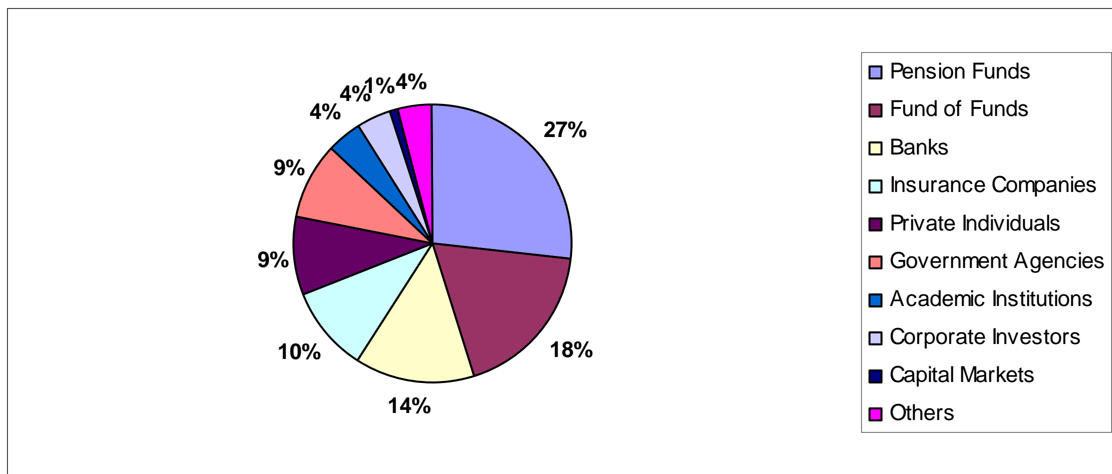
1. Business Angels – are individuals investing their own capital. These investors sometimes create associations in order to increase the amount invested and to lower the risk. This type of investment is sometimes the only chance for starting entrepreneurs;
2. Independent Investors – are investors whose capital comes from several different sources; for example from pension funds, insurance companies, banks or individuals. Independent investors are not legally connected to the organizations that provided the capital;
3. Dependent Investors – are divisions of large organizations such as pension funds, banks or other financial institutions. The institutions provide capital to these divisions, which manage the capital on their behalf;
4. Semi-dependent Investors – are in fact dependent investors who in addition manage funds set up independently on their home organizations;

5. Government Supported Organizations – are investors who obtain the capital directly or indirectly from the governmental resources or are at least supported by the government, e.g. sovereign wealth funds.

3.3.2 Private Equity Funds' Investors

PE funds raise their sources publicly, from three major groups of investors: institutional investors, such as pension funds, insurance companies and banks, corporate and individual investors. These investors are sometimes called "passive" or "hands-off" as they only place their money into the funds and do not participate on investment strategies. These are conducted by the management companies. Nevertheless, the investment strategy is made clear in advance and so are the rules for investors. This is specified in the document called the Information Memorandum or Placing Document, which is written in a manner to attract potential investors. Shares of particular investors of PE funds raised in Europe in 2006 are shown in the graph below.

Graph 3.1: Private Equity Funds Raised by Type of Investor in Europe in 2006



Source: EVCA, 2007

As we can see, pension funds and insurance companies stood behind approximately 37% of sources in 2006. These institutions are supposed to invest the sources in such a manner to ensure safety, quality and profitability. Therefore in most of the countries, there is a limit for the amount of capital of such funds to be invested in private equity funds; usually it ranges between 5–7.5%. On the developed markets, banks, pension funds and insurance companies are not usually restricted to their home

markets but they tend to invest worldwide, in search of markets with the greatest prospective.

3.4 Types of Private Equity Investments

3.4.1 Basic Division

Adhering to the American comprehension of the term private equity, there are basically two types of projects the private equity funds get involved in. The first one are investments in new companies or companies introducing a new product, the second one are the buyouts. According to the EVCA (2007b) terminology, these are further divided in the following way:

1. *Seed Capital*
   - Seed: it represents financing of a very early stage of business, sometimes even before foundation of the company itself. It concerns financing of development of new products, financing of a business plan, choice of management team or establishment of the company. This is certainly the most risky type of investment and the investor can expect a profit from such investment no sooner than in 7–12 years.
2. *Start-up Capital*
   - Start-up: the start-up capital comes after the seed capital, when the company is established and needs investment for further functioning. The product, management team and results of a market research should be already available; nevertheless, this stage is still considered rather risky and the investment returns after 5–10 years.
   - Early Stage Development: the investment is aimed at companies that are already operating on the market and have a certain potential for further development. This potential might remain dormant because they cannot take up a loan at a bank as they do not possess any collateral to back up the loan. So this is a chance for the PE fund to make the best out of the potential. The expected return of the invested capital is in the horizon of 4–7 years.

3. *Expansion Capital*
   - Expansion: the expansion capital is aimed to support a company that wants to strengthen its position on the market, either by introducing new products or expanding to new territories. As it concerns well established companies, the risk is much lower and the expected positive return period shorter, only about 2–5 years.
   - Rescue/Turnaround: the rescue capital is an investment representing a bailout for a company that would otherwise go bankrupt. The capital is provided only if the company is able to offer a good growth plan, which lowers the risk for the financial investor. This type of investment is usually pursued by specialized funds.
4. *Replacement Capital*
   - Secondary purchase/Replacement capital: secondary purchase means a purchase of existing shares of a company from another financial investor or from another shareholder. This form of replacement capital can be also perceived as a form of exit, therefore it is also included in Section 3.5.
   - Refinancing Bank Debt: this type of investment is used to refinance bank debt to reduce a company's level of gearing.

Numerous failures and inability to reach good returns compared to expectations during the exit stage in the 1980's, which was connected to the recession of the world economy, brought about a new focus on the buyout transactions. This type of financing can be considered to be the safest one concerning duration of the investment and the return it brings. It is higher compared to the venture capital funds[4]; nevertheless the capital required for such investment is much greater.

5. *Buyouts*

   The basic types of buyouts are the following ones:
   - Management Buyout (MBO): this transaction enables the current management together with a PE fund to acquire the existing company or a product line.

[4] For more information see EVCA (2006a).

- Management Buy-in (MBI): in this case, the acquisition of the company is done by external management team who buys the shares to take over the company being supported by a PE fund.
- Leverage buyouts (LBO): it is a financing provided to acquire a company by using a significant amount of debt.
- Venture Purchase of Quoted Shares: venture purchase of quoted shares is realized with the purpose taking publicly traded company private.

Each of these types of investment includes a different level of risk and has a different average holding period as it was already mentioned. The investor has to bear the greatest risk when investing in the seed capital, which also requires the longest average holding period, 7–12 years. Therefore the seed capital investments attract only minority of financial investors; and in Central and Eastern Europe they are basically not present at all.

3.4.2 Leveraged Buyouts

Leveraged Buyout Rational and Mechanism

The buyouts are in general less risky compared to the venture capital investments. The reason is simple. The fund is buying an existing company, so it can actually asses its future cash flows that are used to finance the buyout. On the other hand, sources needed for such a transaction are much larger than in case of a seed or a start-up investment. Therefore we usually meet with leveraged buyouts, which means that the transaction is partially financed by debt.

"A leveraged buyout refers to an acquisition of a "target" corporation, in which a substantial portion of the purchase price is borrowed from a 3rd party. Usually a private equity fund (the buying entity) infuses 25%–35% of equity while the rest of the purchase price is funded through senior secured debt and possibly by a subordinated debt." (ČSOB, 2006, p. 1) LBOs are nowadays so popular as they significantly expand PE funds' investment potential. They can realize transactions that would be simply unimaginable only a few years ago. Other advantage consists in tax deductibility of the debt, which makes it a cheaper source of financing compared to equity.

The average portion of debt in such deals ranges between 65%–75%; nevertheless, it very much depends on the region where the deal takes place. Debt ratio levels are often higher in Western Europe. Typically, debt makes up to 40%–60%

of the total transaction size in the CEE countries compared to about 70% in the West. As the companies in the Western Europe suffer by a slow GDP growth rate, they prefer the debt financing which is cheaper for them. This difference of debt proportion also stems from the fact that Czech (and other CEE) banks are usually willing to offer a loan covering only up to 70% of the transaction while abroad the bank loans can finance up to 85% of it.

This and the following description, however, concern only the development until the first half of 2007. The liquidity crisis that broke out in the summer 2007 will undoubtedly have a strong impact on LBOs. The changes brought about by the crisis will be described in Chapter 6.

Sources of Financing a LBO

LBO financial structure is basically made up by three items: equity, senior debt and subordinated debt. These three items, however, do not have to be necessarily all used in every LBO transaction. Thanks to a heavy investors' demand for LBO financing, a wide range of products has appeared on the market. We can observe that the market is still developing concerning certain products and preferences for particular types of financing. However, not all the debt instruments are necessarily used in every LBO transaction.

The equity represents means of the PE fund, which were collected in the fundraising process from the institutional, corporate or private investors. Loans are provided by banks, CDO funds[5], mutual funds or insurance companies. A rough division among the three sources is shown in the table, with a following description of few selected instruments.

Table 3.1: Sources of LBO Financing

SOURCES	PERCENTAGE	Details
(Quazi) Equity	**25–35%**	Common stock, Shareholder loan, Vendor loan
Senior debt	**55–65%**	Acquisition loan (term loan), Revolving loan
Subordinated debt	**10–15%**	Mezzanine capital, High Yield Bond, Second Lien

Source: ČSOB, 2006

[5] A Collateralized Debt Obligation fund, which invests in a diversified group of debt assets. To finance its investments the pool vehicle issues bonds/notes to investors.

Senior debt

Senior debt is a secured debt; therefore the lender requires collateral in exchange for the loan in case the borrower experiences a default. Senior debt is usually partly a term loan and partly a revolving loan. The term loan is typically used to finance the purchase itself while the revolving loan is aimed for working capital (WC) financing.

The term loan is divided into several tranches, which are all pari passu. Tranche A is provided by banks, it consists of term loans with maturity of about 7–8 years; tranche B and tranche C are mainly offered by investment funds with longer maturity and higher price; but they can be funded by banks as well. Nevertheless; these loans are repaid only after full repayment of the tranche A loan and they are basically not yet widespread in Central Europe. In general, repayment of the senior debt starts immediately, with gradually increasing amount of installment as the forecasted cash flow grows; unless it is a subject to a certain grace period, which can reach up to 12 months. The return ranges between 2–3.5% p.a.

Subordinated debt

Subordinated debt is a debt that does not require any principal repayment during the lifetime of the senior debt.. In case of a financial distress, the interest payments can be even suspended, enabling the borrower to shift the resources to the senior debt service. According to Miller (2006), there are these types of subordinated debt:

- *Second lien debt* is a relatively new product, whose popularity has been growing since its appearance on the European market in 2004. It has a slightly different structure than on the American market, where it appeared in the late 1990's. In Europe, it was initially perceived as a "stretch senior" product priced higher than the senior debt to reflect the risk of increased funding. Nowadays, it is not only used as a stretch senior debt but also as a layer of debt between the senior and the mezzanine debt. In general, it is contractually subordinated to the senior debt and superior to the mezzanine debt. Sometimes the loan is incorporated in the senior debt document, which usually deprives the second lien lender of an independent vote. However, it's becoming more common to document the second lien as a separate loan. The return reaches 4–6% p.a.

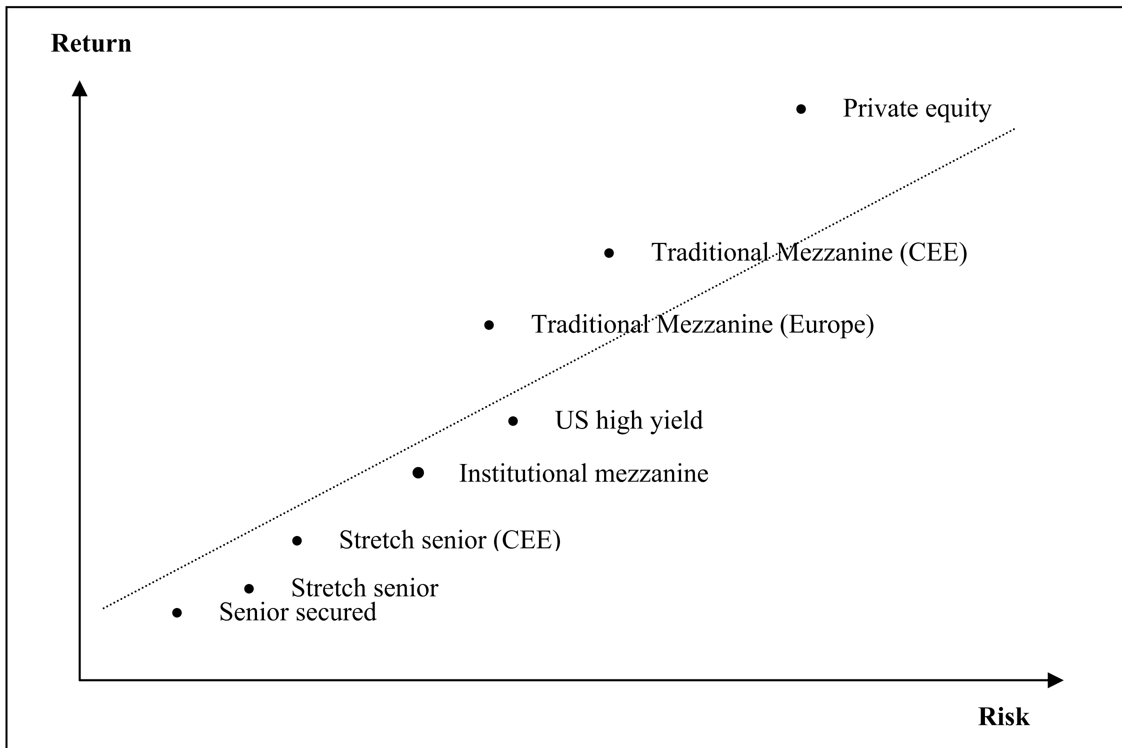
- *The mezzanine financing* is a junior secured type of loan that belongs between equity and the senior debt (or after the second lien debt if it is used) in the company's capital structure. It is widely used in Europe while the United States prefer the high yield debt, which is cheaper. The mezzanine debt is contractually or structurally subordinated to the senior debt and superior to junior unsecured debt. It usually has a longer maturity than the senior debt, typically 8 - 9 years. Mezzanine can be issued with or without equity warrants; the warrantless mezzanine loan is the prevailing form. thanks to higher possible return. Mezzanine interests are partially cash paid and partially rolled up. The rolled up payments are called PIK – payment-in-kind. The return of the mezzanine debt should vary between 8–12% p.a.
- *The high yield bonds* are not yet so widespread in Europe. They are issued to international investors such as CDO funds, pension funds or insurance companies, and traded in liquid market, which is offset by lower yield compared to the mezzanine debt. They are structurally subordinated to the senior debt and the mezzanine and normally unsecured. They are typically used in large transactions to refinance the initial acquisition debt. The average return varies from 8 to 9% p.a.

The preference of the senior debt, as it is visible from the table above, is not a coincidence. PE funds tend to acquire as much senior debt as possible as it is the cheapest source of financing for them. Senior debt is a secured debt; therefore the bank requires collateral, which reduces the risk. In exchange, the interest rate it offers to the client is lower than in case of subordinated debt, which is sometimes unsecured. For the bank the risk that arises from the senior debt as well as the possible return is low.

The subordinated debt is contractually subordinated to the senior debt and in some cases unsecured; therefore in case of default, it can be satisfied only after all the senior debts' requirements are satisfied. The probability that there will be still some assets available to supply the lender is quite low, which is compensated by higher interest rates the company has to regularly pay. Both the risk and return have increased as compared to the previous case. It is vital to the PE investor to assess correctly its overall financial needs; it will be later hard to get a new loan as the company will be

already quite indebted. The position of particular types of loans versus private equity in the risk-return diagram is the following:

Scheme 3.3: Risk-Return Diagram for Particular Types of Loans



Source: Mezzanine Management, 2006

The structure of financing is changing, though. While in 2003 62.4% of the European LBOs were financed using only the senior debt; three years later in 2006 the share of senior debt in the LBO debt structure dropped to only 31.7% (Miller, 2006). Since 2004, after its appearance, the popularity of a second lien debt started to grow in Europe.

Apart from these loans, whose applicants are the PE funds, there are also other loans, which are provided to the target company mainly for the operating and working capital purposes. These are e.g. the CAPEX line or the WC products[6]. The CAPEX line is an arrangement with a bank to extend a specified amount of credit secured by the new investment or shares for a specified period of time aimed for the capital expenditures.

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[6] Working capital products, e.g. RVG products.

3.5 Exit Strategies

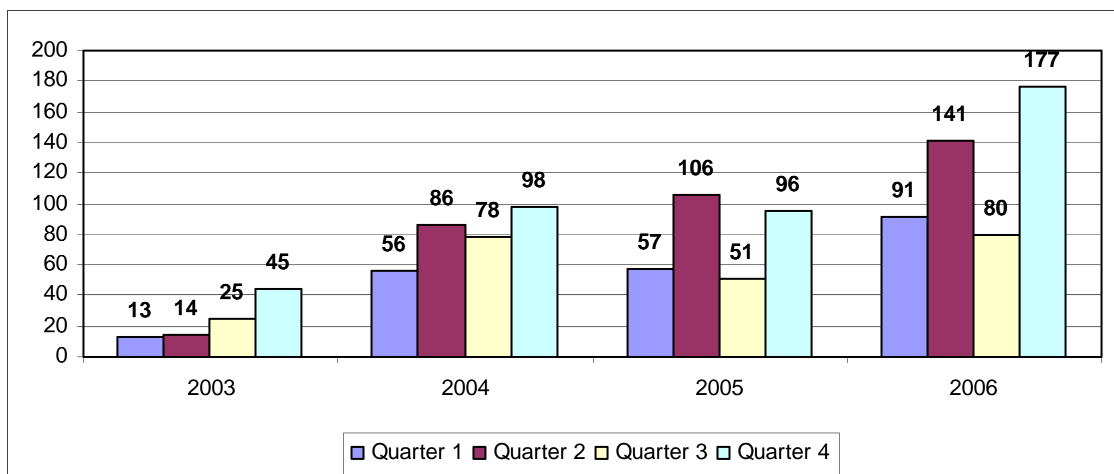
After the restructuring process of a company under the PE fund's management has been finished, the management starts to search possibilities to exit the project. How can the investor make so? The company cannot be simply sold on the stock exchange, as it is not listed there at the time. Therefore there are other forms of exit:

1. IPO
2. Trade sale
3. Secondary sale
4. Repayment of Shares/Loans
5. Write-off
6. Other

IPO

The initial public offering means that the financial investor goes public with the company and sells it on the stock exchange. The IPO indicates a certain quality of the company as there are heavy regulatory compliances and reporting requirements to be satisfied before it can go public. The IPO is typical for the USA, even though Europe is trying to catch up in the past years showing the increasing trend as can be seen in the graph below. Yet, in the bank-based countries such as Germany, France or CEE countries, the stock exchange is still rather underdeveloped.

Graph 3.2: Development of Number of IPOs in Europe 2003–2006



Source: EVCA Barometer, 2005–2008

Trade sale

When the financial investor exits the project through trade sale, it means that he sells his shares to a strategic partner. Strategic partner buys the company because it is connected to his business and he sees potential synergies that could be realized. These might be: saving costs (e.g. personal costs), gaining access to strategic sources, penetrating new markets, increasing its power on the current market and others. Thanks to the perspective of potential synergies, the strategic partner may be willing to offer higher price than the financial investor could otherwise gain through an IPO.

Secondary sale

In the recent years, another trend has appeared – a secondary sale. It occurs when the financial investor sells the company to another financial investor. This usually happens when there is no other appropriate party concerned and the current investor is willing to exit the project.

Payout to investor[7]:

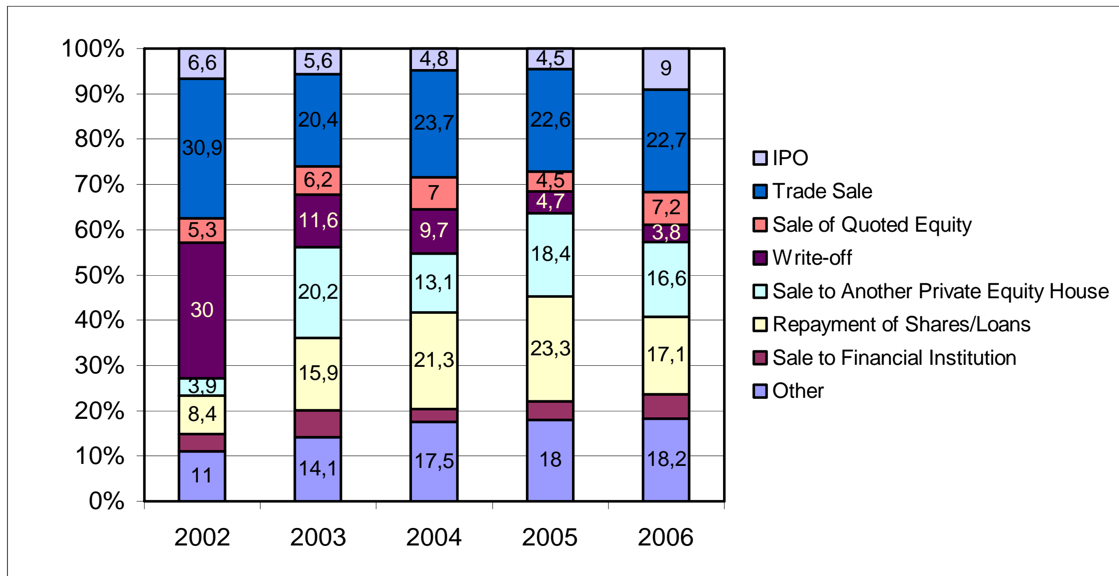
This type of exit signifies either that the owners of the company pay back for the shares they once sold to the financial investors or that the financial investor pays back the bank loan he used to acquire the company.

Write-off

Write-off represents an involuntary exit. It arrives when the management company sees that the project is a failure and it is forced to exit it not to loose more capital. When none of the previous exits can be realized, the financial investor is pressed to sell the company below cost and start the liquidation. Different types of exit and their development since 2002 in Europe are recorded in the graph below:

[7] It is called "Repayment of Shares/Loans" according to the EVCA terminology.

Graph 3.3: European Divestment at Cost 2002–2006 (in % of Total)



Source: EVCA, 2007

The form of exit and the price that the financial investor is offered are very important for measuring the overall success and return of the project. Details of return measurement are disclosed in the next section. In general, about 10% of the projects end up as a total failure, others make profit and 10% of the most profitable investments make up for all the loses of the fund (Mašek, 2006b). According to EVCA, during the past 27 years the average long-term annual return reached 17%; in case of investments ended up by a sale to a new owner, the return reached even 31%. Concerning the return required by financial investors, it ranges between 20–30%.

3.6 Methods of Measuring the Returns

There are several ways to measure the "success" or "failure" of a project. EVCA (2006a) indicates the following measurements:

1. IRR – the interim net return earned by the investor from the fund from the inception to a stated date. It is the rate of return that would make the present value of future cash flows plus the final market value of the investment or business opportunity equal to the current market price of the investment opportunity. The IRR is net; i.e. after deduction of all fees and carried interest.

$$PV(I_0) = \sum_t^T \frac{CF_t(I_0)}{(1+IRR)^t} + \frac{I_0}{(1+IRR)^T}$$

I………investment of the PE fund

PV(I)….current market price of investment opportunity

CF_n…...cash inflows of the acquired company each year

IRR…....internal rate of return

T………lifetime of the project in years

t……….particular years of the project

Unfortunately there is a pitfall of IRR. We cannot use it in case of changing sign of cash flows. This can happen when the project does not generate only positive cash flows all the years but for example requires some additional investment. If cash flow sign changes from negative to positive over the life of the project, then there can be as many IRR as changes of the sign, or none. The final IRR can be determined not sooner than after the end of the project.

2. Pooled IRR – it is obtained by taking cash flows from inception together with residual value for each fund and aggregating them into a pool as if they were a single fund.
3. Horizon IRR – it is used to indicate trends in the industry. The fund's net asset value at the beginning of the period is used as an initial cash outflow and the residual value at the end of the period is taken as the terminal cash flow. The IRR is then calculated by using those two values and any cash received or paid by the fund from or to investors during the specified period of time.

4 Private Equity Drivers and Development in CEE Countries

Nowadays there exist three major areas of private equity: United States and Canada, European Union and the South East Asia. Numerous studies have already been carried out on the US private equity market; however, we will concentrate on the development of the Central and Eastern European market, the Czech Republic is part of. The knowledge gained in this chapter will also serve us as a basis for our analysis of the Czech Republic in Chapter 5.

The CEE countries are considered to be very perspective as the private equity markets are still in their infancy there compared to other private equity areas. The PE markets evolution has been connected to the GDP growth, interest rate development, foreign direct investments (FDI), level of entrepreneurship and R&D expenditures in accordance with the empirical findings in the USA and Western Europe; and to some specific features of the markets such as high number of companies, which have not yet been restructured as a heritage from the communist era, the ongoing consolidation of sectors, EU accession, and generation problems. This is why they have been attracting investors on potentially high yields. At the same time, some of the factors that have a positive impact on the PE market activity such as the easy launch of IPOs have been missing.

4.1 Drivers of Private Equity Activity – Empirical Evidence

Before we start to analyze the overall PE market development in the CEE countries, we need to have a closer look at the drivers and determinants of the PE activity to be better able to analyze the subsequent data provided.

4.1.1 Literature Review

In recent years, researchers in Europe and especially in the USA have conducted numerous studies concerning private equity/venture capital[8] market. We will base our findings on several studies including both data assembled in Europe as well as in the United States. The number of studies concerning (Western) Europe is still quite low compared to the number of US-based studies. Unfortunately, the number of studies concerning the CEE countries is particularly low due to its very short history and

[8] In the following text, we will use the term "venture capital" when the surveys do not include buyouts.

nonexistence of appropriate data sets for all CEE countries[9]. Therefore we will use the results of researches from all the three geographical areas to assess general drivers of private equity markets and then try to recognize the main obstacles peculiar to these countries; including the Czech Republic[10].

Researches have been focused on numerous factors influencing private equity fundraising, investment and performance. The authors basically used three types of methodology: they either developed an econometric model (mostly a panel data model) to study factor interdependencies, or they carried out a quantitative survey by the parties concerned and analyzed the responses, or they used aggregated information about fundraising, investments etc. to make a general overview of private equity market direction. In the next table we bring an overview of most frequently studied factors in a sample of few selected researches. These researches are the ones that are most related to our further analysis. Some of the indicated factors will be subsequently discussed in detail.

Table 4.1: Overview of Determinants Analyzed by the Reference Authors

Potential Determinants	Gompers and Lerner (1998)	Jeng and Wells (1998)	Romain and La Potterie (2004)	Phalippou and Zollo (2005)	Felix et al. (2007)
	USA industry aggregated data	21 Countries, panel data and cross selection	16 countries, panel data	US and European data	23 European Countries, panel data
Macroeconomic Conditions					
GDP	√				
GDP Growth Rate	√	√	√	√	√
Level of Interest Rate (1 Year)	√		√	√	
Level of Interest Rate (10 Years)			√	√	√
Difference of the Two Interest Rates			√	√	
Private Pension Funds	√	√			
Entrepreneurial Variables					
Capital Gains Tax Rate	√	√	√		
Labor Market Rigidities	√		√		
IPO	√	√			√
SMC Growth Rate		√			√
Capital Market Returns	√			√	
Level of Entrepreneurship			√		√
Technological Opportunities					
Number of Triadic paterns			√		
Business R&D Growth	√		√		√
Stock of Knowledge	√		√		

Source: Based on Félix et al. (2007), completed by Petra Sedláková

A study carried out by Gompers and Lerner in 1998 is one of the cornerstone studies that is being cited in nearly every consequent paper. These two authors examined factors that influence the venture capital activity – on the industry, state and

[9] There have been some researches, which included the CEE countries, but there was usually only a small number of them in a large sample of West European countries.
[10] This will be developed in detail in Chapter 5.5.

firm-specific level; and the fundraising. They used a sample of private equity firms based in the USA and excluded data for leveraged buyouts. On the state level, which mainly matters for our purpose of application on the CEE countries, it was discovered that the main drivers are industrial and academic R&D spending, GDP growth per capita and capital gains tax rate; the latter being negatively related to venture capital. Regulatory changes influencing pension funds are also important.

In 1998, Jeng and Wells conducted a research on a data sample of 21 countries from different continents collected between 1986 and 1995, using the panel data approach. In their paper they modeled separately the venture capital supply and demand, which was later used by other authors as well. They confirmed their hypothesis about cyclicality of private equity and venture capital markets, which is caused by IPOs divestments. Government policies also seem to be important as they establish a regulatory environment and can enhance the activity in economic downturns. The influence of GDP and market capitalization growth on investments unexpectedly proved insignificant. They also drew an important conclusion about different stages of venture capital investments being influenced by slightly different factors.

In 2003, Kaplan and Schoar examined the performance and capital inflows of private equity funds. They used a sample of data set of individual fund performances from 1980 to 2001. They compared the average funds' returns over the period to the return of the S&P 500 and found out that they are roughly equal. They found out that returns of funds raised by one private equity firm tend to persist over time. In general, they examined factors such as the fund size, sequence number[11] and experience of PE firm, not purely macroeconomic factors. They found out that the performance of the two previous funds has a positive effect on the performance of the current PE fund. They also claimed that the PE firms that raise funds in the boom times are less likely to raise a following fund as the current fund will perform worse.

Romain and La Potterie (2004) carried out a research examining main determinants of venture capital on a sample of 16 OECD countries over the period 1990–2000. They showed that venture capital is positively and significantly influenced by GDP growth, short-term and long-term interest rates, growth rate of R&D

[11] *"Fund families raise one fund at a time. The first fund ever raised by a given fund family is assigned a sequence number of 1, the second fund is assigned a sequence number of 2 etc."* (Phalippou and Zollo, 2005, p. 14)

expenditures and technological opportunities. They also focused on the effect of the setting of the labor market by including labor market rigidities and TEA[12]. They found out that labor market rigidities reduce cyclicality of venture capital through the effect of suppressing the positive effect of GDP growth rate.

Phalippou and Zollo (2005) used data collected in the USA and Europe for the period 1980–2003 to analyze determinants of private equity funds' performance. They stated that private equity is related to business cycles and public stock market. Concerning the interest rates, they see that funds that invested in a period with high interest rates and credit spreads[13] underperformed. They confirmed the relation between performance and fund size, and performance and sequence number as already observed by Kaplan and Schoar (2003). According to them, the length of investment matters as well, and the relation is negative.

Klonowski (2006) investigated the role of venture capital[14] in Central and Eastern European countries. He has been engaged in the topic since the end of 1990's concentrating either on the region as a whole or on particular countries. In his research from 2006, he focused mainly on the development in Poland, Hungary, the Czech Republic and Slovakia giving an overview of situation between 1998–2003 concerning fundraising, investments and exits. He indicated Poland as the regional leader and pointed out the heterogeneity of the region. The Czech venture capital market was identified as one of the weakest ones in the CEE region.

Félix et al. (2007) conducted a research to find drivers of venture capital in Europe; using the venture capital equilibrium model already used by Jeng and Wells (1998) or Romain and La Potterie (2004). The research paper analyzed data of 23 countries including four CEE countries – the Czech Republic, Hungary, Poland and Romania; the period concerned was 1992–2003. They focused on standard macroeconomic determinants such as GDP growth rate, market capitalization growth or interest rates, and added unemployment rate, trade sale divestments (as opposed to sole emphasis on IPOs by other authors) and price/book ratio. Their results confirmed positive impact of GDP, which, however, was not statistically significant. The impact of interest rates was also significant but the sign varied in case of model

[12] *"Total Entrepreneurship Activity - index computed by adding proportion of adults involved in the creation of nascent firms and the proportion involved in new firms."* (Romain and la Poterie, 2004, p. 6)
[13] *"Credit spread is the difference between the yield on the corporate-BAA bonds and the 10-year treasury bonds."* (Phalippou and Zollo, 2005, p. 11)
[14] Klonowski uses the term "venture capital" in the sense of "private equity".

with macroeconomic indicators only and other models. Unemployment rate showed out a significant negative impact on venture capital investments.

Groh et al. (2008) carried out a quantitative survey based on a questionnaire sent to 1,079 limited partnerships worldwide, of which 75 responded. Respondents had to evaluate the attractiveness of the region, key determinants of activity in the CEE region and other characteristics. Regarding the key determinants, economic activity, entrepreneurial opportunities and taxation turned out to be very important in a decision making process. Their overall conclusion was that the supply of capital is relatively low in the region given its opportunities.

4.1.2 Determinants of Private Equity Activity

For our further analysis we will focus on the following determinants of PE activity: GDP growth rate, IPOs, interest rates, R&D expenditures, the level of entrepreneurship, capital gains tax rate and pension funds' legislation, and will sum up the empirical evidence on their relation to private equity market, and their significance.

As it was already stated, private equity is procyclical; therefore the GDP growth rate effect is positive and significant as reported by Gompers and Lerner (1998) and Romain and La Potterie (2004). The first two suggested that the possible explanation of this effect is that a growing economy has more potential to create new firms that demand venture capital; therefore the incentive comes from the demand side. We suggest that economic growth also supports internal growth of companies, which then attract buyout funds as they are able to generate enough cash flow to pay the debt installments. Romain and La Potterie (2004) also studied whether a time lag matters and found out that only the contemporary GDP growth rate matters. The positive GDP growth rate impact can be, however, diminished by existence of labor market rigidities. As opposed to the previous authors, Jeng and Wells (1998) find the impact of GDP insignificant. Almost ten years later, Félix et al. (2007) confirmed the findings of Jeng and Wells of positive but in most models insignificant impact of GDP growth rate. The overall influence of GDP growth rate is positive; however, the degree of importance can vary over countries.

Regarding the IPO, it is vital as it represents an important route of exit (mainly in the USA) and therefore stimulates the private equity supply and demand (Félix et al., 2007). Its positive and significant effect, which belongs among the strongest ones, was reported also by Jeng and Wells (1998), while no effect was

observed by Gompers and Lerner (1998). Félix at al. (2007) even claimed that trade sales are of the same importance, especially concerning the European market, as it is the most common exit route there.

Jeng and Wells (1998) also examined the effect of market capitalization growth. They found the effect to be positive but insignificant. Félix et al. (2007), who also examined the possible dependency, arrived to the similar conclusion: there is a positive effect of market capitalization; nevertheless, it is not convictive and for example for early stage investments the effect is null (Félix et al., 2007).

Both short-term and long-term interest rates have a positive and significant impact on the venture capital (VC) activity, which according to Romain et al. (2004) signifies stronger demand effect than supply effect of interest rates. The positive relation between interest rates and venture capital supply is quite surprising as *"investing in bonds is an alternative to venture capital investment, when the interest rate increases, the attractiveness of the investment in venture capital funds diminishes"* (Félix et al., 2007, p. 8). Gompers and Lerner (1998) find a negative relation between short-term interest rate and venture capital on the state level, on the aggregated level the effect is positive. Romain et al. (2004) studied not only the effect of short-term vs. long-term interest rates but also their difference (spread), which proved to have a negative and significant impact via the supply side effect - the greater the difference between short-term and long-term interest rates, the less the investors will be attracted by venture capital. The positive impact of short term interest rates was also confirmed by Gompers and Lerner (1998) at the aggregated as well as on the state level. Phalippou and Zollo (2005) confirm the importance of interest rates on private equity concerning the timing of investments.

Other area of interest was the technological opportunity represented by growth rate of business R&D expenditures and business R&D capital stock as specified in Romain and La Poterie (2004). Both determinants were significant and positively stimulated PE activity. Its positive effect was even increased with the increase of level of entrepreneurship in the country. However, the positive effect is not obtained until a minimum level of entrepreneurship is reached. Gompers and Lerner (1998) also acknowledged the positive and significant impact of R&D; in their case defined as industrial and academic expenditures. The observed positive effect is related to entrepreneurial activity – R&D expenditures stimulate creation of entrepreneurial firms that demand venture capital. Félix et al. (2007) also expected a positive effect;

however, the empirical result was quite disappointing for them, as the sign of the variable differed across regressions and was insignificant.

Jeng and Wells (1998) also reported the importance of reduction of restriction for the pension funds' investments as they can possibly be one of the most active PE funds' investors. They found out that the investments of pension funds are not important across countries but they are important over time. Gompers and Lerner (1998) reached a similar conclusion about the importance of pension funds legislation.

The impact of the capital gains tax rate has been studied by Gompers and Lerner (1998), who found that it has a significant negative effect on the size of funds raised. Jeng and Wells (1998) claimed that the tax's effect on venture capital activity is not significant, which was also confirmed by Romain and La Potterie (2004). In the survey carried out by Groh et al. (2008), limited partners, however, named the taxation system among the top three factors of attractiveness of CEE countries.

The level of entrepreneurship should not be omitted. It was acknowledged by Romain and La Potterie (2004) that the level of entrepreneurship has a positive impact on venture capital intensity. However, the effect is not straightforward but works through the increase of business R&D capital stock. The level of entrepreneurship was measured by the TEA index, which was later used also by Félix et al. (2007). They expected the TEA index to be positively related to venture capital investments; nevertheless, in their analysis, TEA proved to be insignificant and the signal of the coefficient even varied across regressions. One of the possible explanations, which were offered by the authors, was that TEA does not precisely capture the level of entrepreneurship.

As we can see, the authors did not always arrive to the same conclusion about signs and significance of the determinants of private equity. However, GDP growth rate, IPOs, interest rates, R&D expenditures and the level of entrepreneurship were found significant in most of the cases, and were also the most frequent determinants to analyze. Therefore we shall keep them in mind during the analysis of the private equity market in the CEE countries.

4.2 Development of the Private Equity in Central and Eastern Europe

We are now going to outline the development of private equity market in the CEE countries within the frame of the determinants stated above and show the recent trends,

both positive and negative. In addition, we will also examine the role of financial market maturity as one of the key determinants of the activity.

The data mainly focuses on three statistics: fundraising, investments, and divestments. These statistics should indicate the strength of private equity development in these countries. Fundraising reflects the attractiveness of the market, investments signals sufficient number of interesting projects and divestments shows the investor's capability to exit the project and realize the final profit or loss on the project (Klonowski, 2006).

4.2.1 Macroeconomic and Legislative Environment

Development of private equity in Central and Eastern European Countries was triggered by the change of the political situation at the turn of the 1980's. Privatization, which followed soon after the fall of regimes, offered a great opportunity for private equity; however, it mostly remained unused as there were not yet institutions possessing funds and know-how that could realize such projects as in the Western countries, the legal environment was not sufficiently developed and there was a great political risk. First serious interest in the CEE countries can be noticed after 1992, when the countries became relatively politically stable and therefore there was finally space for private equity expansion.

"The major macro-economic goals accomplished since then include stoppage of 'galloping' inflation and its systematic reduction, the reduction of interest rates, the stabilization and convertibility of local currencies, and the privatization of state-owned enterprises. Achievement of these ambitious macro-economic objectives, as well as the creation of legal and administrative foundations to encourage competition and free-market economy behavior, has lead to a strong private-sector growth."
(Klonowski, 2006, p. 165)

Private equity development went through several stages so far:

1. *First stage 1991–1994* – emergence of private equity thanks to the help of European Union's Phare program, sources of European Bank for Reconstruction and Development (EBRD) and the USA. Private equity investments were not very popular at the time as they mostly did not reach the required rate of return on capital. Nevertheless, private equity scored in Hungary, which established

the Hungarian Private Equity and Venture Capital Association (HVCA)[15] already in 1991, followed by the Czech Private Equity and Venture Capital Association in 1995.

2. *Second stage 1995–1998* – American and West European financial investors were penetrating the region attracted by the ongoing privatization of state-owned companies. New local players emerged as well. However, the PE market development slowed down due to the Russian crisis, which affected mostly the Baltic countries through the export. The Czech Republic suffered from a financial crisis in 1997–1998, which resulted in a negative GDP growth rate in those two years.
3. *Third stage 1999–2006* – new local and regional players emerged on the market as a result of an overall macroeconomic stabilization. Investors newly need to struggle for the best investment opportunities due to increased competition. First buyout transactions generally backed by a financial leverage are realized in the region. One important milestone during this period was represented by the accession of (some of) the CEE countries to the EU in 2004, which strengthened their credibility and subsequently boosted up the PE market activity. Some signs of improved activity were already visible after 2000, when all the countries have already opened accession negotiations, during which they undertook to fulfill certain political, economic and legal criteria.

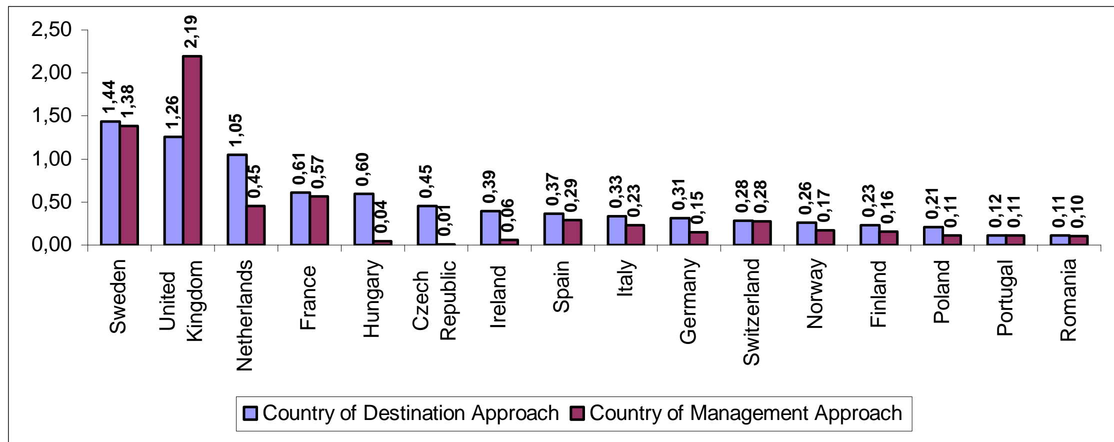
Concerning the overall macroeconomic indicators; the CEE region has been quite favorable for private equity market development. The *GDP growth rate* has been on average increasing in the past years. Apart from Hungary, since 2004 all the CEE countries recorded a GDP growth rate surpassing 4% every year; and some of the countries reached even double digit growth; e.g. Estonia and Latvia in 2005 and 2006. This growth rate compared to the EU 15 average of 2.4% signifies an outstanding performance. The *interest rates* which affect the private equity activity from both the demand and the supply side, have been decreasing, which supported the supply side effect and led to increased activity of PE funds.

Despite the increasing activity, when we compare PE investments as a percentage of GDP, which expresses the *maturity of a country*, majority of CEE countries still lags

[15] According to the practice in the Western Countries.

behind the EU 15 score. It is interesting to compare this indicator deduced from the EVCA's "country of management" and "country of destination[16]" approach. It reveals us the roles the states are playing.

Graph 4.1: Private Equity Investments as % of GDP in 2006 in Selected European Countries



Source: EVCA Yearbook, 2007

As we can see, there are a few European PE market leaders, such as Sweden, United Kingdom, Netherlands or France, under either of the approach. This signifies maturity of these markets. The most remarkable change on the other hand occurs in case of Hungary and the Czech Republic, which very much profit from the market approach. The explanation is simple: in 2006, there was one outstanding transaction carried out in each of the country, which improved their market approach score. The great difference between the market and the office approach in case of majority of CEE countries indicates that the countries still rather play a *role of a target* than an acquirer. As it was noticed by Groh et al. (2008), the supply of local capital is relatively low in the region given its investment opportunities. Despite the existence of a few strong local players, PE funds with regional or worldwide-focus prevail; therefore the office approach score is quite low. Given the results, there is still great space for improvement on the national level, which will, however, not be so easy to reach, because of the small size of particular CEE countries, which do not offer enough investment opportunities by themselves.

Nowadays, private equity represents an important source of capital for firms in the CEE region; however, the situation differs in case of venture capital investments, and expansion and (leveraged) buyout investments. As for the last two forms,

[16] See Chapter 2.

which concern mid-sized or large companies, private equity has played an important role as other *access to capital* has been complicated for the firms: the banks had been generally rather cautious to provide long-term debts for investment purposes before 2002; the option of an acquisition by a strategic partner can be limited because of the high fragmentation of certain markets; and thanks to the underdeveloped capital markets the companies do not have a possibility to easily obtain new capital by issuing shares or bonds.

The *non-functioning capital markets* not only inhibit raising of new capital but they also hold back the private equity market development as IPO is one of the favorite exit routes (currently mainly in the USA). The Prague Stock Exchange (PSE) and especially the Warsaw Stock Exchange, however, have lately been showing some signs of increasing activity. The Warsaw Stock Exchange has been particularly vivid, being able to keep up with its competitors Frankfurt and Euronext carrying out dozens of IPOs every year. The Prague Stock Exchange has remained on the average of approximately one IPO per year since 2004 but apart from the IPO of Zentiva in 2004 and Pegas Nonwovens in 2006, none of the IPOs was executed as a form of exit of a PE fund from a company.

Concerning the stock markets, in the United States and in Western Europe, there has recently been more delisted companies than IPOs carried out by private equity investors. *Delisting of publicly traded companies* can be a healthy step for underperforming companies or for companies, of which the business model is changing profoundly. A PE fund can increase the value of the company through financial and strategic changes. However, it is not suitable for companies with high variability of profits, as the profits of the target company serve for interest payments. Such a strategy removes the low performing companies from the stock exchanges and may actually improve the overall returns of the stock markets. This concept has lately been introduced in the CEE countries as well, mainly in Hungary and Poland. In the 1990's during the privatization era, many companies were listed on the stock exchanges but as they were not performing well, a great number of them has already been delisted. Nevertheless, there are still numerous candidates for delisting in the CEE countries.

While private equity represents a viable alternative for financing of the later stage development of companies and buyouts, its role concerning the *seed capital* (and start-up capital; however, not to such extent) is truly tragic. Starting firms, not being able to show firm (financial) history, basically have no chance to obtain a loan in

a bank. Private equity theoretically seems to be a good solution; nevertheless, this model does not work very well in the CEE countries as the buyouts promise a great return and sooner. In addition, a lower risk is naturally incorporated.

The average share of seed capital was 0% between the years 2003 – 2006, by addition of the start-up capital, the average increases to 3% over the same period. This is a very unpleasant situation for CEE countries given the fact that today's giants like Microsoft, Apple or Intel were also financed by venture capital at the beginning. However, it shows very well the different role private equity plays in these countries: while in the West private equity has served as a financial solution for new starting-up firms, with a special focus on the high-tech industry, in CEE countries PE investors are rather *engaged in traditional industries*.

In the CEE countries, *small and medium enterprises* (SME) are playing a key role. Even though the region is quite heterogeneous, the share of SME in non-financial business reached over 99% in all CEE countries in 2004 concerning the number of enterprises, of which majority was represented by micro enterprises with below ten employees. According to Eurostat statistics, the SME sector employed approximately 68% of persons in 2004. Unlike the Western European SME, majority of CEE SME was founded in mid–1990's; therefore the companies are usually now reaching their maturity stage. And without an appropriate successor, they represent an attractive target of private equity investors. These investments further stimulate the GDP growth through business innovations and job creation. Unfortunately the seed and start-up projects are largely avoided.

Another issue for private equity market development is represented by the *legislation*. CEE private equity markets clearly benefited from the process of adapting legal codes as a part of the accession to the European Union. Nevertheless, a few obstacles to further private equity market development persist; namely the legislation concerning pension funds, insurance companies, and capital gains tax rate. Pension funds' legislation is very important as it influences the fundraising – therefore the amount available for investments. In some countries such as Poland, the Czech Republic, Romania and Slovenia, pension funds are not allowed to invest in private equity; concerning the insurance companies, it is mostly allowed, however, restrictions on the volume of investment or geographical area are often imposed.

As for the *tax rate on capital gains*, the European average of 15% is surpassed in Slovenia (20%) for individuals selling shares, in Poland it is 19% and in Hungary it

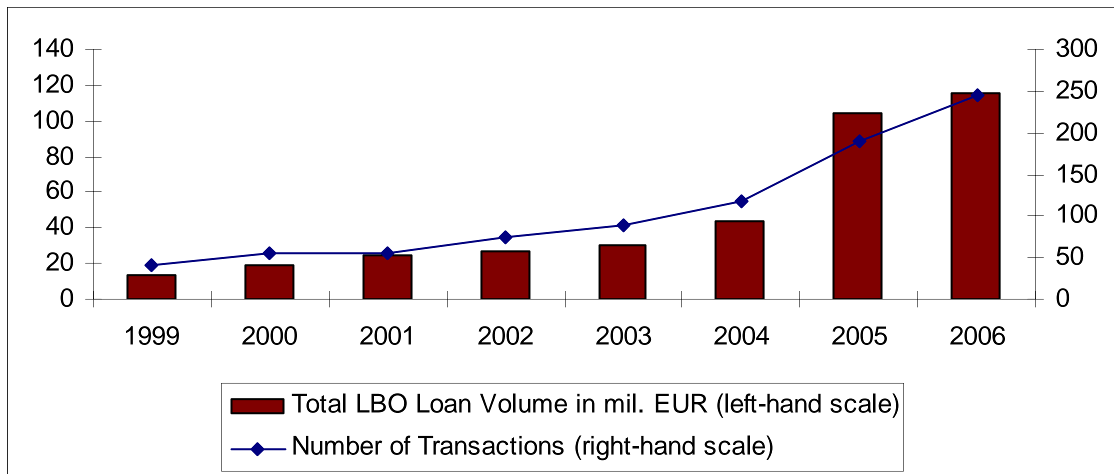
reaches 25% for income from stock options and carried interest. These high levels are not very encouraging for investors.

Regarding the fiscal *R&D expenditures*, when we compare the gross domestic expenditure on R&D as a percentage of GDP, majority of CEE countries remains under the average of 1.86 of EU 27 for the past six years. The two CEE countries being the closest ones to the average are the Czech Republic and Slovenia. An explanation can be provided by looking at R&D incentives that the countries offer. The Czech Republic or Slovenia do provide incentives, e.g. in form of an additional deduction of R&D costs, an additional deduction of depreciation or reduction of the specialist's salary tax base; while other countries such as Romania and Bulgaria basically provide no incentives and are at the bottom of the list.

In the 1990's the *situation on the banking market* was quite complicated for both companies asking directly for long-term loans and for the PE funds' demand for leveraged financing. The banks were not willing to accept high levels of risk and on the contrary, as they were not yet privatized, they did not possess the necessary know-how to carry out certain types of transactions. The entrance of an international owner after the privatization was mutually advantageous, as the local banks received know-how, improved their credibility and the banking market has deepened as new financing structures were introduced. At the same time, the owner penetrated to the market possessing knowledge of local environment thanks to these local banks.

What was crucial for the PE funds leveraged financing was the high liquidity on the banking market, low interest rates, presence of teams that were able to carry out such transactions and the move towards client-driven approach since 2002, which enabled the funds to negotiate more flexible terms on loans. Within the *boom of LBOs*, there was no obstacle for buyouts in becoming the prevailing form of private equity investments. PE investors were suddenly able to reach investments that they could only dream of a few years ago. The Central and Eastern European buyout market has become increasingly competitive as the investors were attracted by emerging market growth rates with Western level of risk, which was granted by the accession of majority of CEE countries to the EU. In 2001, there was still majority of PE transactions carried out by using equity only; however, later on, commercial banks started to provide senior and subordinated debts on a larger scale. The regional focus on expansion capital was therefore in 2003 replaced by focus on leveraged buyouts. The growth in LBO bank financing in Europe over the past 8 years is demonstrated in the following graph.

Graph 4.2: Growth in LBO Bank Financing in Europe 1999–2006



Source: Geršl, 2007

The average level of debt now typically makes about 40–60% of a transaction compared to up to 70% in case of the West-European countries. Since 2005, the debt financing has been approximately 20% cheaper in the CEE countries; however, its strong position in the Western European countries has persisted. There are few reasons why the share of debt in CEE countries does not reach the Western levels: the value creation in CEE countries often comes from company's growth and performance, not financial engineering and level of leverage – simply the region is growing so fast that there is no need to over-leverage the companies; the banks are not willing to participate on the transaction to such extent because of the risk, set debt to EBITDA ratio used and for motivation purposes. If a PE fund shares the burden of a project through placing its own capital, it is more concerned with the success of the project.

The low interest rates led to easy access to financing for PE funds, which pushed the prices of the target companies very high. Therefore LBOs have not only become the prevailing form of investments of PE funds, but PE funds have become an important player on the M&A market. Thanks to the "low" price of debt, PE investors have been *crowding out strategic investors*, who finance the acquisitions by using less debt. As the financial investors were *pushing up the prices*, the strategic investors were no longer able to win the auctions. Therefore some targets that would create more value in hands of a strategic investor ended up in a PE fund's portfolio. This may gradually lead to the tactics when the companies will prefer to grow organically than to grow through M&A. As it is stated in the McKenzie study (2007), nowadays, private equity

stands behind one in three transactions in the United States and one in five transactions in Europe.

The liquidity crisis and its impact on various debt instruments has, however, affected both the Western and CEE countries' debt markets but to a different extent as will be discussed in detail in Chapter 6.

Box 4.1: LBOs Outlook

There has been a trend in increasing leverage in the past three years, which was stimulated by low interest rates and default rates, excess liquidity and new market participants. The growing attraction of providing leverage finance to private equity houses and corporations has led to increased competition among banks. This environment very much favored the PE funds.

With the turmoil of the global debt market caused by the US sub-prime market, there has been a reduction of liquidity, which will inevitably lead to decrease of leverage levels. As a consequence, we might even witness reduction of certain debt instruments, such as second lien debt and PIK notes as the market will return to more simple debt structures.

Deloitte
The Debt Confidence Survey 2006, 2007

4.2.2 Overview of PE Market Activity since 2001

The year 2001 brought an overall decline of activity on the CEE M&A markets in accordance with the global market recession. This fall was caused by an overall slowdown of economy that simultaneously affected all the three world major production centers: the USA, Europe and Japan. The roots of the recession were already set in 1999 and 2000 as a result of the oil price increase and a crisis of the technological sector. The terrorists' attacks in September 2001 played a crucial role, too. It affected the fundraising as well as the investment activity for a few subsequent years.

Fundraising

In general, there are two types of funds in CEE countries: funds that usually operate a network of offices in several CEE countries such as Mid Europa Partners, Arx Equity (formerly DBG Eastern Europe) or Advent International; and funds that

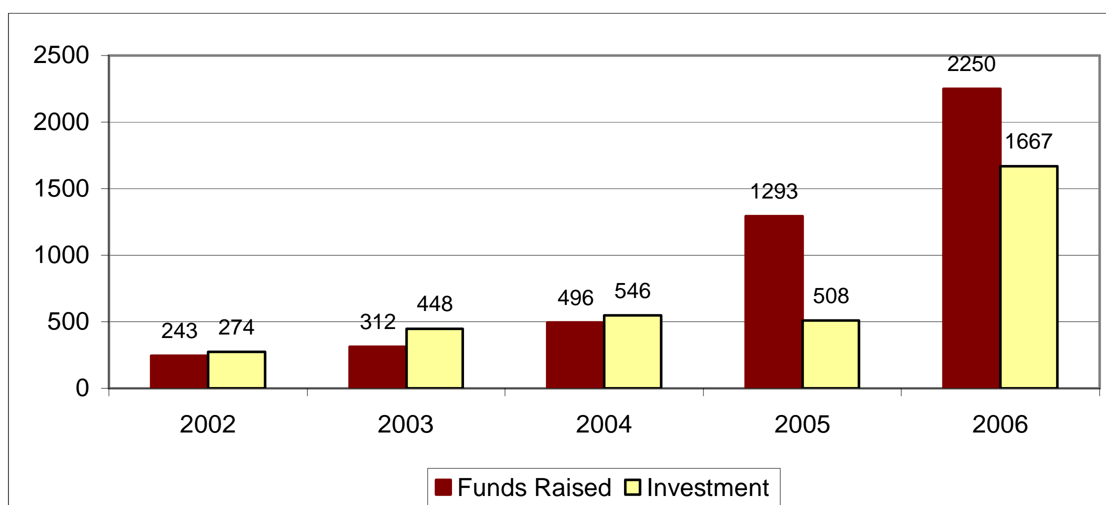
operate out of one country; e.g. the Polish Enterprise Investors or Czech Venture Partners.

In 2001, there was a significant decrease in fundraising activity after the outbreak of the world economic crisis. It can be explained by the fact that institutional investors from Western Europe and the United States have formed the main source of CEE private equity funds. Therefore being hit by the recession naturally lowered their fundraising appetite and the amount raised in the region lowered.

Since 2003, after a two-year fall, the fundraising activity started to grow again and reached EUR 312m. The year 2005 recorded an outstanding (143%) increase of funds raised in CEE countries and throughout Europe as well. It reflected the growing interest of institutional investors thanks to attractive returns and investors' intention to diversify their portfolios by investing in new geographies (EVCA, 2005b). In 2006, the revival continued and PE investors raised some record funds: Enterprise Investors launched a new EUR 600m fund, Mid Europa Partners raised a EUR 650m Emerging Europa Convergence Fund II and the British Bridgepoint Capital Limited entered the Central European market with a new fund BE3 with EUR 2.5bn.

However, the amount raised compared to the amount invested indicates a lack of good investment opportunities for funds in the last two years. One of the possible explanations is that the PE funds that had managed to avoid the impact of the crisis and had raised new funds after 2001 had unique investment opportunities as the value of companies both public and private was falling down. In 2005, this favorable investment environment disappeared.

Graph 4.3: Funds Raised and Invested in CEE 2002–2006 (in mil. EUR)[17]



Source: EVCA, Central and Eastern European Statistics, 2005–2007

Investments

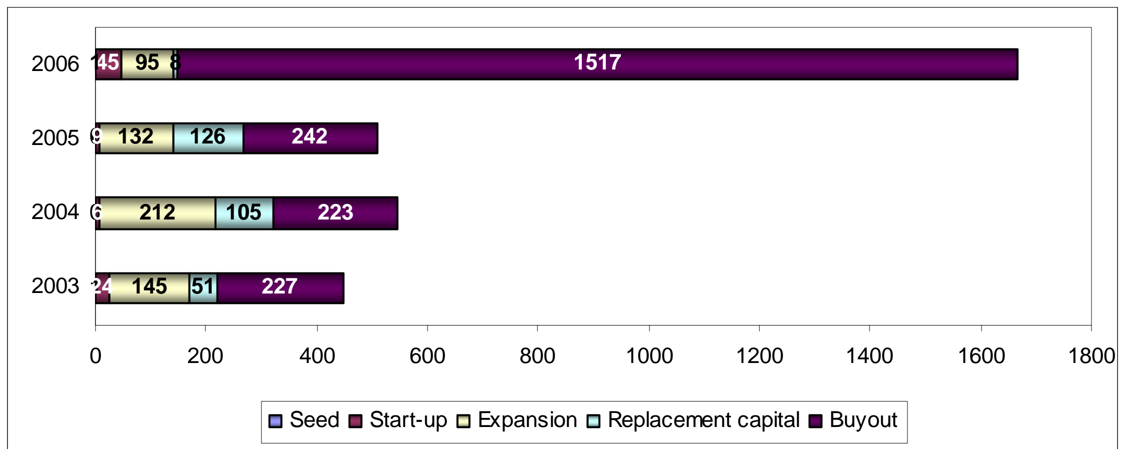
Throughout the years, the largest investments were directed to the Czech Republic, Hungary, Poland and Romania, e.g. in 2005, 85% of the investment activity was concentrated in those four countries. Sectors that the PE funds are most interested in include telecommunications, consumer goods and services, industrial products and services, media and financial services. These preferences have been quite stable over time.

Concerning the type of investment, there is a very limited number of seed capital investments. These investments do not require great amount of capital therefore they should be domain of domestic investors exactly as it works in Western Europe. Nevertheless, in most of the CEE countries, apart from Hungary and Baltic states in 2006, there has been no seed capital activity at all due to lack of interest of both foreign and domestic investors.

Expansion capital remains rather low and relatively stable over years compared to buyouts that experienced a great boom in the past three years. Buyouts, namely leveraged buyouts, have become so popular because of the convenient macroeconomic environment as described above, and low default rates. In 2006, buyouts represented 91% of all capital invested by PE funds in CEE countries.

[17] The data does not include those funds that have declared a dedicated investment allocation to CEE and are not located in the region.

Graph 4.4: Distribution of Investments in CEE Countries 2003–2006 (in mil. EUR)



Source: EVCA, Central and Eastern European Statistics, 2005–2007

After 2001, financial investors carried out a few outstanding deals. In 2002, Bridgepoint Capital and TCR Industrial Managers backed the MBO in Nocibe, the French perfume chain, for a consideration of EUR 250m. Senior and mezzanine debts for EUR 180m were arranged by BNP Paribas. A consortium of investors including Viva Venture, a subsidiary of Advent International, and Enterprise Investors acquired a 65% stake in Bulgarian Telecommunication Company for EUR 230m. The transaction was backed by a syndicated loan.

In 2003, a consortium of GMT Communications Partners and AIG Emerging Europe Fund paid EUR 325m for acquisition of Invitel, formerly Vivendi Telecom Hungary. A senior debt was extended in order to finance the transaction. In March, Innova Capital and GTECH Corporation agreed to acquire Polcard, Polish card payment processing provider from Polish banks and a hotel chain for EUR 57.6m.

In 2004, MobilTel EAD, a Bulgarian mobile telecommunications operator, was acquired by seven PE firms and existing shareholders of MobilTel Holding. The value of the transaction reached EUR 1.1bn, of which two thirds were financed by a debt; a syndicated and a term loan facility. In Romania, Deraso Holding, a company owned by a few private equity firms, agreed to sell a 15% stake of MobiFon, Romanian telecommunication company, to the Canadian data and short messaging service provider Telesystem International Wireless.

During the year 2005, the investment activity moderately slowed down because of lack of outstanding investment opportunities. There was one significant secondary buyout, in which Mid Europa Partners purchase the Aster City Cable from HM Capital Partners for a consideration of EUR 413m. Another deal exceeding EUR 100m was

acquisition of B. H. Centrum (traded as Prague Marriott Hotel) by Walton Street Capital from an Austrian real estate developer for the price of EUR 130m. The Austrian Erste Bank provided loan of EUR 127.5m; consisting in non-recourse first and mezzanine debt instrument.

The greatest deal of 2006 was realized in the Czech Republic, when a group of PE investors including Lehman Brothers Private Equity, Mid Europa Partners and Al Bateen Investment Company took over České Radiokomunikace for a consideration of EUR 1.19bn, of which EUR 750m was financed by senior and mezzanine loan. By acquiring České Radiokomunikace, the group also became owner of 39.2% stake in T-mobile ČR. A mega deal also took place in Hungary, where First Chemical Holding, a company owned by Permira and Vienna Capital Partners took private the entire issued share capital of Borsodchem, Hungary-based chemical manufacturer. The value of the transaction was EUR 1.06bn.

Exit

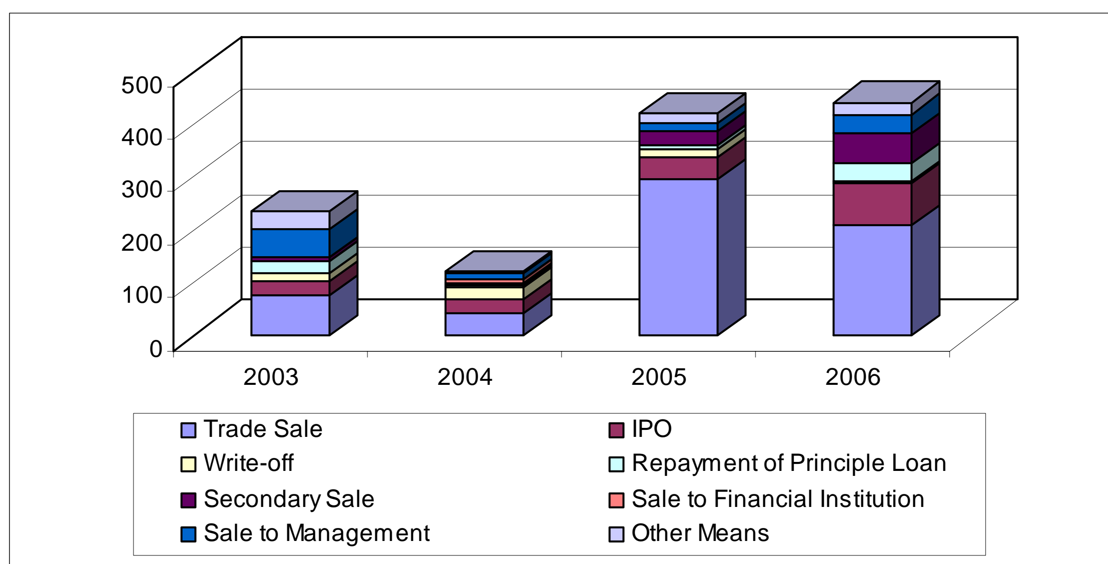
Concerning the exit strategies, there have been a few trends in the recent years and a few remarkable transactions. Since 2002, volume of divestments followed an increasing trend, with the exception of the year 2004, when it dropped by 48% to grow again in 2005 and 2006.

Majority of exits in CEE countries were realized through trade sale to both international and domestic industry buyers; their number is on the increase. In 2005, France Telecom agreed to acquire the remaining 36.12% in Orange Slovensko for EUR 522.5m, from a consortium led by AIG New Europe Fund managed by an American PE firm AIG Capital Partners. A year later, Advent International Corporation sold 96.7% of Terapia, a Romanian pharmaceutical firm, to an Indian pharmaceutical company for EUR 270m. In 2007, GMT Communications Partners Limited together with Mid Europa Partners LLP agreed to sell Invitel Tavkozlesi Szolgaltato, a Hungarian telecommunication company, to Hungarian Telephone and Cable Corporation for EUR 470m.

Another exit strategy is IPO. IPO was not used very much as the capital markets were not particularly developed in CEE countries. Nevertheless, the Warsaw Stock Exchange has proved to be an employable way of exit in the recent years. Since 2002, IPO's have been realized also through the Prague Stock Exchange, Nasdaq and the Vienna Stock Exchange. In 2004, Zentiva, the Czech-Slovak pharmaceutical group

backed by Warburg Pincus executed an IPO, in which it offered 32% of its shares on the Prague Stock Exchange; being the first IPO as a form of exit on the Czech stock exchange. Enterprise Investor, a Polish PE firm, exited from Comp Rzeszow, a Polish software company, through an IPO on the Warsaw Stock Exchange on the same year. The transaction earned EUR 31.4m. Between 2003 and 2006, the number of IPOs increased by more than 200%; nevertheless, the exit route's popularity remains far behind its popularity in the USA.

Graph 4.5: Divestments in CEE Countries 2003–2006 (in mil. EUR)



Source: EVCA, Central and Eastern European Statistics, 2005–2007

Since 2004, we could also see a gradual increase in number of exits via secondary sale, a sale to another private equity house. Major secondary sales included e.g. HM Capital Partners' exit from Aster City Cable, Polish provider of communication and services, by a sale to Mid Europa Partners for EUR 413m in 2005 or AIG Capital Partners' acquisition of a 90% stake in Bulgarian Telecommunication Company from Viva Venture, a subsidiary of Advent International Corporation, for a consideration of EUR 1.64bn in 2007. Part of the transaction price was financed by a loan arranged by a consortium of banks led by the Royal Bank of Scotland. Between 2003 and 2006, the number of secondary sales grew eight times and its share on total divestments increased from about 2% to roughly 13%. Compared to the previous routes of exit, write-off and sales to financial institutions rather decreased over years. In the period concerned, number of transactions has already been realized and exited. The major "success stories" are shown in the following table.

Table 4.2: Realized Projects in Europe and Their Returns

Rank	Company	Investment (in mil.)	Sector/Industry	Lead Advisor	Money Multiple
1	Czech On-Line	€6,40	Telecoms	DBG	31x
2	Euronet	$8,8	Financial Services	EV, Innova, Advent	11x
3	Terapia	€25	Pharmaceuticals	Advent	10x
3	E-Pub	$1	Internet Games	Euroventures+	10x
5	Computerland	$4	IT/ Systems Integr.	Enterprise Investors	8x
5	Karneval Media	$60	Cable TV	Mid Europa	8x
7	Stomil Sanok	$9	Rubber products	Enterprise Investors	7x
8	Polfa Kutno	$14	Pharmaceuticals	Enterprise Investors	5x
8	Lukas	$15	Financial Services	Enterprise Investors	5x
8	Town & City	$5	Outdoor Advertising	Innova	5x
8	Zentiva	$125	Pharmaceuticals	Warburg Pincus	5x
8	Mobifon	$43	Telecoms	Mid Europa	5x
8	LPP	$14	Retail	Enterprise Investors	5x
14	BTC	€25	Telecoms	Advent	4x
14	Hungarocamion	€13	Transportation	BoA, DBG	4x
14	Brewery Holdings	$28	F&B/ Beer	Advent	4x
14	Orange Slovensko	$180	Telecoms	AIG-CET, Mid Europa	4x

Source: Mid Europa Partners, 2006

The activity of PE funds has considerably grown during the past few years thanks to economic and political stabilization of economy in the CEE countries, which was enhanced by the preparation for the accession to the European Union and the entrance itself. The possibility of relatively low risk and great potential returns in comparison with Western Europe attracted foreign investors and strengthened the local ones. In addition, thanks to particularly favorable economic climate coming after the 2001 slowdown, the privatization of the banks and overhand of liquidity, bank loans became widely available.

In the past four years, we have seen a considerable expansion of private equity in terms of fundraising, investments and divestments, and penetration of "Western" trends such as increase in the IPO activity, secondary sales, buyouts, public to private transactions and changing structure and levels of debt financing in the CEE countries. The region seemed to be on the right track to catch up with Western Europe.

However, we must not forget that CEE region still remains quite heterogeneous, and the aggregated statistics do not appropriately mirror the situation in all countries but the overall direction, which is pulled by the dominant countries such as Poland, Hungary or the Czech Republic. The situation in particular countries may differ as they are on different level of development.

5 Development of Private Equity Funds in the Czech Republic

Since the beginning of the 1990's, the Central and Eastern European countries have disclosed themselves as future PE targets as they promised a great potential to investors; the Czech Republic was one of them. The following two decades were in the name of transformation of the economy into a market-driven one and its opening to the outer world, consolidation of industries and attraction of foreign investors, which triggered the M&A activity, peculiar to the entire CEE region.

The private equity market activity has been increasing in the past four years in the Czech Republic thanks the favorable economic development, low inflation and interest rates, consolidation of sectors, Czech banking sector development and oversupply of liquidity on the world markets. Thanks to this favorable market environment, the Czech Republic has been approaching the Western markets by adapting number of European trends as we have expected.

At the same time, there have been forces that disabled the Czech private equity market to reach its potential. These factors are represented by the legal and tax environment that discourages or disables PE firms to establish new PE funds directly in the Czech Republic and raise funds from local investors, but they force them to raise funds abroad and use the Czech Republic as a source of potential targets. The new legislation on thin capitalization rules has also posed difficulties on the PE market; however, at least a moderate change is expected to be passed with the effect from 2009.

5.1 M&A Market Development

When we are trying to assess trends on the M&A market, we necessarily have to face the general reluctance of participants to reveal information about transactions, therefore the available statistics do not always have to be complete. We will base our analysis on the data from the publications by PricewaterhouseCoopers[18], Deloitte, and single transactions from the Mergermarket database in order to make the description as complex as possible.

[18] PriceWaterhouseCoopers indicates the volumes in USD, while the other two sources generally work with EUR, therefore the figures must not be mixed-up.

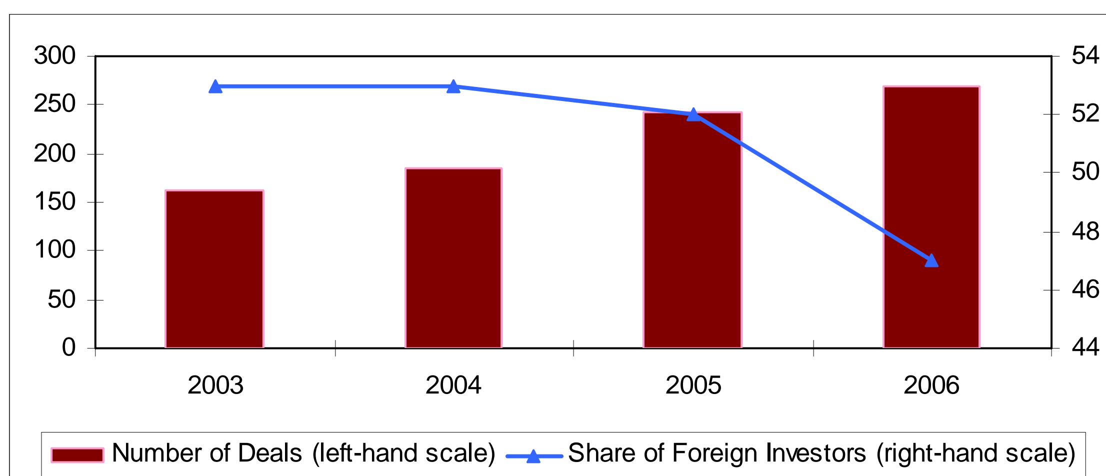
5.1.1 Trends in M&A Activity

In the 1990's the Czech Republic went through a process of privatization. The transfer of property from the state to individuals was a necessary step in order to open the markets and restore the health of numerous companies. Foreign – at first strategic – investors played an important role in it especially at the end of 1990's, during the privatization of strategic companies, which concerned sectors such as banking and financial services, telecommunications, utilities, manufacturing and industrial products and services. The end of 1990's can be considered to be the true beginning of the international M&A activity on the Czech market.

The Czech M&A market has experienced a significant fall down in 2001, copying the development on the global markets. The interconnection of the markets acknowledged in 2001 can be explained by several facts: increasing foreign trade, which makes the business cycles of different countries more dependent on each other (therefore more synchronized with each other); existence of supranational organizations, for example those connected to the European Monetary Union, imposing strict macroeconomic rules on the countries; interconnection of capital markets and increasing cross-border M&A activity, which helps to transmit the supply and demand shocks among economies. The scope and the timing of the effect on particular economies are then dependent on the local economic situation and business structure.

Following 2001, the market remained decelerated for the following two years, reaching the bottom in 2002, when the number of private sector deals dropped to 144, representing a 35% decrease as compared to 2000. In 2003, the number of deals as well as the volume knocked off the bottom and started to grow again. In 2005, the number of deals was for the first time above the 1999-level. The number of transactions carried out in 2006 surpassed the 2002 figure almost twice, the volume of transactions more than three times reaching the total value of USD 6.2bn in 2006. The disclosure rate has been oscillating around 27% in the past five years as compared to the 41% CEE regional average in 2004. It remains among the lowest ones in the region.

Graph 5.1: Number of Publicly Disclosed Deals in the Czech Republic 2003–2006



Source: PricewaterhouseCoopers Studies, 2004–2007

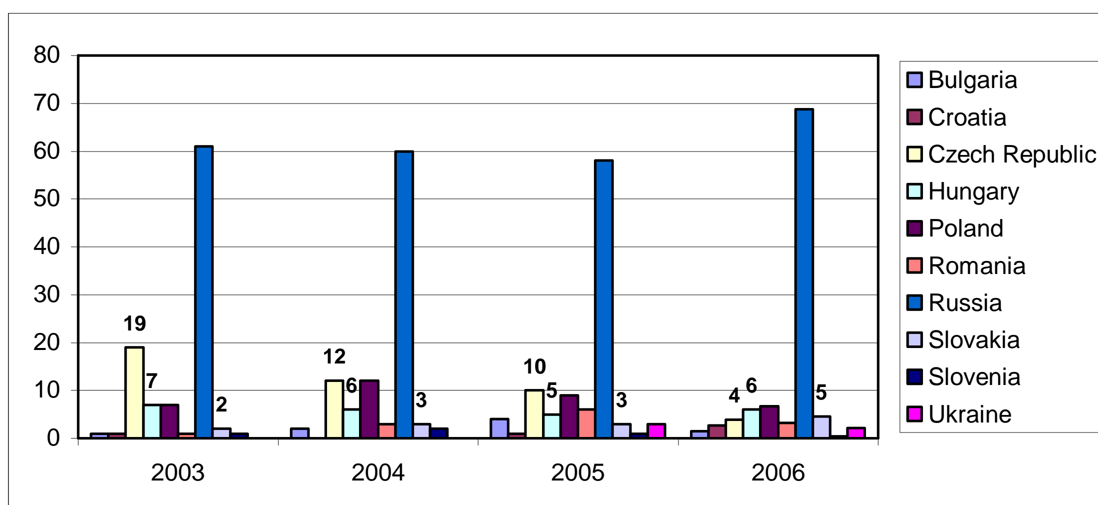
Over the decade, the M&A market has been influenced by emergence of the cross-border transactions, consolidation of sectors and increase in value of deals, which is related to mass emergence of private equity investors and expansion of leveraged transactions allowing for higher volumes of deals.

Cross-border activity

The Czech Republic, Poland and Russia have been the three most attractive countries in the region for a few years regarding the *volume of inward transactions* carried out by both international and domestic investors. Russia has always been quite specific, as the deals are often politically-driven[19] and it is not included among the CEE countries in all the statistics. However, the PwC statistics does include Russia and the volume of deals accounted for around 60% of the volume of all transactions carried out in the CEE countries between 2003 and 2006. Concerning the Czech Republic, in the last two years, it has rather been losing its position in favor of Slovakia and Hungary, and ranked 5th in 2006.

[19] There has not practically been any activity of the PE funds in Russia so far.

Graph 5.2: Market Value of Deals by CEE Countries 2003–2006 (in %)



Source: PricewaterhouseCoopers Studies, 2004–2007

The Czech Republic has also ranked among the first three countries concerning the *number of private sector deals*. However, we could observe not only growing number of incoming transactions but also the outgoing ones, which implies growing strength of some Czech firms. During the three years 2004–2006, their number grew from 8 to 44 deals; targeted particularly to the CEE region. It is evident that after years of being a target, Czech companies are beginning to play the role of an acquirer.

Box 5.1: Cross-border Expansion of Czech Companies

"The continuing increase in the number of transactions that Czech companies completed abroad in 2006 confirms that some local companies have become big and strong and must expand abroad in order to remain competitive against multinational companies. Important outward transactions were completed in 2006 by ČEZ, PPF, Agrofert Holding and Zentiva."

Miroslav Bratrych, Director, Transactions Services
PricewaterhouseCoopers
Central & Eastern European Mergers & Acquisitions Survey 2006

Share of foreign investors (in terms of volume) in the Czech Republic has been decreasing in the last four years. While it remained above 50% level between 2002 and 2005, in 2006 it dropped to 47%, which was; however, still above the CEE average of 39%. There are several reasons behind: majority of strategic companies, which attract

foreign investors, have already been privatized, so the number of potentially attractive targets in the Czech Republic decreases, and at the same time Czech financial groups are becoming stronger and are expanding their activities.

Consolidation of sectors

The greatest M&A transactions were connected to consolidation of sectors, mainly banking, utility and telecommunication sector; and were mostly carried out by foreign investors. As a part of the banking sector consolidation, some of the banks were sold to strategic foreign investors, such as ČSOB to KBC Bank in 1999 for EUR 1.07bn; 52% stake in Česká spořitelna to Erste Bank in 2000 and the remaining 48% stake in 2002 with the total value of the two transactions reaching EUR 1.4bn; the acquisition of Komerční banka by a French bank Société Générale in 2001 for EUR 1.19bn or the acquisition of 85% stake in Živnostenská banka by UniCredito Italiano in 2002, which was completed in November 2007.

In 2002, RWE, one of the largest European utility companies, took over Transgas and six other regional gas utilities, closing a deal worth EUR 4.1bn, which became the largest transaction ever in the Czech Republic for a few subsequent years. The energy sector also recorded an acquisition of 34% stake in Pražská energetika in 2004 for EUR 140m, 85% stake in United Energy in 2005 worth EUR 96.4m, and an acquisition of 50% stake in Plzeňská energetika in 2006. All three deals were carried out by financial groups operating in private equity. A major player on the market is also the energy group ČEZ. It acquired several companies in the energy sector in 2003; however, the Czech Anti-monopoly Office did not approve the transaction. Therefore in 2004, ČEZ was forced to sell off some of them, which enhanced the activity in the sector. In 2006, ČEZ carried out two cross-border transactions by concluding deals in Poland and Bulgaria.

The telecommunication sector saw four crucial deals; Český Telecom's acquisition of Eurotel Praha's 49% stake worth EUR 1.21bn in 2003, an acquisition of Český Telecom by Telefónica in 2005 for EUR 6.29bn and a sale of 73% in Oskar to Telesystem International Wireless for a consideration of EUR 377m in 2005. Following the transaction, Vodafone concluded an agreement to buy 100% stake in Oskar Mobil and 79% stake in MobiFon from Telesystem International Wireless for USD 3.5bn and USD 950m for the net debt. In 2006 České Radiokomunikace were acquired by a consortium of private equity firms for EUR 1.19bn.

Volume of transactions

In 2003, the volume of an average transaction was USD 109m particularly thanks to deals in the telecommunication sector (e.g. Eurotel Praha, TelSource). In 2004, no transaction above USD 1bn was concluded, the two greatest deals – acquisition of 85% of TV Nova by CME and purchase of 70% of Karbon Invest by RPG Industries, did not reach the value of the previous year's deals. Therefore the average deal value dropped to USD 60m. It rose by 60% to EUR 96m in 2005 thanks to the utility and telecommunication sector (Český Telecom, Oskar Mobil) and slightly fell again in 2006 to EUR 92m despite the acquisition of České Radiokomunikace.

The average value of transactions has been rather oscillating over time, as it depends on several factors including the *availability of sources for investors*, *offer of possible targets* and *density of competition*, which influences the prices. What has been clearly growing is the number of big deals over USD 100m. While there were 3 transactions over USD 100m in 2000, in 2006 there were already 18 of them. The deal values have been increasing mainly thanks to increasing participation of private equity investors and availability of LBO financing.

Sector analysis

Most transactions have been concluded in the manufacturing sector, which has traditionally been the most attractive industry in the Czech Republic. Manufacturing is followed by foods & beverages, utilities, telecommunications and media. In 2004, manufacturing was dominated by Russia's OMZ's purchase of three divisions of Škoda Holdings for a consideration of EUR 40m. Other major investments included Gorenje's acquisition of Mora Moravia and Swarowski's acquisition of Carborundum Electrite.

The greatest transactions; however, took place in 2005, when the state offered Vítkovice Steel in a privatization process. The company was acquired by Evraz Holding for a consideration of USD 268m. In 2006, major transactions consisted of acquisition of Kablo Electro by a Danish industrial concern NKT for EUR 111.9m or sale of MSA to the Russian group Celjabinskyj Truboprokatnyj Zavod. In December 2007, Tesla, the electro technical equipment manufacturer, was acquired by Kilcullen Kapital Partners for an undisclosed consideration. Unfortunately, a very low disclosure rate is typical for the manufacturing sector.

Other vital sectors include foods & beverages. In 2005, Nowaco was acquired by a consortium of private equity investors for a consideration of EUR 90m. In 2006,

Český olej, owner of a controlling stake in Setuza, was sold to M. L. Moran, the Czech--based private equity group. Moran sold it a few months later to Cesmapol, a company backed by the PPF Investments. The value remained undisclosed in both cases. Other transactions concerned e.g. Walmark, Delta Pekárny, Olma, Jemča, Promil, Kofola and Poděbradka. The telecommunication and utility sector was already described in the previous section.

5.1.2 M&A Growth Incentives

There have been numerous incentives enhancing the M&A activity in the Czech Republic. We will list the major ones and then have a look at few of them in detail. The factors are:

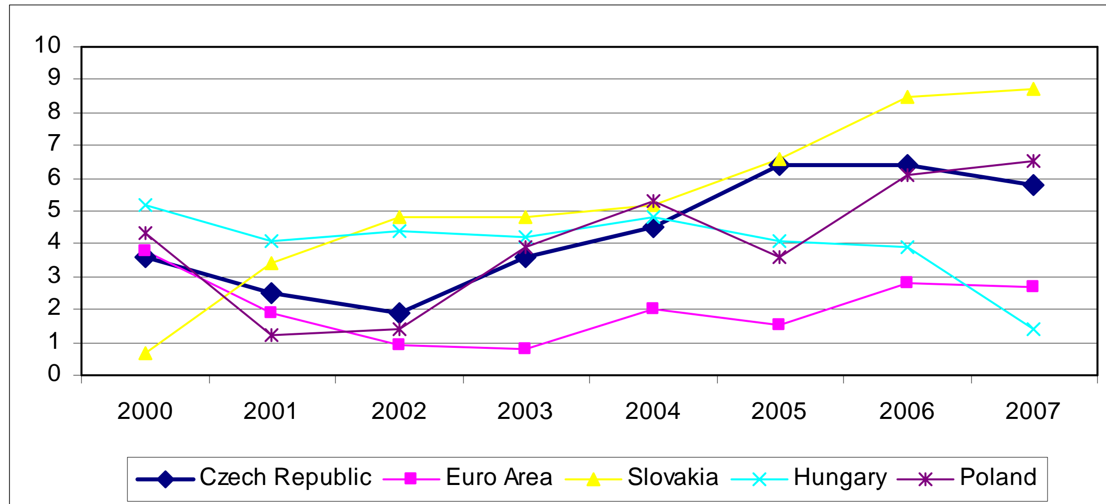
- High growth of GDP (among the highest in the region)
- Low inflation
- Consolidation of sectors
- Growth limit reached by Czech-based firms
- Relatively low wages and skilled labor force
- Possibility to expand further in the eastern direction
- Foreign Direct Investments

The Czech economy experienced a minor decrease of *GDP growth rate* from 3.6% in 2000 to 2.5% (2001) and 1.9% (2002) compared to the significant fall in Euro area's GDP growth rate falling from 3.8% in 2000 to 0.9% in 2002, which resulted in an economic slowdown and a decrease of the M&A activity all over Europe. The GDP growth rate decline in the Czech Republic was caused by a decrease of export due to weakening foreign demand and strengthening Czech crown, which jumped from CZK/EUR 35.61 in 2000 to CZK/EUR 30.81 in 2002; however, the Czech economy recorded a smaller activity decline than it was expected.

In 2003, the GDP grew by 3.6%, the same rate as in 2000 (while in the Euro area it dropped even more to 0.8%) and the M&A market finally started to recover, which was confirmed by a 13% increase in number of transactions. Since 2003, GDP growth rate has been increasing, over performing the oscillating development of the GDP growth rate in the Euro area. Even compared to other CEE countries, the Czech Republic's GDP growth performance has been very good, apart from Slovakia that has outperformed the Czech Republic in the past three years (reaching 8.7% GDP growth rate in 2007). The high GDP growth rate contributed to the attractiveness of the Czech

Republic for number of foreign investors. According to the Eurostat expectation, GDP growth rate is now expected to fall: to 4.7% in 2008 and grow again by 5.0% in 2009.

Graph 5.3: Development of GDP Growth Rate 2000–2007 in Selected Countries (in %)



Source: Eurostat, 2007

Apart from the GDP influence, another macroeconomic factor – *inflation* is worth to stress as well. After years of high (even double-digit) inflation, it significantly dropped between 1998 and 1999 from 10.7% to 2.1%. Except for the years 2000 and 2001, it remained under the reasonable level of 3% p.a. (2.8% in 2007). The growing inflation that the Czech Republic is experiencing now should according to analysts be rather of a temporary nature as it is mainly caused by the one-off VAT increase in 2008. Therefore the effect should fade away.

Other factors supporting the M&A activity in the Czech Republic concern especially *small and medium enterprises*, which usually face two main problems: the generation exchange and the recognition that the enterprise reached the peak and without new (often foreign) capital they cannot attract new customers, expand abroad or at least keep up with the pace of their competitors not to lose their current markets. An acquisition represents a viable solution to the second problem.

Skilled labor force remains among the reasons of attractiveness of the Czech market; however, the same cannot be stated about low wages. They still fall far behind the EU 15 average but belong among the highest ones concerning the CEE countries. Some foreign investors still perceive the CEE region as homogenous and do not distinguish among particular states; therefore the Czech Republic is becoming relatively expensive and some of the investors are *expanding eastwards*. However, the

Czech Republic should still profit from the skilled labor force and the good geographical location in the few coming years.

5.2 Private Equity Emergence

Venture capital[20] emerged on the Czech market at the beginning of the 1990's. First funds providing venture capital were founded thanks to the help of the United States, the European Union and EBRD. The very first fund established in the Czech Republic in 1991 was the Czech-American Entrepreneurial Fund (*Českoamerický podnikatelský fond*), sometimes also called the "Bush's Fund", which was financed by the American government. In 1994 it was followed by the Regional Entrepreneurial Fund (*Regionální podnikatelský fond*) and Venture Capital Fund (*Fond rizikového kapitálu*) founded by the former Ministry of Economy in Ostrava. These two funds were financed by the European Union's Phare program.

The first fund to be established by using the "real" private sources was the Renaissance Fund. Since the 1995 the international funds started to penetrate the Czech market. Their advantage consisted in greater experience in private equity financing and better access to sources.

5.2.1 CVCA

In accordance with the practice in the developed countries, the Czech Private Equity and Venture Capital Association was founded to promote the private equity financing and to associate private equity investors. It was established in Prague in 1995. Its main activities are lobbying, organizing seminars and conferences, promoting its activities in the private equity domain and data assembly. There are two types of CVCA membership for companies that are interested to join it:

- Full membership for (management) companies involved in venture capital activities and investing money of the 3rd person through a PE fund
- Associated membership for consulting or investment companies or banks investing own resources.

CVCA has currently 11 full members; e.g. 3TS Capital Partners, Advent International, Argus Capital Group, Czech Venture Partners, Arx Equity (formerly DBG Eastern Europe), Genesis Capital, KBC Private Equity, and 19 associated

[20] We use the term "venture capital" here instead of "private equity" as at that time there were no buyouts yet, so the funds were purely venture capital focused.

members. Some of the funds are based in the Czech Republic such as Genesis Capital but majority of them operates on the regional basis. The CVCA members currently manage about CZK 40bn and they have already invested about CZK 50bn into about hundred of projects since its establishment in 1995. The value of funds present in the Czech Republic ranges between EUR 10m and 300m with focus on investments from EUR 1m to EUR 30m (Čurda, 2007).

5.2.2 Private Equity Financial Groups

Apart from the standard PE funds and their management companies, there are local investment groups on the Czech market such as J&T Finance Group, Penta Investments, PPF Investments, RPG Industries, Jet Investment, which operate similar to private equity funds. Even though these investors are becoming very important on the Czech market concerning the number and volume of deals, neither CVCA nor EVCA statistics and publications include them, nor there is any other official statistics to track these transactions. Therefore we will dedicate the next paragraphs of the thesis to describe this phenomenon.

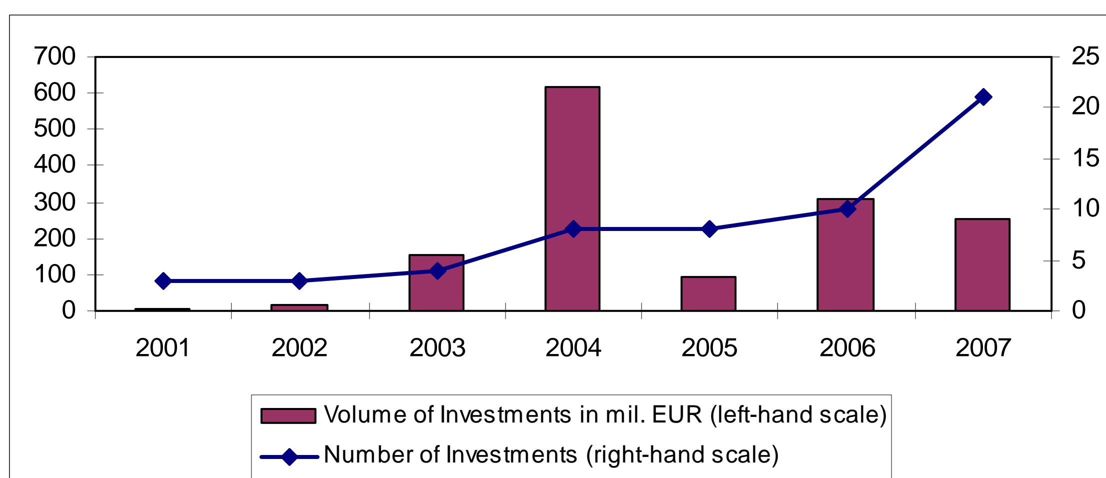
These financial groups emerged during the 1990's either in the Czech Republic or Slovakia. Even though these groups claim to operate on the private equity market, we cannot count them among private equity funds. The reason is the manner in which they raise their funds. Most of the groups were established by a few individuals, who are the main shareholders until today; therefore the companies serve to multiply their personal assets (Penta investments, PFF Investments, RPG Industries). The other possibility is that the company invests sources of a limited group of investors (Kilcullen, Jet Investment). In both cases, the funds are not raised publicly as in case of a PE fund.

These financial groups do not make business only in private equity but they are often engaged in other kinds of business, e.g. J&T provides private banking and real estate services, Benson Oak offers M&A Transaction Services and other consulting services concerning privatizations, project financing and risk management; Slavia Capital Group is a holding including companies focused on securities brokerage and trade financing; and Kilcullen provides consulting on commercial property, finance or renewable energy.

Disclosure rate of transactions carried out by these investors is very low, since 2002 it has oscillated around 39%. These groups specialize in buyouts and have

become adequate partners to private equity funds. The greatest deals carried out in the recent years included acquisition of 54.3% stake in Severomoravské vodovody a kanalizace by Penta in 2003 for a consideration of EUR 55.5m, acquisition of 70% stake in Karbon Invest by RPG Industries for EUR 400m in 2004, acquisition of 85% stake in United Energy by J&T Finance Group for EUR 96.4m in 2005. In 2007, Penta acquired 99.98% stake in Aero Vodochody from the government of the Czech Republic for EUR 103m. The following graph brings an overview of publicly disclosed transactions carried out by eleven major financial groups[21] between 2001 and 2007.

Graph 5.4: Number and Volume of PE Investments in the Czech Republic 2000–2007



Source: Mergermarket, newspapers: own calculations

The major divestments during the period included a sale of 85% stake in TV Nova Group by PPF to CME for EUR 630.9m in 2004 and sale of Severomoravské vodovody a kanalizace by Penta Investments in 2006, which earned EUR 248m for this transaction. By this exit, Penta appraised its investment carried out in 2003 more than four times. Even thought the greatest volume of divestments was in 2004 and 2006, the number of divestments has been gradually increasing over the past six years.

Due to the low disclosure rate it is very hard to trace some trends in volumes of investments, because the lower volume one year can be simply caused by the fact that smaller deals were publicly disclosed compared to the previous year. However, the number of deals has been growing since 2004 thanks to the favorable macroeconomic situation, which strengthened the investors; their past successes that generated money

[21] The statistics include J&T Finance Group, Penta Investments, PPF Investments, RPG Industries, Jet Investment, Kilcullen Kapital Partners, M. L. Moran, Slavia Capital Group, Benson Oak, Rex Investment and Arca Capital Bohemia

for new investments, and to the sufficient number of investment possibilities. Apart from the investments carried out in the Czech Republic, these groups have also been expanding abroad, especially in the CEE countries.

These investors are looking for industries and particular companies that have a good growth potential. Compared to the early years of "opportunistic" investments, nowadays, investors often follow the buy & build strategy and focus on a few selected industries[22]. At first, a solid platform company is acquired, to which more companies are added through follow-on acquisitions in order to offer better products to clients and use the economies of scale. J&T Financial Group is one of the investors pursuing this strategy. In the last four years, J&T has acquired four companies in the energy sector: United Energy, Pražská energetika, Plzeňská energetika and První energetická, in order to build up its presence in the electric power generation sector. The group plans to build its own power plants, modernize the current ones and is even pondering about development of own sources of renewable energy. It has also launched a program called "World of health" (*Svět zdraví*), acquisitions of clinical laboratories. Similar approach can be detected in behavior of Penta in the pharmaceutical sector.

What is it that makes these financial groups so successful? It is their flexibility, background of a strong financial group, which sometimes enables them to offer higher prices than strategic investors, know-how and experience, which helps to create a good growth plan, and references from the past deals. Thanks to all these factors, these financial groups have become strong, and therefore play a crucial role in future shaping of the private equity market in the Czech Republic.

5.3 Private Equity Funds' Activity

We can divide the PE fund's activity on the Czech market into four stages: the first one lasting from 1991 to 1994, the second one from 1995 until 1998, the third one from 1999 until 2006, and the last one after 2006. The year 1995 was chosen as a break point as there was a significant increase of activity on the PE market and 1998 was the year of entrance of numerous foreign investors after the economic stabilization of the country, and the initiation of privatization of strategic companies. The outbreak of the world financial crisis in 2007 represents another turning point, which will be analyzed in the last chapter.

[22] However, they have not definitely left the opportunistic investments.

5.3.1 First Stage and Second Stage 1991–1998

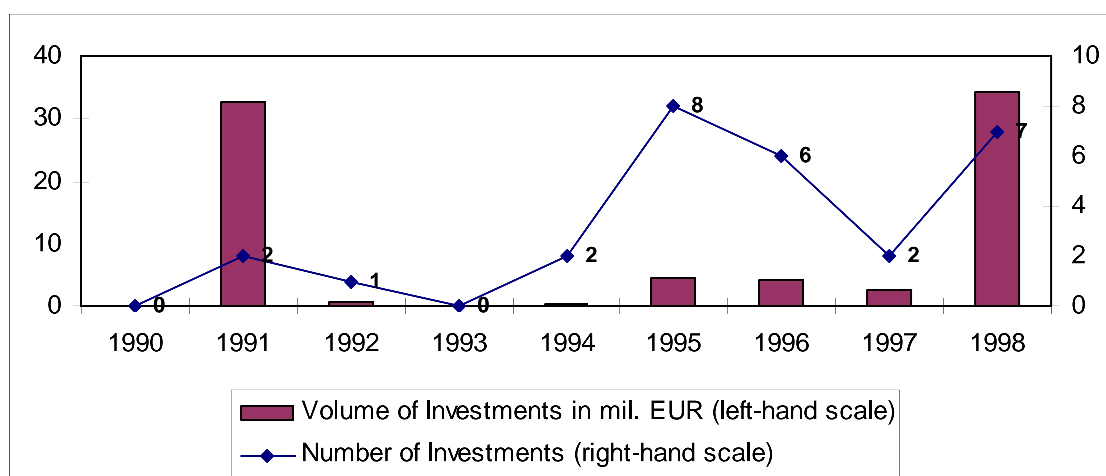
Regarding the first stage and the second stage, we have to rely solely on the information provided by CVCA, which is the only available source of information at that time. Nevertheless, neither the CVCA statistics sufficiently cover the period with regard to fundraising and divestments.

The four crucial funds, which were active in the Czech Republic, were the Czech-American Entrepreneurial Fund *(Českoamerický podnikatelský fond)*, Regional Entrepreneurial Fund *(Regionální podnikatelský fond)*, Venture Capital Fund *(Fond rizikového kapitálu)* and Renaissance Partners. The first three were founded as foundations *(nadace)* and as such were affected by the Act no. 227/1997 Coll., which adjusted the manner, in which the sources of the foundations could have been legally used. According to the Sec. 23, the foundation was newly not allowed to run a business by itself or to participate in doing business of a third person. Under certain conditions, a foundation could only make part of a joint-stock company and buy its publicly traded securities. Unfortunately, companies attracting private equity investors are not publicly traded, so the law put an end to the private equity activities of the foundations.

Apart from 1991, the first five years of the private equity history in the Czech Republic were quite poor concerning the value and volume of deals. Since 1995, Renaissance Partners emerged on the Czech market and the number and volume of investments grew up. However, it then remained oscillating showing no clear trend. This can be accounted to the fact that there were new emerging funds and at the same time foundations had to cease their activities as of 1998.

The year 1998 represented a significant milestone as the number of transactions was 7 and the total volume of all deals reached almost EUR 35m thanks to acquisitions of Fezko and Dental. The market was no longer divided among the three or four players, but numerous international funds entered the market, e.g. Erste Private Equity Limited, Riverside, Conti Capital and Arx Equity (formerly DBG Eastern Europe). The situation is depicted in the following graph.

Graph 5.5: Number and Volume of PE Investments in the Czech Republic 1990–1998



Source: Jež, 2007

Concerning the stage distribution, majority of capital was used for the expansion and start-up transactions. There was no seed capital, which in fact represents a problem for private equity market development until now. Buyout transactions, which nowadays represent about 70% of deals, were not prevailing until 2003 as they are more capital demanding and require companies in certain stage of development, for which the market was not ready yet. Sector analysis shows us that manufacturing, computer software, Internet and construction belonged among the most popular sectors at the time.

5.3.2 Third Stage 1999–2006

The course of the third stage of PE market development, which started in 1999, is recorded by more sources; therefore it can be depicted in a greater detail. Our major source will be the EVCA statistics as it is the most complex one[23].

Fundraising

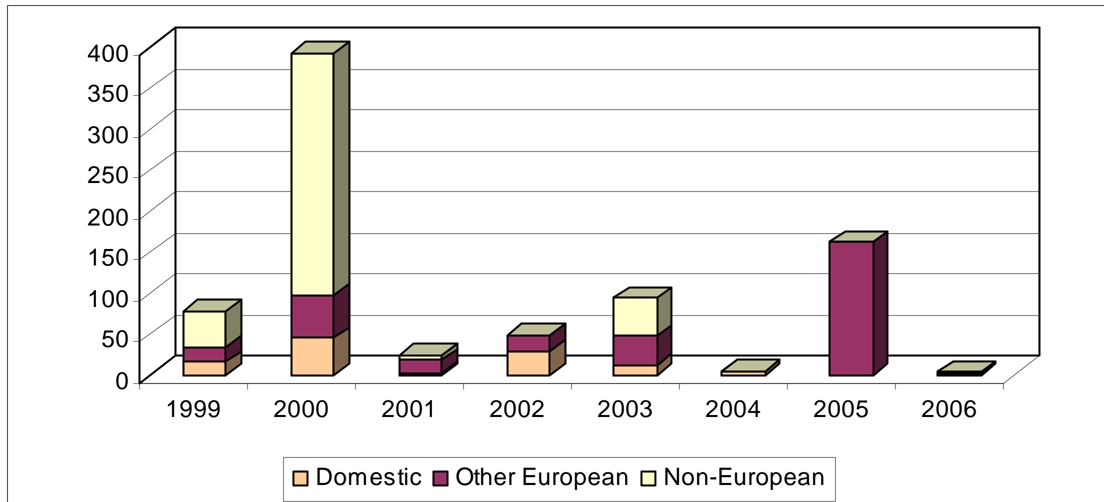
Regarding the fundraising activity, the market went through severe fluctuations, which did not avoid majority of CEE countries. Fundraising grew to EUR 393m in 2000 thanks to contribution of banks and private individuals, to drop in 2001 and 2002 as a consequence of the global crisis, and rise again to EUR 94m in 2003; when it represented the highest share on total funds raised in CEE countries. However, the very

[23] Concerning the EVCA statistics, we will basically adopt the "office" approach (apart from the section concerning investments) as specified in the methodology in Chapter 2 as the "market" approach is not available for the whole period.

next year it substantially declined to EUR 5m with banks being the only investors. In 2005, fundraising grew again to EUR 162m thanks to corporate investors' interest and realized capital gains. However, another decrease came in 2006, when half of EUR 3.4m raised was made up by realized capital gains and half by the funds of funds. The cumulative funds raised in the Czech Republic for the period 2000–2006 reached EUR 730m.

With such a fluctuation we cannot identify any visible trend that the behavior would follow. Concerning the origin of the sources, it has been changing as well. In 2003, only 13.5% of sources were of domestic origin, compared to 100% in 2004, 0% in 2005 and 59.6% in 2006. Domestic sources were prevailing always in the years of declined fundraising activity; so we can conclude that it was always mostly the lack of interest of foreign investors that caused the fall in volume of funds. Decline total fundraising after 2005 can be also accounted to the fact that EBRD ceased to finance Czech PE funds as the Czech Republic is no longer classified among the emerging markets.

Graph 5.6: Fundraising Activity in the Czech Republic 1999 - 2006 (in mil. EUR)



Source: EVCA Research Department, 2007

Regarding the structure of the PE funds' investors, the Czech Republic is quite specific as the pension funds and insurance companies, the major investors in the West[24], are restricted from investing in private equity. The main investors in the Czech Republic are banks, corporate investors, funds of funds and private individuals.

[24] They stood behind 27% of funds raised in 2006 in Europe.

The Czech Republic is a source of private equity managers, whereas the financial resources are rather generated abroad mainly with a regional focus. It is also because of the legal status of private equity funds, which is usually not tax-preferred (Martinovičová, 2007).

This statistics of funds raised by the management companies with a local office in the Czech Republic is, however, a bit restrictive as it does not include all the funds that were or will be available. Therefore we will now mention funds not only raised by the management companies in the Czech Republic but also other funds raised and destined for the CEE countries, including the Czech Republic. As there has been an oversupply of liquidity on the markets, PE firms have gradually been increasing the closing value of funds. Currently, about 20 funds are actively invested in the Czech Republic.

In 2003, Genesis Capital established a new EUR 40m fund called Genesis Private Equity Fund. Investors into the fund were Česká spořitelna, European Investment Bank, LMN Investors and the EBRD. In January, Czech TOP Venture Fund was launched by Česká spořitelna to target small and medium enterprises in the Czech Republic. The same month, Arx Equity (formerly DBG Eastern Europe) announced first closure of its DBG Eastern Europe II at EUR 67.2m. The fund's primarily focus was to be on the Czech Republic, Slovakia, Hungary and Poland.

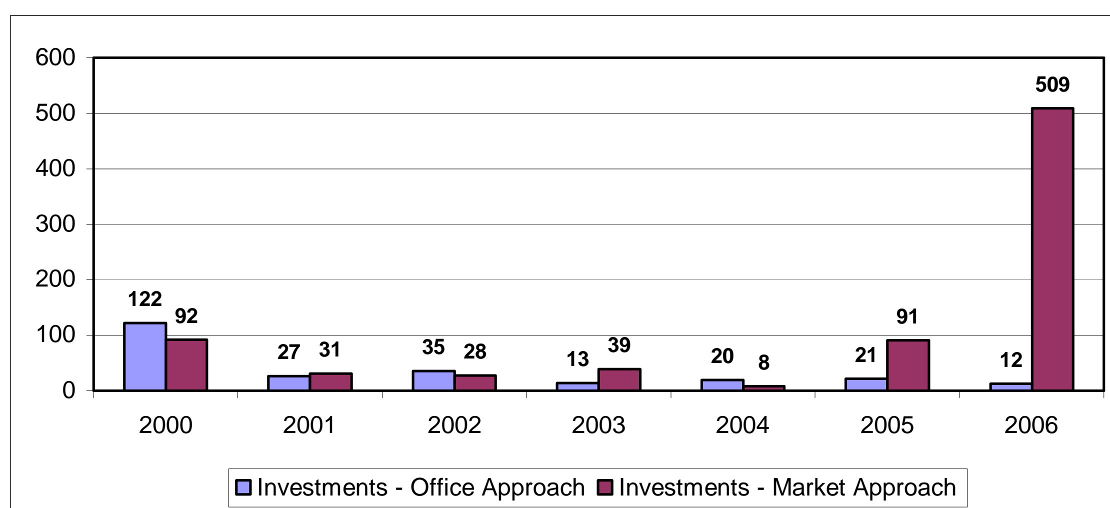
In 2004, Enterprise Investors raised a new Central European fund, which had a first closing of EUR 200m. The fund focuses 70% of the sources to investments in Poland; the remaining 30% are distributed among the Czech Republic, Hungary, Slovakia, Bulgaria and the Baltic countries. The fund was definitely closed in June 2004 having raised EUR 300m. European New Horizon LP, the first fund of Centurion Capital was closed at a value of EUR 150m in June 2004 with a focus on CEE countries.

A record fund BE3 was raised in 2005 by Bridgepoint Capital reaching EUR 2.5bn. The sources are being used for investments in the CEE countries. Enterprise Investors launched another fund of EUR 600m in 2006, which will carry out investments in the CEE region. Companies in industries with high barriers to entry can obtain sources from Emerging Europe Convergence Fund II of Mid Europa Partners, which was closed in January 2006 with EUR 650m. After adding all these sources raised for the whole region, we can see that the availability of sources in the Czech Republic is not as desperate as it may have seemed from the previous graph.

Investments

The number and volume of investments has been quite high between 1999 and 2001 thanks to several factors including sufficient number of non-restructured companies with original ideas promising high growth potential, favorable economic environment and entrance of new market players, which pulled up the prices of deals through tightening competition. There was 46 initial investments and 42 follow-on investments worth EUR 178m. The decrease in activity between 2002 and 2004 can be accounted to the economic slowdown in 2001, harsh competition and entrance of international companies (producers), which showed that not every promising project is able to compete with the international players and can be turned into a success story. Only 41 investments were realized with a total value of EUR 68m. During the last three years, the activity went up again as many funds have exited their projects[25] and were therefore searching for new investment opportunities. Thanks to the favorable interest rates and GDP growth, PE funds have been able to compete with strategic investors over the targets and the targets were generally performing well. This is important especially regarding the buyouts, where the targets have to repay the debt, which was used for the acquisition, by the cash flow they generates. The PE funds were able to carry out a few outstanding deals, which pushed the statistics up.

Graph 5.7: Investments in the Czech Republic 2000–2006 (in mil. EUR)



Source: EVCA Research Department, 2007

[25] There has been a vivid exit activity in 2004 and 2005.

As we can see in the previous graph, there is a great difference in results depending on the approach used. In the past four years (apart from 2004), the investment activity measured according to the market approach was much more vivid than when using the office approach. This can be explained by the fact that the Czech Republic has rather been playing a role of a target than an acquirer due to unfavorable legislative environment for the PE funds established in the Czech Republic.

What is alarming concerning the investments is the distribution of investments to particular stages. There has basically been no seed capital and a limited number of start--up projects in the past years. Abroad, those projects are usually financed by domestic institutional investors such as insurance companies or pension funds; unfortunately the Czech legal system is quite unfavorable towards this structure as will be discussed later.

There is a lack of domestic investors and foreign investors are usually interested in large-scale projects. Small perspective firms could be possibly financed by business angles, which unfortunately do not possess enough of capital. How to get out of this situation? (Mašek, 2007c). The sources for small companies and start-up investments were supposed to be provided by a new venture fund called Capital (*Kapitál*) that was planned to be launched by the investment agency CzechInvest in cooperation with the Ministry of Industry and Commerce. The fund would be raised from private as well as state sources and would dispose of CZK 450m with a focus on investments ranging between CZK 5–20m. Later, the fund was projected to become a part of a program called "Joint European Resources for Micro to Medium Enterprises" (JEREMIE). JEREMIE should have been included within the Operational Program Entrepreneurship and Innovation for the years 2007–2013 *(Podnikání a inovace)* prepared by the Ministry of Industry and Commerce, as an initiative of the European Commission and the European Investment Bank (European Investment Fund). The program would provide micro credits, guarantees and venture capital.

In 2006, the Ministry and the European Investment Fund led negotiations to specify the functioning of the program. It was based on the idea of creating a "holding capital fund", which would finance growth and expansion of small enterprises. The model would be as applied within the Structural funds and the Cohesion fund: sources are provided not only by the European Union, but they are co-financed by the particular country, according to its priorities. Unfortunately, due to the change of the staff at the ministry after the elections this conception was put aside. The new minister

of the industry and commerce, however, claimed that he would like to implement the program within the program EU Competitive Strength and Innovation *(Konkurenceschopnost a inovace)*.

In accordance with the trends in CEE countries, the Czech Republic has recorded an increasing number of leveraged buyouts, and its specific type – management buyout. Only a few years ago, the managers did not understand the mechanism of private equity financing; e.g. whether private equity goes to equity or debt or whether the fund takes over the whole company, etc. However, the managers have been turning to PE funds recently as they found out that it represents a viable way of financing a management buyout. In 2006, VUES Brno was acquired by two senior managers and Arx Equity (formerly DBG Eastern Europe) in a MBO for the consideration of EUR 80m. Post acquisition, the managers hold 20% in the company, while the fund manages the remaining 80%. A few months earlier, the management of Pegas Nonwovens, a Czech textile company, backed by Pamplona Capital Management, the UK PE firm, acquired the company for an undisclosed consideration.

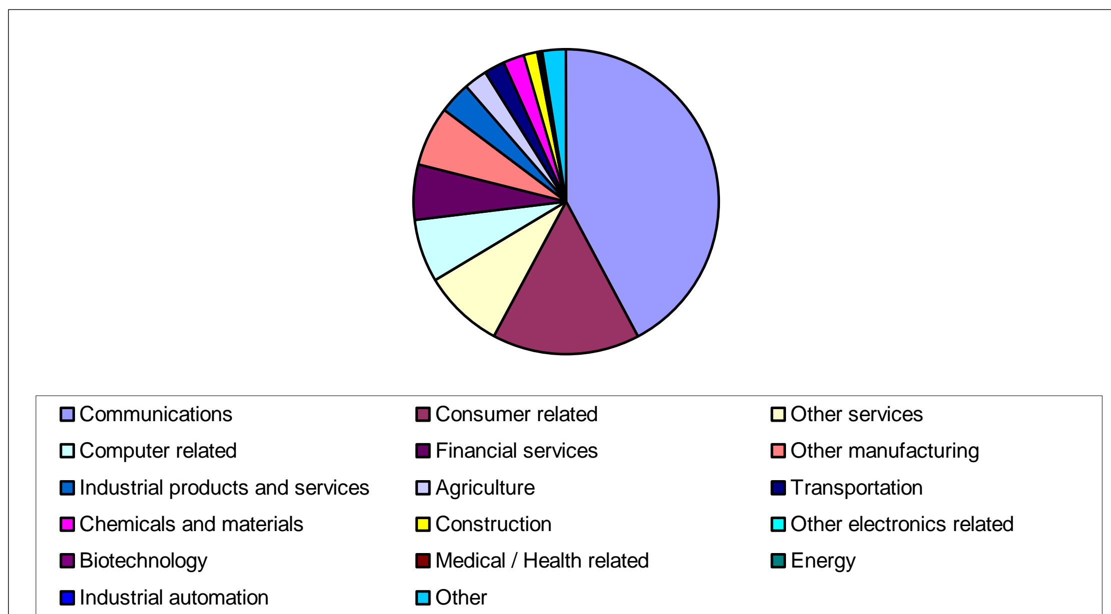
The main advantage for managers in MBOs consists in obtaining easier access to (debt) financing compared to if they would have carried out the buyout by themselves. In addition, they can still participate on the management of the company. At the same time, participation of the management on the buyout represents an advantage for the PE fund, as the management: usually knows better the background of the company and its functioning than an external acquirer; the management can be aware of a comparative advantage of the company, which may not be visible to external market players; and the board of directors that must approve the transaction is usually more in favor of the acquisition in case of a MBO.

A new concept has been introduced to the CEE countries lately - taking public company private. This approach is based on the fact that number of companies was listed for wrong reasons and because they did not create any value, the new investor takes them private again. Even though there has not been such a transaction yet in the Czech Republic, it is just a question of time as such transactions have already been carried out in neighboring Poland and Hungary in 2006.

Regarding the sector distribution, the greatest investments were directed to telecommunication, IT, and Internet sector, as the Czech Republic was trying to catch up with the West. These sectors were followed by consumer related sectors and

constructions. These preferences partially correspond to the general preferences of the CEE region; however, there is a stronger focus on construction and pharmaceuticals.

Graph 5.8: Sector Distribution in the Czech Republic by Volume since 1999–2006



Source: EVCA Research Department, 2007

Concerning particular transactions, the EVCA statistics we based our analysis on, does not include all the deals carried out by the PE funds on the Czech market, but only deals realized by the European PE funds. In the following text, we will also include important deals realized by other funds, e.g. Riverside, Warburg Pincus, or Lehman Brothers to help to complete the picture of the market.

The greatest investments by that time were carried out in 2000, when their value reached EUR 92m. They included acquisition of 100% stake in Svoboda Press by Argus Capital Partners and acquisition of 35% stake in Netcentrum by Intel Capital for an undisclosed consideration. In 2001, investments substantially dropped to EUR 31m; among the larger deals there was an acquisition of Systinet Corporation by a consortium of Windcrest Partners and 3TS Venture Partners for a consideration of USD 2.3m. They also participated in other rounds of funding alongside with other investors such as Warburg Pincus and Esther Dyson.

Investments kept falling until 2004 due to the ongoing global crisis. Some investors even became worried whether it is not the end of private equity in the Czech Republic. In 2005 investments for the first time approached the 2000 value. They increased to incredible EUR 91m, more than ten times the value of 2004 deals,

thanks to several outstanding deals such as purchase of 75% share of Computer Press by the Riverside Company form Bancroft Private Equity, or acquisition of CCS Česká společnost pro platební karty by Advent International. The company was acquired from JP Morgan Asset Management and individual investors, details of the transaction were not made public. Other deals included acquisition of Nowaco Central Europe, including Nowaco Czech Republic, by CCMP Capital Advisors and Bancroft Private Equity for EUR 90m; and Intel Capital's and Enterprise Investors' acquisition of 65% stake in AVG Technologies (formerly Grisoft) for EUR 41.7m.

In 2006, deal value reached EUR 509m thanks to acquisition of 100% of Metal Znojmo by KBC Private Equity. The same group together with three private investors acquired 80.5% stake in Tatra from Terex Corporation for a consideration of EUR 62m. The same year ARX Equity Partners (formerly DBG Eastern Europe) acquired 80% stake in VUES for an undisclosed consideration and Genesis Capital acquired 85.53% stake in Energetické strojírny Brno for a undisclosed consideration. The greatest deal not included in the EVCA statistics was a deal carried out by a consortium of Lehman Brothers, Mid Europa Partners and Al Bateen Investment Company that acquired České Radiokomunikace for a consideration of EUR 1.19bn, which became the largest transaction ever carried out by PE funds in the Czech Republic.

Exit

Apart from the two prevailing ways of exit in the Czech Republic – trade sale and write-off, new strategies have become popular: secondary sale, IPO and sale to management. Concerning the trade sale, in 2002 Czech Venture Partners exited the start-up investment into Ekol Gas Ostrava by a sale to a strategic investor. Czech Venture Partners reached the IRR of 18% in this investment. In 2005 a consortium of private equity investors including Advent International, CCMP Capital Advisors, Mid Europa Partners and four other investors, sold the Oskar Holding (including Oskar Mobil) to the Telesystem International Wireless (TIW), Canadian mobile operator, for a consideration of EUR 377.5m. TIW subsequently sold Oskar Mobil to Vodafone International Holdings. Advent International acquired Oskar Mobil in 1999, when it was operating under its former name Český Mobil. Advent achieved more than three times multiple of the original investment by this successful exit. In 2006, 3TS Capital Partners exited from its investment in Systinet, where they held a minority stake.

The stake was acquired by Mercury Interactive Corporation, producer of business technology software, for a consideration of USD 105m in cash.

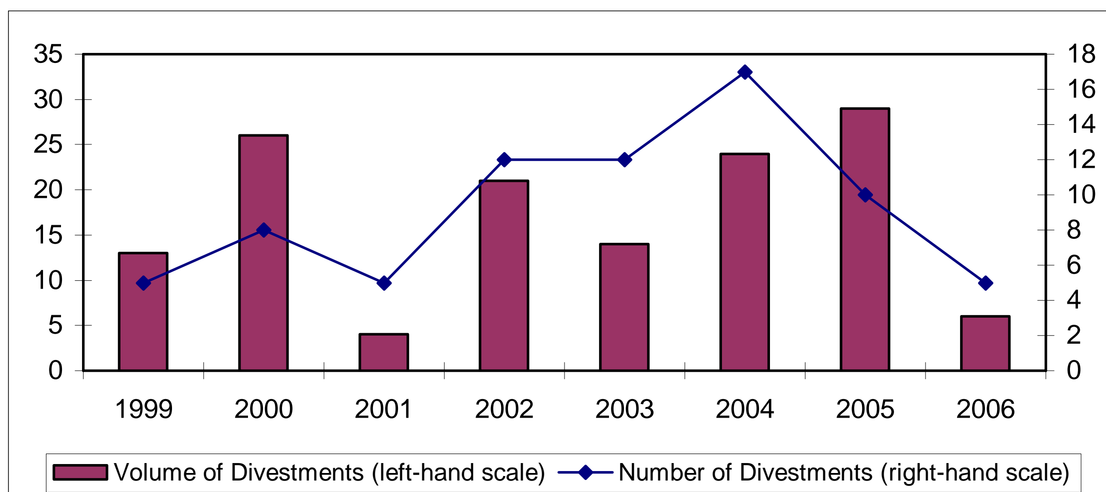
Secondary sale popularity can be documented in 2004 by a sale of Primalex owned by the Riverside Company, acquired by the company in 2003 for a price of EUR 15.6m, to the SigmaKalon Group, Dutch paint and coatings producer, who was backed by the PE investor Bain Capital. The terms of the contract remained undisclosed. In 2006, Genesis capital acquired 85.5% stake in Energetické strojírny Brno from Advent International for an undisclosed consideration. Advent acquired the company in 2002 for EUR 3m.

In 2004, the generic pharmaceutical manufacturer Zentiva, backed by the US PE investor Warburg Pincus, announced the first Czech IPO of a company backed by a PE fund on the Prague Stock Exchange. The market capitalization reached approximately EUR 580m; the firm retained 54% stake in Zentiva. Warburg acquired a 67% stake in Zentiva in 1998 and increased its stake in the following years. In 2006 it sold its last 20% stake to the French pharmaceutical firm Sanofi Aventis for EUR 430m. In December 2006, Pegas Nonwovens, a Czech-based textile company, whose owner was Pamplona Capital Management, a British PE firm, was introduced to the Prague stock Exchange and became the second PE related IPO. There have been a few IPOs since then on the PSE (ECM, AAA Auto), however, none of them was realized by a PE fund as a form of exit. And thanks to the total failure of the AAA Auto's IPO, whose price dropped from CZK 55 in September 2007, when it was introduced to the stock exchange, to below CZK 20 in April 2008, the credit of IPOs have been shaken.

There has also been a great number of write-offs, especially at the end of 1990's and beginning of 2000. The score of write-offs ranged between 0 and 9 in the period 1999–2006. The greatest number of write-offs was recorded in 2002 and 2003, when its share on total divestments averaged 70%. It is visible from the graph below, as relatively high number of companies exited in those two years compared to the low volume of divestments. There are two main reasons behind: due to the economic crisis, there have not been strategic investors strong enough to acquire the companies and generally there was a low demand; the second reason consists in the potential of the companies. In this period, there has been growing competition due to incoming foreign producers, and the investors often found out that even a promising company with an original idea is not always able to generate profits facing the hard competition,

e.g. in the automotive and glass making sectors, the PE funds made several big investments that ended up as a total failure.

Graph 5.9: Number and Volume of Divestment in the Czech Republic 1999–2006 (in mil. EUR)



Source: EVCA Research Department, 2007

5.3.3 Private Equity Funds' Activity Incentives

There have been a few major incentives, which supported the activity of financial investors in the Czech Republic:

- High GDP growth
- Low inflation
- Low interest rates
- Oversupply of liquidity on the markets
- Banking sector development
- Low capital markets activity
- Number of Czech-based firms to be restructured

The high *GDP growth rate* and *low inflation* have boosted up the overall market activity, not only the PE market. However, the high GDP growth promises good profits of companies, which is important for leveraged buyouts, where the cash flow generated by the target company serves for debt repayments. What was also crucial mainly for buyouts was the easy access to financial means, which was caused by two main determinants: low interest rates and banking sector development. Concerning the *interest rates*, in December 1998, the 2-week discount rate of the Czech National Bank was cut down to single-digit number and kept steadily decreasing, which draught downwards the interest rates of commercial banks. As the Czech environment was

becoming more stable and the debt financing more available, it was attracting larger number of foreign investors and strengthened the local ones.

The fierce *competition among Czech banks* is another factor the funds could profit from. As the Czech banking sector is now established, banks experience clients' tug-of-war. Within the frame of this fight they were coming up with innovations trying to satisfy old clients and attract the new ones. Thanks to low default rates and decrease of margins on other forms of financing, banks were willing to undergo projects with higher level of risk, which promised higher returns in exchange. Apart from standard acquisition financing, the banks started to offer different types of subordinated loans such as second lien loans[26]. Not only that the banks significantly expanded their product portfolio but they also changed their attitude toward the leverage multiples, which increased to approximately 4.5x EBITDA[27] for the senior debt and to 6x EBITDA concerning the total debt in mid-2007.

Not all the financial investors investing in the Czech Republic use the services of Czech banks, especially the regional-based funds may ask banks in their country of origin or in a country with a greater experience in acquisition financing. However, it is hard to provide appropriate statistics as the funds as well as the banks are generally not willing to disclose neither the number of loans nor their volume. From the fragmentary Mergermarket statistics, we can conclude that the transactions carried out in the Czech Republic in the past seven years were usually leveraged by Erste Bank, Bank Austria, ING Group, Commerzbank and the most active Czech players were ČSOB, Česká spořitelna, BAWAG Bank, and Raiffeisenbank, the first two having a statute of associated members of CVCA.

The development of private equity was also enhanced by the *weak capital market* in the Czech Republic. The fact that Czech firms cannot easily obtain new capital by issuing shares or bonds, leads investors towards private equity. On the other hand, the inexistence of an easy IPO procedure on the Prague Stock Exchange and the overall atmosphere such as low volumes of trading also represents an obstacle for private equity, as IPO is one form of divestment. However, trade sale, as a prevailing form of exit all over Europe including the Czech Republic, seemed to be satisfactory, therefore the positive effect of weak capital markets on private equity demand predominated.

[26] In the Czech Republic less than five second lien loans have been extended in total.
[27] The EBITDA is used as it is considered to be an indicator of a company's ability to generate cash flow to repay the debt.

Until 2003, the expansion capital investments prevailed as there was a high number of established, *non-restructured companies with a growth potential,* which were an ideal target for the PE funds. As the number of such companies was continuously decreasing the funds reoriented towards buyouts that are built on a strategy to buy a company, retrieve the inefficiencies, and fast resell in a few years. The number of such targets remains obviously high.

5.4 Legal Form

Activities of the parties involved in the private equity business are not regulated by any special law in the Czech Republic, but they are subject to the same legislation as the corporate sector. The main objective of the structuring of a private equity fund is to provide transparency and avoid double (or even triple) taxation; which means to ensure that each investor is treated as if he invested directly into the target firm. Because of the diversity of investors (institutional, corporate and individual investors), the fund's structure should be suitable for all of them and should generally ease all the operations. It should also respect the traditional distinction between investors and managers of the fund. Nevertheless, the main driver behind the search for the best PE fund legal form remains the tax optimization. From this point of view, the Czech Republic is still in the process of searching for the right form.

5.4.1 Private Equity Fund Statute

In most of the countries, private equity funds take the legal form of a limited partnership company. The reason is that the legislation in all the developed countries is not strictly determining the limited partnership form but it provides a great space for its determination in the partnership agreement (Dvořák, 1998). This is considered to be a suitable form given the differences among all the participants in a PE fund. In the Czech Republic PE fund was until 2006 approximated by the *komanditní společnost*, or *veřejná obchodní společnost*, which carried all major characteristics of the limited partnership.

In 2006, the Act no. 189/2004 on Collective Investment was amended, and a new possible legal structure for PE funds was created, the so called "fund of qualified investors". Owing to the favorable 5% taxation of the fund of qualified investors, it represented a progress concerning the tax point of view.

Limited Partnership *(Komanditní společnost)*

The limited partnership form consists of two parties - a limited partner and an unlimited partner:

1. *A limited partner* (*komanditista*) has a limited liability, i.e. he is only liable on debts incurred by the firm to the extent of his non-paid up investment. When the fund makes profit he is entitled to receive the amount that is proportional to his initial investment. All the PE fund's investors usually gain the limited partner statute. However, there are so called cornerstone investors and common investors. To become the cornerstone investor, the investor has to subscribe an amount exceeding the initial commitment and the subscription has to be realized in the first closing of the fund.
2. *An unlimited partner* (*komplementář*) has no obligation to invest in the company, but is the one legally responsible for the management of the company. The partner has an unlimited liability and gets a part of the profit (before tax) as specified in the contract[28]. The unlimited partner usually consists of cornerstone investors, promoter[29] of the fund in case he exists, and the management company. The unlimited partner is often established in a country with a liberal legislation such as the Cayman Islands, Bermudas, the Channel Islands Guernsey or Jersey, Ireland or Cyprus to minimize the tax burden. In general, it is another company founded as a limited liability company *(společnost s ručením omezeným)* for the purpose of limitation the original "unlimited" liability.

This structure is not fully tax transparent. The tax base is computed from the entire taxable income of the company with the exception of the income belonging to the unlimited partner. This tax base is subject to the corporate income tax. A double taxation occurs as the profit is firstly taxed on behalf of the limited partnership and then on behalf of the limited partners – individual investors. The unlimited partner's share is taxed only according to the legal statute of the partner; therefore one level of taxation is avoided. The core problem, however, consists in distribution of profits between the limited and unlimited partners, as the shares do not have to correspond to the initial contribution of the partners. So, despite the fact that this legal form better corresponds

[28] Concerning the Czech law, it is specified in Act n. 513/1991 Coll., Sec. 93–104e
[29] Will be defined in section 5.4.2.

to the principal of limited/unlimited partner scheme as known from abroad, the tax practice is rather disadvantageous.

General Partnership *(Veřejná obchodní společnost)*

Another form of a PE fund can be the General Partnership. It is formed by two or more persons (natural persons or legal entities), who are liable for the company's obligations to the extent of their entire property. The profit is distributed evenly. There is no restriction on the type of investments made.

Compared to the limited partnership, this structure is transparent for both domestic and non-domestic investors. According to the Commercial Code, the profits of a general partnership are not taxed by the corporate tax but each share of the profit is taxed in correspondence with each partner's legal statute. However, this legal form does not meet one of the core requirements - the distinction between limited partners (investors) and unlimited partners (managers), which is not legally possible.

It is quite complicated to carry out a profound comparison of the two forms according to the particular Czech experience as a little number of the funds has actually been established in the Czech Republic so far.

Funds of qualified investors

In 2006, the amendment to the Act n. 189/2004 on Collective Investment enacted in 2004 as a successor of the Law on Investments Companies and Investments Funds, enabled a "funds of qualified investors" (FQI) to be created. According to the Sec. 56, funds of qualified investors may be structured and used as private equity funds; the maximum number of investors is 100, which can be, however, exceeded subject to special permission of the Czech National Bank. The funds are destined for experienced investors (companies or individuals), who dispose with sufficient amount of capital. The minimal investment is CZK 1m. The fund is established for a limited period, a maximum of ten years, after which it has to be closed.

FQI can be established either as investment funds in a form of a joint stock company (more simple form), or as a mutual fund (closed or open-ended) without a separate legal standing, which is established by a management company that controls the fund. The fund has certain freedom to choose the assets in which it will invest and it

is subject to simplified supervision of the Czech National Bank[30]. There is no limitation on gearing, liquidity and scope of investment.

The decrease of nominal corporate tax rate to 5% belongs among the major benefits of this legal form. Unfortunately, the disadvantages prevail: if the fund is established as a mutual fund, with the existence of limited partners, it gains its legal standing through establishment of an investment company. In case of a fund in a form of a joint stock company, the division on limited and unlimited partners is uncertain and complicated, given only by a contract. The funds are still subject to regulation of the Czech National bank, and have certain limitation for investors. To sum it up, this legal form is costly and not very flexible; therefore it will not cause a boom of funds being newly established in the Czech Republic.

5.4.2 Management Company Statute

The fund is controlled by a private equity firm, also called the "Management company" or the "General Partner" (GP) that works as a consultancy firm. The relationship between the management company and the fund is set on the contractual basis. The main factors a fund considers during the choice of a management company are the experiences and past performance. However, if a management company proves to be inefficient or the running results do not correspond to the expectations, the fund usually enables to call off the GP by the qualified majority of investors.

The General Partner searches the projects, carries out the investment valuations, realizes the projects, monitors them and chooses the best exit strategy at the end. Nevertheless the main decision-making power belongs to the Investment Committee, which is a necessary part of every fund. It is composed of investors and representatives of the management company. The management companies are usually founded as a joint stock company or limited liability partnerships (*akciová společnost* or *společnost s ručením omezeným*). For the tax purposes, the management companies are not registered always in the country of interest but sometimes "off-shore".

The remuneration of the management company basically consists of two parts: a management fee and a success fee, usually called "carried interest".

[30] The fund is required to fulfill only a limited number of notification duties.

1. *Management fee* – is an annual fee, which is set up as a fixed percentage of the managed assets. It usually ranges between 1.5 and 2.5%; however, the exact amount depends on the size of a fund. Concerning the large funds (over EUR 1bn), the management fee usually decreases to about 1.5% compared to small funds, which reward the management companies by a fee that equals to 2.5% or more of the assets concerned. We can often come across another scenario with a so called commitment period. After a commitment period is over, the management fee decreases and the stated percentage concerns only the funds collected before the end of this period.
2. *Carried interest* – is a share of profits that the fund manager is entitled to once he has returned the cost of investment plus the hurdle[31] to investors. Carried interest is normally expressed as a percentage of the total profits of the fund. The normal share for the management company is usually around 20%, therefore it retains 20% of the profits generated by the fund and distributes the remaining 80% to investors. Compared to the management fee that is fixed, the carried interest varies according to the fund's performance, which is a result of the control of the management company. Therefore GP is motivated to increase the returns in order to increase its own income.

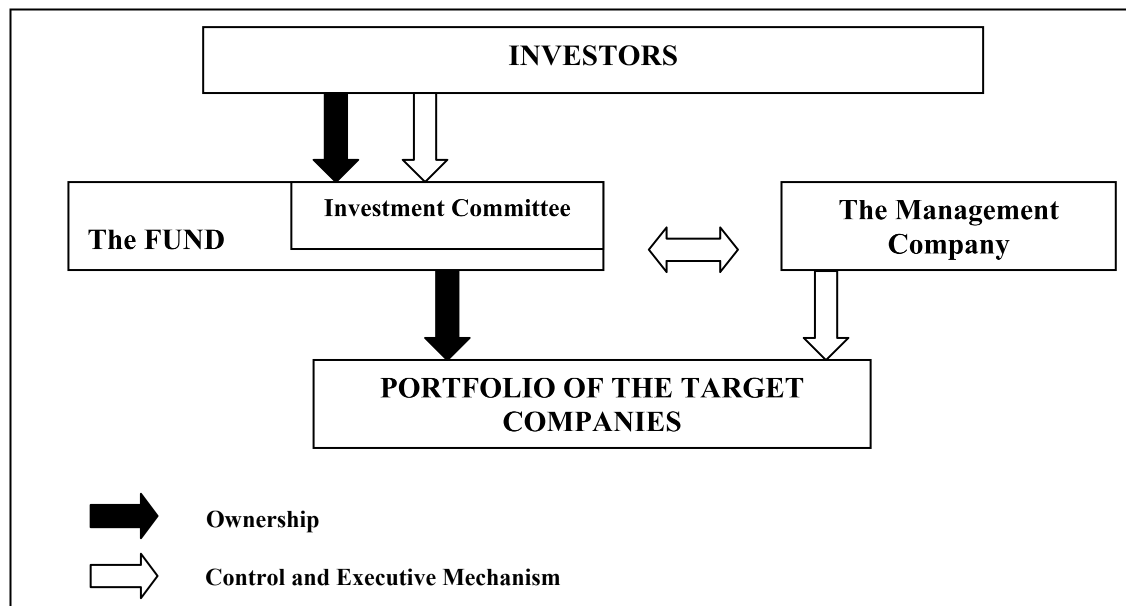
In case of dissolution of the contract between a management company and a fund initiated by the fund's qualified majority, investors usually insist to cut down GP's share on return. In case of a premature termination of existence of the GP, the share on return is not paid out at all.

Apart from the fees that the general partner receives from the funds, there are fees obtained from the target companies: an underwriting fee, a syndication fee or a broken deal fee. Nevertheless, the amount is rather insignificant compared to the fees obtained from the fund.

The last person entering this structure is a promoter. He is the initiator of the idea to establish a fund; he organizes the process of the establishment by carrying out all the necessary negotiations, and he manages the fund under his name. If the promoter is clearly defined, then he is usually a part of the unlimited partner. The relations among participants of the process are shown in the following scheme.

[31] Minimum investment return required by investors that is usually derived from the expected inflation.

Scheme 5.1: Legal Structure of Private Equity Funds



Source: Dvořák, 1998

5.4.3 Law on Financial Assistance

The prevailing form the private equity investments in the Czech Republic is a buyout transaction; therefore we are now going to clarify the legislation concerning financial assistance provided by the acquired company. This legislation is crucial as majority of buyouts are financed by a large portion of debt. The law on Financial assistance accepted in the Czech Commercial Code is based on the Second Council Directive 77/91/EEC adopted by the European Economic Community in December 1976.

Second Council Directive 77/91/EEC

The Second Council Directive 77/91/EEC specifies safeguards that have to be followed by the companies in the Member States in order to protect interests of members and others, concerning the formation, maintenance and alteration of capital of the public limited liability companies. The Sec. 23(1) exactly states that: *"a company may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party."*

In the second paragraph, transactions concluded by banks and other financial institutions as a part of normal business, and acquisitions of shares by or for the company's employees are excluded. The directive is supposed to serve as a protection

of shareholders and creditors by ensuring maintenance of the capital of the target company and prohibiting its misuse.

However, the statutory prohibition can be relaxed. A company can follow the so called "whitewash" procedure and overcome the prohibition, if the provision of financial assistance will not reduce the company's net assets, or to the extent that they are reduced if the assistance is provided out of distributable profits. The target company also has to be able to meet its liabilities as they fall due. This declaration carried out by all company's directors must be accompanied by auditors' report confirming the declaration. The whitewash procedure has been enacted in the UK Companies Act in 1985. In Slovakia, the limited liability companies are also exempted from the prohibition.

Law on Financial Assistance in the Czech Republic

In the Czech Republic, the law on financial assistance is incorporated in the Act n. 513/1991 of the Commercial Code, Sec. 161 (e) and 120 (2). Section 161 (e) of the Commercial Code, claims that covered companies may not grant advance payments, loans or credits for the purpose of acquiring its shares or secure credits or loans for such purposes or other obligations (debts) relating to the acquisition of these shares. The law concerns joint stock companies (*akciová společnost*) and limited liability companies. Unfortunately, in the Czech Republic there is no exemption relaxing the prohibition as in the UK or Slovakia, which should be changed as it may prevent some deals from being carried out.

5.5 Drawback of the Czech Environment

There are basically three types of private equity drawbacks in the Czech Republic. The first one is legal arrangement, concerning pension funds' and insurance companies' regulation, IPOs and legal support for fund managers. The second area is tax regulation, represented by e.g. the problem of triple taxation and new thin capitalization rules. The last complication consists in absence of trustful data and a short PE history in the Czech Republic.

The poor legal and tax environment in the Czech Republic was confirmed by the yearly quantitative survey on business regulation and protection of property rights carried out by the World Bank. The survey assesses ten stages of a business' life: starting a business, dealing with licenses, employing workers, registering property,

getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business; and compares 178 countries across the world. Even though all these determinants are not crucial for private equity market development and at the same time, some important determinants are not included; it can provide us a general overview of conditions for "Doing Business" in the Czech Republic. Since the last survey, the Czech Republic moved from the 52nd place to the 56th place[32]. What is especially alarming is the fact, that among the European Union countries, it ranked third from the bottom, only Poland and Greece provide less ease to do business.

5.5.1 Legal Regulation

Nowadays, legislative regulation represents a problem especially for the fundraising activity. Due to the rigid regulation, pension funds and insurance companies, the major PE funds' investors in Europe, are excluded from the group of potential investors in the Czech Republic. Therefore the amount raised by funds in the Czech Republic is quite low compared to what it could be, and funds investing here are usually raised abroad within regional funds. A change in the law on collective investment carried out in 2004 was supposed to bring a solution; however, in reality nothing has changed. Other legal issue is lack of legal support for fund managers. We will refer to the EVCA's Benchmarking Tax and Legal Environment survey to show how the Czech environment is perceived on the European level.

Pension funds

Unlike in other European countries, the Czech pension funds do not play any role on the domestic PE market at all. The Czech regulation did not implement the EU Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, and the national regulation basically deprives pension funds of the possibility to invest in private equity. According to the Act n. 42/1994 Coll., Sec. 33 they are basically allowed to invest in bonds issued by OECD countries, European Investment Bank (EIB), EBRD or by other international financial institution, which the Czech Republic is part of; into allotment certificates of the open shares funds or quoted securities. According to the amendment enacted in 2004, Act n. 36/2004 Coll.,

[32] Doing Business 2007 rankings have been recently recalculated to reflect changes to the methodology and the addition of three new countries; however, we used the results that were available before this change.

a maximum of 5% of the entrusted assets may be also invested in other assets than specified in the law. The amendment also introduces a common rule for pension funds' investments, which resembles the prudent man principle: it requires the pension funds (a trusted agent) to invest funds entrusted to it with prudence to ensure safety, quality, liquidity and profitability (Sec. 33(1)). The 5% limit potentially opens up a space for private equity investments, which is unfortunately closed by another limitation.

This limitation comes in form of prohibition of negative business results. In case of a negative business result, shareholders have to pay the loss made. According to the Act no. 42/1994 Coll., Sec. 35(2) in case that a pension fund ends up in red numbers, the fund has to cover the loss by retained earnings, reserve fund or other funds created from earnings. If these sources are not sufficient, the loss has to be covered by reduction of capital stock[33]. Private equity investments, however, do not generate positive return every year, especially at the beginning of the project. Therefore they are not a desirable target for pension funds.

EVCA continuously monitors national legal development. They have so far carried out three researches focused on tax and legal environments; the Czech Republic was included in a research performed in 2004 and 2006. The research evaluates environment for investors and fund managers, target companies and the environment for retaining talents. The position is graded on a scale from 1 to 3, "1" meaning optimal and "3" meaning unsatisfactory. Regarding the situation of pension funds as potential investors, the grade for the Czech Republic reached only 2.20 in 2006, whereas the European average was 1.55. There has been no improvement since the evaluation of 2004. However, as pension funds practically do not invest in the Czech Republic, the grade should have rather been 3.

Insurance companies

A similar problem occurs in case of insurance companies. According to the Act n. 363/1999 Coll., insurance companies are allowed to invest in e.g. securities issued by unit of collective investment, quoted shares, bond issued by member states or central banks of the member states, EIB or EBRD (i.e. only liquid assets). In 2004, the Act n. 39/2004 Coll., Sec. 21a(10) newly allows insurance companies other composition of financial placement; however, it has to be approved by the Ministry and must not

[33] If the fund distributes profit, a minimum of 5% falls on reserve funds, a maximum of 10% goes to shareholders, and the rest is distributed among participants of the funds, whose retirement insurance expired the year the particular profit was made.

contradict Sec. 13(9) setting the rules for investments of the technical reserves sustaining safety, profitability, liquidity and diversification. It also has to comply with Sec. 4 and Sec. 8 of the Act. This exception seemed to be quite promising for private equity until a public notice was accepted by the Ministry later in 2004, which put an end to the hope of the insurance companies. According to the EVCA survey, the investment environment for the Czech insurance companies remains unsatisfactory, as it received grade 3 in the 2006 survey.

European pension funds keep 2–5% of their assets in private equity, insurance companies around 2–3%. Given the fact that pension funds and insurance companies have contributed to the European fundraising between 2002 and 2006 by 23.9%, 10.8% respectively, the Czech Republic should be willing to change the legislation. The first change, which should be carried out is cancellation of the law requiring pension funds to end up in black numbers every year. By this legislative move, the greatest European investor – local pension funds – would be allowed to participate in the fundraising in the Czech Republic.

Legal support of fund managers

Despite the care each fund manager dedicates to each investment, it is not rare that the investment is a failure and the company goes bankrupt. Fund managers often participate in the management of the target company by becoming a member of the statutory body of the company. A problem arises as according to the Act n. 455/1991 on Trade Licensing, an entity, an individual or a corporate body, who was part of the statutory body of a company that is facing bankruptcy, cannot execute the same position in another firm for the three subsequent years.

The managers may then prove at the court that they managed the company with prudence to ensure safety, quality and profitability. However, the legal proceedings may be prolonged to several months or years, so it is obvious that the current legal form is very disadvantageous for them as they carry the increased risk and may be handicapped in the future job seeking process.

5.5.2 Taxation

According to the World Bank's regular survey on entrepreneurship, the taxes and jurisdiction belongs among the most problematic factors in the Czech Republic. Apart from the specific problem of multiple taxation, there is also a problem of taxation

of option plans, which in the West serve as a part of remuneration of fund's managers, and non-existence of special tax for SME.

Multiple taxation

In the Czech Republic PE funds are exposed up to triple taxation: first the taxation occurs on the target company level – the income is taxed by the corporate tax; then the fund is subject to the corporate tax, and finally the investor is subject to the corporate or individual income tax accordingly. According to the Act n. 586/1992 on Income Tax, the investor is freed from paying the income tax if it is a corporate investors that holds at least 10% of the base capital of the fund for a period of twelve consecutive months (Sec. 19(3b)), an individual investor, who holds securities for more than six months (Sec. 4(1w)), or an individual, whose ownership of interest in an limited liability company exceed 5 years (Sec. 4(1r)). Otherwise, the income is taxed again. There is no special tax on capital gains for companies; however, individuals are taxed according to the Act n. 586/1992 Coll., Sec. 8 on income from capital gains. The tax is lowered and reaches 15% in 2008. As of January 2009, it should further drop to 12.5%.

The triple taxation naturally lowers returns for investors, therefore makes private equity inattractive. As the Czech legislation is not able to prevent the triple taxation thoroughly, the funds are usually established in the tax-advantageous countries such as Bermudas, Jersey, or Guernsey. The funds of qualified investors could represent a solution given its lowered taxation of 5%, but due to persisting low interest of management companies, this advantage is not sufficiently appreciated.

Special corporate tax for SME

The nominal corporate tax rate lowered from 24% in 2007 to 21% in 2008 and should decline down to the target level of 19% in 2010, which is below the European average. However, there are neither tax incentives for investments in private equity, nor a special tax for small and medium enterprises to enhance their activity, which is a problem for all CEE countries. From this point of view, the state support of private equity is insufficient.

Consolidation of capital gains and losses

Another problem concerning taxes arises because of the current legal regulation that does not allow consolidation of capital losses and profits within a fund. The fund realizes profits in two ways: it either sells its share in the target company or it liquidates

the company in case of a failure. Successful and failed investments have a different timing. Failures are usually liquidated sooner than a profit is realized via successful exit from a company, and the profit is subject to the tax. The current legal system, however, does not allow tax consolidation in the Czech Republic; therefore each company within a group (fund's portfolio) has to be taxed individually. Given the nature of the business of private equity funds and the average 10% level of failures – it would be desirable to enable the tax consolidation.

Option plans

Stock option may be an effective remuneration for the management of the private equity managed companies. Nevertheless, the Czech Republic does not encourage this kind of remuneration as the legal setting is ambiguous. Generally, there are three possibilities how to tax option plans: upon grant, upon exercise, and upon sale. The first two ways are basically taxed when the money from the possible gain is not yet received. According to EVCA, there should be no taxation of unrealized gains, therefore the first two solutions are not optimal, and the most recommended solution is the third one. In the Czech Republic, there are two possible interpretations of the law, which are dependent upon the particular option plan.

The practise is the following: either a manager works in a company on a contractual basis and receives options on the company's shares. Then the options are taxed upon exercise and they are subject to the payroll tax, according to the Act no. 586/1992 on Income Tax, Sec. 6. In addition, the social and health contribution has to be submitted. In this case, the tax base is derived from the difference between the exercise and market price. Nevertheless, exercising the options does not always have to bring profit in the future, when the underlying asset is sold. Therefore this structure is not very favorable to expansion of options as a part of remuneration of managers.

Another possibility consists in a different approach in interpretation of options. By accepting options, managers undergo a risk as their possible profit is connected to the future development of the company. Options can be perceived as investment carried out by the managers; therefore their exercise is taxed as income from capital gains in accordance with the Act n. 586/1992 on Income Tax, Sec. 8 – Income from Capital Gains. The tax rate is lowered to 15% and there is no need to pay the social and health contributions. This comprehension clearly lowers the tax burden for option holders.

However, the best solution would be to tax the income after the underlying asset is sold and the managers actually make the profit.

Thin capitalization rules

In May 2007, the government of the Czech Republic passed a bill on new rules on thin capitalization[34] and general tax deductibility of financial costs[35] on total loans and credits. The government reasoned that interests are vulnerable to tax planning, especially in a sense to replace dividend by interests, which are, as compared to dividends, tax deductible. In other words, the government wants to prevent situations when a subsidiary pays "dividends" in form of high interests to the parent company (for the loan provided by the parent company) to avoid the 15% tax rate on dividends and to lower the tax base.

The former rules on thin capitalization incorporated in the Act n. 586/1992 on Income Tax, Sec. 25 stated that interests from loans and credits were non tax-deductible if the sum of loans and credits, provided by associated (meaning capital association) persons, to equity surpassed the ratio 4:1 (6:1 in case of banks and insurance companies). There were no constraints on the interests from the loans and credits provided by third persons.

As of January 1, 2008, the limit for the associated persons decreased to 2:1 (3:1 for banks and insurance companies). Newly, there is also a limit for the third party loans and credits: the sum of loans and credits, from all associated and third persons, to equity must not exceed 6:1 (4:1 as of 2009). In addition, the sum of financial costs must not exceed the 12-month PRIBOR/LIBOR plus 4%. There is one exception concerning the thin capitalization rule, which concerns interests under CZK 1 million per year, which are exempted from the rule. The law is valid for new loans and credits (and amendments to existing contracts), and as of 2010 for all loans and credits.

This is a very unpleasant situation for the private equity market as the following practice is quite common: PE fund acquires a target company and provides an additional loan to the company, or the target company extends a loan at a bank to provide financing for working capital and capital expenditures. The new bill basically

[34] Thin capitalization sets the tax acknowledgeable volume of loans and credits from associated persons, of which the financial costs will be tax acknowledgeable cost.
[35] Financial costs mean all the costs related to loans and credits from both associated and third persons such as interests, fee for guarantees, costs for hedging operations etc.

cancels this practice as either the limit for the associated persons (the fund) or all persons (fund and the bank) will be easily surpassed.

What is especially alarming is the fact, that the law will mostly affect the small and medium enterprises in the investment phase, which will suddenly have to face this barrier to further development. This segment has very limited chances to reach other forms of financing as it is not usually able to provide collateral to back up a loan, therefore the interest rate it is offered at a bank, ranges above the PRIBOR/LIBOR plus 4% rate also set in the new rules. On the other hand the CZK 1-million exemption is not sufficient for all the small enterprises. Because of the increased tax burden that they will have to face, the companies might easily find themselves in a liquidity trap. Setting the maximal average interest rate for all the diverse tax payers has no clear economic foundation (KMPG, 2007).

As we know from the field of corporate finance, the structure of debt and equity of a company influences its economic efficiency. According to the KPMG Study (2007) as the companies will be forced to maintain a structure of capital that will comply with the law, the companies may become inefficient, which will worsen their financial situation and possibly also their rating. As a consequence of the worse rating, the companies will have to borrow for higher interest rates, which will obstruct their further development.

5.5.3 Reliance of Private Equity Data in the Czech Republic

The history of private equity in the Czech Republic as in all the CEE countries is quite short and private equity market still faces two major problems: there are no trustful data and the funds do not reach the required returns. The *existence of trustful data* is complicated due to the unclear definition of private equity investors. CVCA currently assembles data for private equity firms that raise their funds publicly and have a local office in the Czech Republic. Even though the approach of CVCA theoretically corresponds to the “office approach” of EVCA, the two data sets do no correspond at all. It is due to EVCA’s different definition of a PE investor, which includes also other investors apart from the full members of CVCA. The previous example depicts the problem very well: we can almost say that there are not two identical statistics carried out by two different sources for the same period of time. Therefore it is always important to know the methodology that was used to compile the statistics and choose the one that fits the best to our comprehension of private equity investors. However, it

would be useful in the long-term to reach an agreement over comprehension of the private equity investors, so that the data would be mutually comparable and would serve better for trends assessment. This problem unfortunately does not concern only the Czech Republic, but the availability and trustfulness of the statistics is a problem for the whole CEE region.

The low returns reached in the past years compared to the *high required returns* represent another problem for private equity expansion. In the following scheme we can see the real long-term performance, which a PE fund's manager could have reached dependent on the quality of the manager and quality of the choice of a sector involved.

Schema 5.2: Real Long-Time Private Equity Performance in Europe

	"Bad" Sector	"Median" Sector	"Good" Sector
"Bad" Manager	–4%	0%	4%
"Median" Manager	4%	8–10%	16%
"Good" Manager	12%	16%	30%

Source: Martiny and Koch, 2007

With the median sector and the median manager, the long-term return reached only between 8–10% for the investor all over the Europe, which is far below the 30% level every investor dreams of.

6 Impact of the Subprime Mortgage Crisis on Private Equity in Europe

After the record-breaking year 2006, the first half of the year 2007 suggested that the year 2007 was about to bring another year of records. However, the turmoil in the US mortgage market that burst out in July 2007 and later spread into the debt market, brought to an end the previous M&A market boom, which was nourished by buyouts carried out by private equity funds. Due to the interconnection of the world debt markets, the liquidity crisis did not remain restricted to the United States but started to spread worldwide. The private equity market has been affected through the decrease of large leveraged buyouts; however, the scope of the impact on particular debt markets depends on the interconnection of the local and international markets, debt instruments commonly used by the country and other external conditions such as the Basel II adoption, which caused the inability of banks to evaluate the risk.

Not surprisingly, the effects of the crisis are not entirely negative: as always, there are losers and there are winners. Losers are the PE funds that got carried away during the credit bubble and will now face lower returns in certain funds. On the other hand, the PE funds that have raised new funds, have an unique opportunity to buy the best-class assets at a discount. At the same time, the market will be cleaned out of the bad debt and the equilibrium between lenders (banks) and borrows should be restored again; at least for some time.

6.1 Roots of the Crisis

The favorable economic situation in the United States led to ease in financing and to increasing number of extended subprime mortgage loans in the past few years. Special mortgage products such as mortgage loans with initial lower installments or interest-only options enabled subprime borrowers, which would never be able to reach to a mortgage loan before, to become home owners. Nowadays around 15% of all US mortgage loans are estimated to be in the subprime class. On the other hand, it made them extremely vulnerable to interest rate movements. After a series of interest rate raises in the spring 2007, many subprime borrowers found themselves unable to pay the installments. As the house prices, which were previously over valuated, started to fall, the mortgage collateral has shrunk so the borrowers had no chance to refinance their mortgage loans.

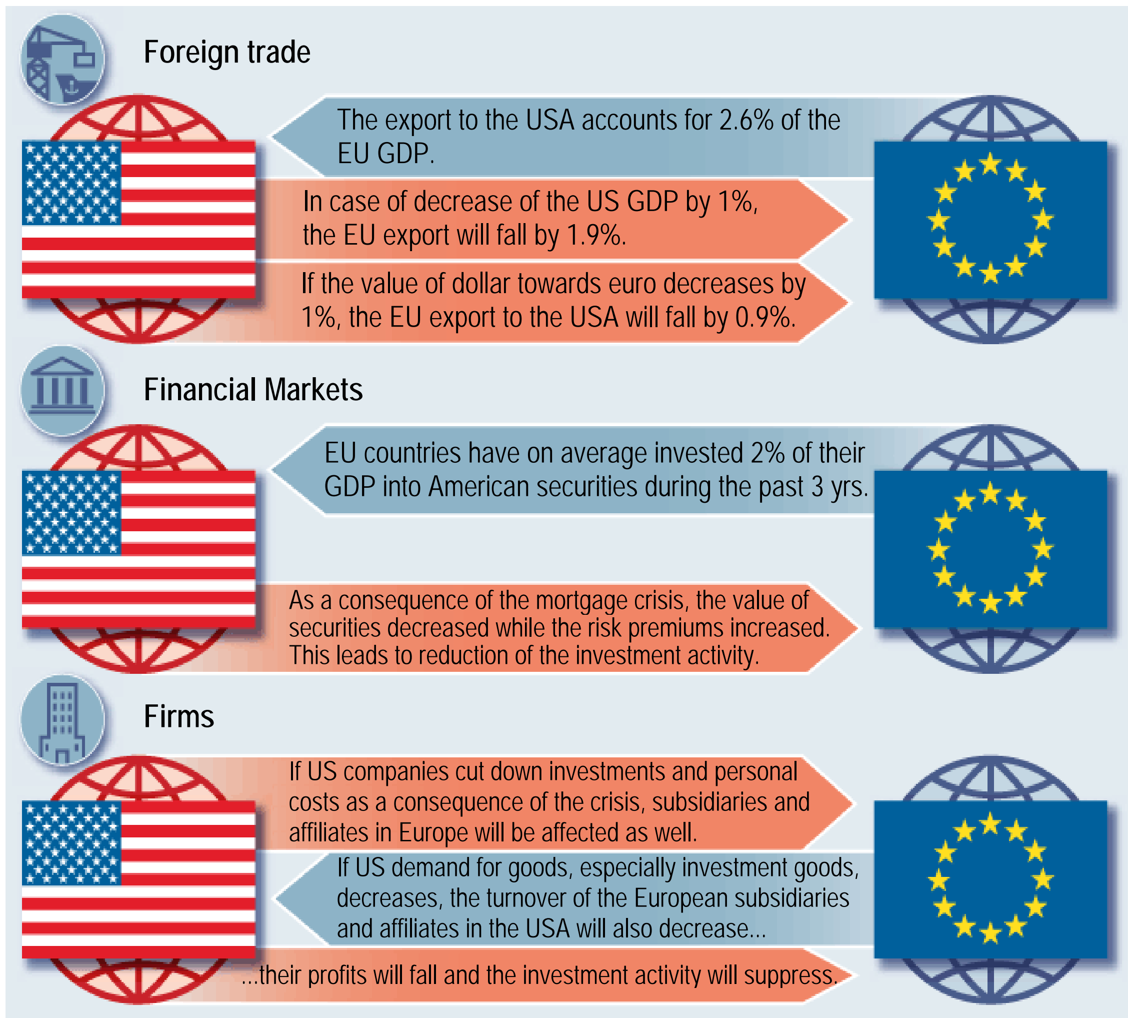
Due to the fact that the banks did not keep the mortgages on their balance sheets, which would make them the only sufferer, but further traded with the receivables through the so called "securitization" of mortgage loans, the mortgage crisis could spread worldwide. *"While some of these securities have been sold to direct holders, many have been sold to conduits established by the parent bank or financial institution for subsequent repackaging. Such conduits are structured investment vehicles (SIVs) and collateralized debt obligations (CDOs)."* (OECD, 2007, p. 19) These debt packages were subsequently sold to investors without great knowledge of details of the securities included. However, as they received high ratings from the rating agencies, there was no reason to be worried. Major investors were hedge funds, banks and some asset managers and insurance companies; from the USA as well as Europe and Asia.

Whenever the borrowers become insolvent, the investors had to mark down the value of the debt and suffered great losses. The investors, usually affiliates of banks, typically issued commercial papers with maturity of less than one year to be able to buy the long-term security packages. In the course of 2007, the end-investors stopped buying these short term papers as they were afraid that the proceedings were used to purchase the U.S. subprime mortgages. The whole model broke down and the banks and hedge funds started to disclose their losses or went bankrupt.

By August, it became evident that the cheap credit period and the M&A boom is over and banks and hedge funds are in trouble. The European Central Bank, the US Federal Reserve (FED), the Bank of Japan and the Russian Central bank even had to inject billions of dollars into the banking system due to the lack of liquidity on the money markets, which came after the system of mortgage loan securitization broke down. FED also decreased its discount rate several times (e.g. August 2007, September 2007, December 2007) to prevent the mortgage crisis effect on the American economy.

Nevertheless, the economists start to indicate the situation in the United States as a beginning of a recession. The EU countries will, therefore not only suffer directly as a consequence of their investments into American securities, but also through exports and business as it is shown in the following schema.

Scheme 6.1: Impact of the Recession in the USA on European Union



Source: Hospodářské noviny, 2008

6.2 Impact on the Private Equity Markets in Europe

As a consequence of the crisis, several *hedge funds and banks defaulted* or had to be bailed out, the financial markets have become more volatile and the overall economic uncertainty diffused. In Europe, banks suffer from lack of liquidity on the interbank market as there is no longer mutual trust among the banks. Therefore the banks do not want to provide loans to each other being afraid that the other bank will not be able to stand up to its obligation. A bank that wants to extend a loan on the interbank market has to pay much higher interest rates. It results in a lack of liquidity as the banks deposit their money at the central banks instead. The mortgage crisis has turned into the liquidity crisis.

Concerning the private equity market, the part that is particularly affected are *leveraged buyouts*. Leverage buyouts are vitally dependent on the banking sector

development. It will now be more *difficult for PE funds to obtain resources*, as the banks increased interest margins, tightened covenants, and require improved documentation; at the same time, the funds will have hard times to repay the loans for two reasons: firstly, with the overall slowdown of economy, the acquired firms are likely to have lower profits, which serve to repay the debts. Secondly, the loans extended by the PE funds were usually set with deferred maturity, which means that the smaller part e.g. 30% of the loan was repaid in the first three years after the loan was extended, and the rest was to be repaid afterwards. However, as the PE funds have had an average holding period of usually less than three years, they relied on the fact, that they will resell the company before they have to start repaying the higher portion of the debt. Now, as the exits are not so easy anymore, the time when these larger parts of loans have to be repaid is coming.

Many buyout deals that were already announced were either cancelled or repriced. The United Kingdom and Ireland were hit especially hard as their economies are tightly connected with the US economy. Fitch, the rating agency, estimates that there has been 64 postponed M&A transactions in January in the United Kingdom with the total value of USD 351bn (Pečinková and Němec, 2008).

Not only that the banks tightened the requirements, lowered the debt multiples reaching on average up to 6.1x in the summer 2007, but in some countries we observed the so called *credit crunch*, which means that the banks significantly limit the number of all loans, both to companies and households, as a consequence of small supply of liquidity. Such a scenario was observed in e.g. the United Kingdom in the last quarter of 2007.

Together with the new credit limits, a *change in leveraged products* offered has also occurred. The change mainly concerns the second lien debt and the mezzanine debt, the two subordinated secured debts. The second lien debt has appeared on the European market in 2004 and soon became popular thanks to its simplicity, convenience, and flexibility. The debt is provided by banks. The crucial difference between the second lien and mezzanine debt comes in case of an insufficient collateralization. Regarding the second lien debt, it is not subordinated to priority senior debt as for the payment rights, which is not the case of the mezzanine debt. *"The risk of insufficient collateral is common in, for example, European leveraged buyouts where full collateral coverage is impended by local legal restrictions on granting security and guarantees. These restrictions include rules regarding: financial assistance,*

thin capitalization, capital maintenance, and corporate benefit." (Muzilla and Siebens, 2006, p. 6)

However, in the past months, the second lien debt has practically disappeared from the European market as the banks are no longer willing to offer these loans, especially to the major applicants for second lien - hedge funds, which are now on the black list of all the banks. So there comes the chance for mezzanine debt, provided by specialized mezzanine funds, to become again the main junior component of leveraged financing. The European second lien debt volume decreased from over EUR 3.6bn in June 2007 to about EUR 0.4bn in November, to moderately increase to EUR 1.3bn in December 2007. Mezzanine loans also reached record volumes in June 2007 (EUR 3.4bn), and followed an identical decreasing pattern until November 2007 (around EUR 0.55bn), however, ended up on approximately EUR 2.25bn in December 2007.

With the uncertain debt market development, the PE investors will have to *rely more on investors' funds* now. Due to the market volatility it may also become more complicated to resell the company, when the fund decides to exit the project. This may shift the trend from buyouts to venture capital investments that are less demanding on financing. The funds could also change their strategy from "buying, restructuring and relatively rapidly reselling the company" (typical for buyouts), towards longer holding periods.

Even though the situation may seem hard for all the market players, there are PE funds that are actually able to profit from it. The PE funds that remained strong enough thanks to their reasonable behavior are now making money on overall decrease of value of companies and imprudent behavior of some investors. Blackstone, the US private equity group, has raised a USD 1.3bn fund in December 2007 to invest into securities including collateralized debt obligations, bonds that are backed by the mortgages. Other funds have been following the example. Some of PE giants admit that their best investment opportunities were realized during the economic crisis in 2002–2004. It is obvious that we are now facing a similar situation. Who remained strong, can now buy the *best assets* the losers are getting rid off *at a discount.*

A new threat has appeared on the world markets, which represents a serious competition to both private equity and strategic investors – sovereign wealth funds (SWF). These funds have existed since 1953 when Kuwait Investment Authority established them in order to benefit future generations; however, they are now

emerging at full-strength. There have recently been some cases in the USA and Asia, when SWFs acquired not only companies, which were targeted by PE firms, but the PE firms and banks themselves. It will be clear in a few months whether a similar development will follow in Europe as well.

6.3 Analysis of the European versus Czech Private Equity Market

In Chapter 5, we based the results concerning the Czech Republic on EVCA statistics, which monitors the activity in the Czech Republic carried out by European private equity funds. In this chapter we will focus on investments – buyouts carried out by both private equity funds (European and non-European) and financial groups investing in private equity. We chose the buyouts as they are the ones to be mostly affected by the liquidity crisis and they represent over 70% of all private equity deals in Europe. Our aim is to compare the trends to the ones in Chapter 5 and see whether they correspond or not. In addition, we will compare the results for the Czech Republic to the overall development in Europe, to see whether the two developments correspond or not.

Our main source of data will be the Mergermarket database completed by articles from newspapers and questionnaires sent to PE investors[36] operating in the Czech Republic. The Mergermarket database has certain limitations as described in Chapter 2 and unfortunately does not sufficiently cover 1990's and the beginning of 2000 for the CEE countries. The newspapers and questionnaires did not provide us with a complete information either; however, the main purpose of this analysis is to compare the trends, which correspond to the ones detected in the EVCA statistics to a certain extent. We will also see that the Czech Republic is following the European development until mid-2007, when the two markets start to diverge. We do not aim to provide an exhausting statistics of all deals carried out in the Czech Republic.

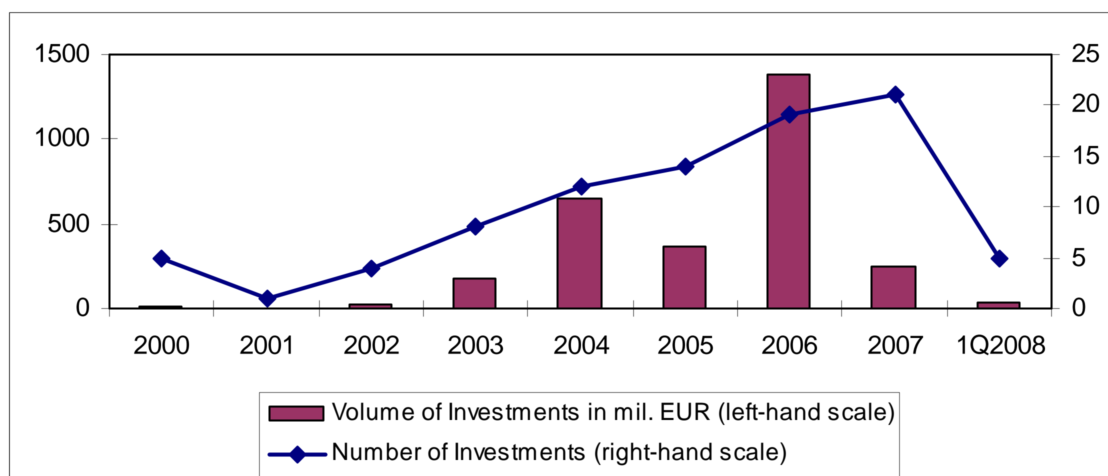
6.3.1 Analysis of the Czech Market

The slowdown of PE investment activity in 2001 can be accounted to the overall economic slow down and harder competition due to entrance of new companies on the Czech market. In our opinion, the fact that the statistics are better accessible and more

[36] A questionnaire was sent to PE funds – the CVCA members – to ask about their past activity in the Czech Republic. The response rate of the questionnaire was 53%; however, the investors did not always provide all the requested information, especially concerning the volume of deals.

complete only in the last four years plays a role, too. Until 2003, the slow continuous growth of volume of investments corresponded to the EVCA statistics. The disclosure rate of deals varied between 20% and 63%.

Graph 6.1: Number and Volume of Investments in the Czech Republic 2000–2008



Source: Mergermarket, own calculations

However, in 2004, the activity went up significantly as there were such transactions as RPG Industries' acquisition of 67% stake in Karbon Invest for EUR 400m or J&T's acquisition of 34% stake in Pražská energetika for EUR 140m and Penta's acquisition of Fortuna sazková kancelář for the consideration of EUR 75.1m. The total value of the five disclosed investments reached EUR 645m with the disclosure rate of 42%. These three major deals were not included in the EVCA statistics as they were not carried out by PE funds; that is why the activity remained quite low in the graph 5.7.

In 2005, the activity went up by almost one fifth concerning the number of investments; however, their volume decreased as the three greatest deals did not even reach the value of the Karbon Invest deal in 2004. In May, Nowaco, the distributor of chilled and frozen food was acquired by a consortium of private equity firms CCMP Capital Advisors and Bancroft Private Equity for the consideration of EUR 90m. J&T acquired 85% stake in United Energy for EUR 96.4m through its portfolio company Czech Energy Holding. The greatest deal was the acquisition of B. H. Centrum (trading as Prague Marriott Hotel) by Walton Street Capital and Merrill Lynch Global Principal Investment for EUR 130m. The value of all disclosed investments reached EUR 368m and the disclosure rate was 50%.

The year 2006 was a record breaking one as the first PE deal surpassing EUR 1bn was carried out in the Czech Republic. In November, Lehman Brothers together with Mid Europa Partners and Al Bateen Investment Company acquired České Radiokomunikace for a consideration of EUR 1.19bn. Other greater deals were carried out in the manufacturing and industrial products and services sector. The total number of deals was 19, of which the six disclosed deals reached together the value of EUR 1.38bn. In 2006, the value of deals went up also in the EVCA statistics; however, as it did not include the České Radiokomunikace deal, the growth was not as significant.

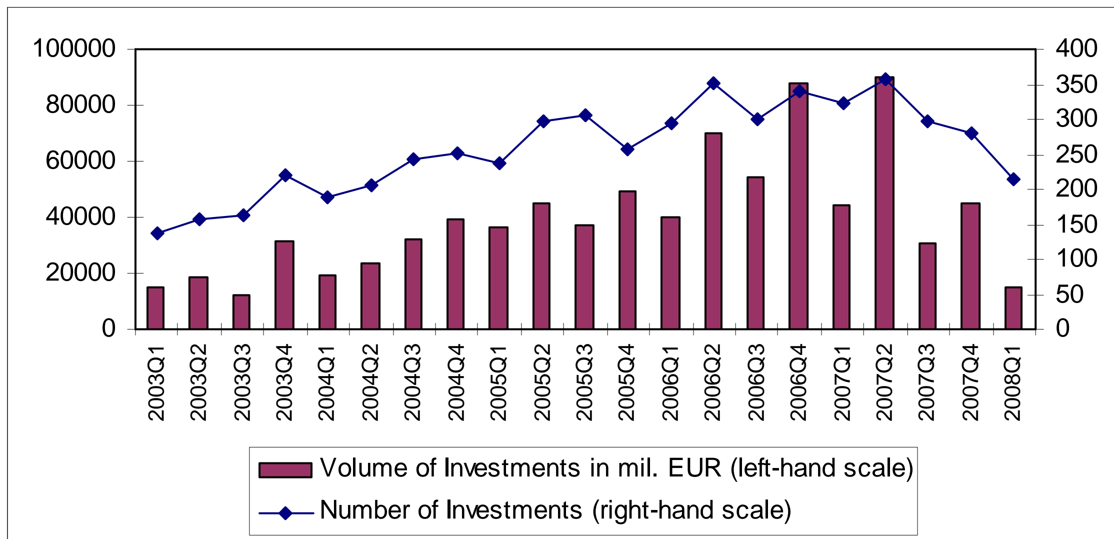
In 2007, the value of investments reached EUR 244m. The disclosure rate was quite low 43% and the greatest disclosed deals reached only EUR 100m in case of the acquisition of over 50% stake in NetCentrum by Warburg Pincus, and EUR 53m in acquisition of Bochemie by Benson Oak Capital. Nevertheless, the volume of investments cannot be taken as the detector of the activity, as it very much depends on the investors' decision, which deals they will disclose. So even though the volume of investments went down, the activity represented by number of investments kept on growing.

In the first quarter of 2008, there were already 5 investments carried out, which represents 20% of the investments in 2008. The Czech Republic does not seem to be heavily touched by the financial crisis. Does it correspond to the European development?

6.3.2 The Czech Republic versus Europe

The Czech Republic followed the same development as the European market until summer 2007. The subprime mortgage crisis, which turned into the liquidity crisis, has negatively influenced the European activity, especially through the large European players such as the United Kingdom, Germany or France. Due to the *credit crunch*, which hit the financial markets in the second half of 2007, the amount of debt available for the private equity buyouts has decreased. It has not totally disappeared though, however, now the cheap debt is gone and an investor, who wants to extend a loan, must take into account the increased price of the loan, which compensates the shortage of supply.

Graph 6.2: Number and Volume of Investments in Europe 2003–2008



Source: Mergermarket, own calculations

In the last two quarters of 2007 and the first quarter of 2008, the number and volume of investments carried out in Europe has considerably decreased to the level of the year 2005 as number of transactions had to be cancelled or postponed. However, not all the players on the market are losers. The funds that managed to act reasonably during the credit bubble or have raised new funds are the winners of this war as they are now facing some *great investment opportunities*. As the credit crisis continues, both public and private companies are getting cheaper. Some of the PE investors have also *focused on distressed debt*.

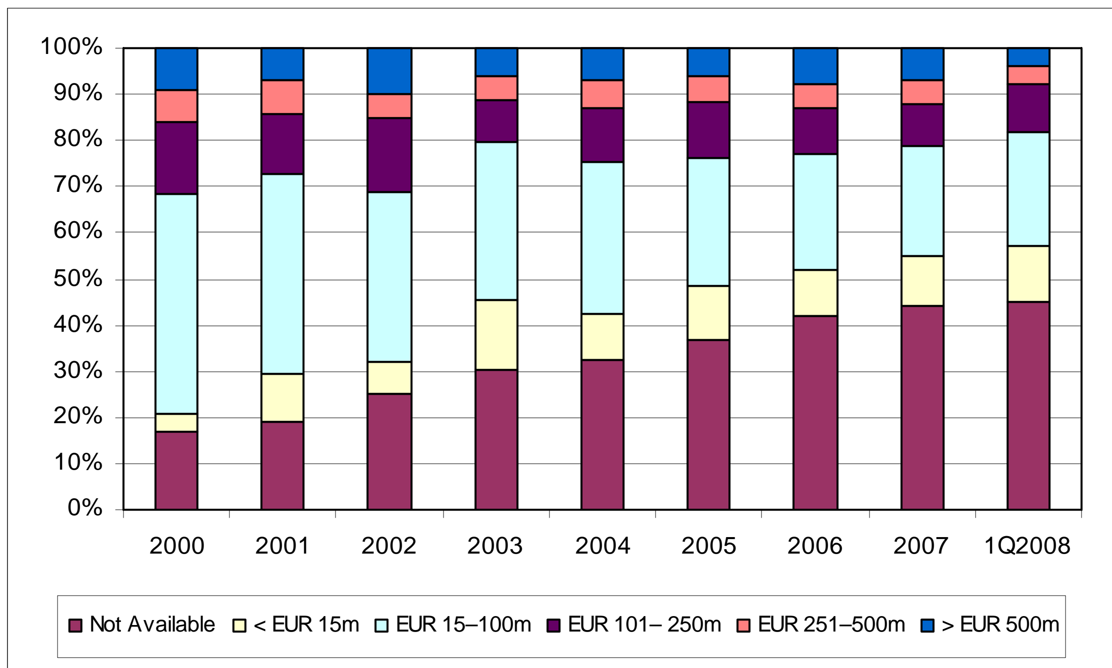
How is the crisis going to influence the *value of the deals*? Not only that the debt is becoming more expensive, but the banks are also tightening the *leverage levels*. Before the liquidity crisis, average senior leverage reached 4.9x EBITDA in mid-July, and the total leverage reached 6.1x EBITDA; in December, the senior debt dropped to 4.6x and the total remained on 6.1x. It is not as significant fall as we would probably expect but it is given by the fact that the banks were still fighting over the few deals that were actually being realized on the market. However, a further fall is to expect. Investors will be able to borrow less money to carry out the transactions so naturally the value of investments should drop in the future.

So far, no significant difference between 2006 and 2007 has been noticed regarding deals between EUR 15m and EUR 100m, and EUR 101m and EUR 250m, the two most favorite bands. However, the *mega deals* have been affected. The share of deals over EUR 500m on all transactions had decreased from 8% in 2006 to 7% in 2007

to 4% in the first quarter of 2008. The greatest deal of 2007, the acquisition of Alliance Boots, a pharmacy-led wealth and beauty group by AB Acquisitions, a company controlled by a PE firm Kohlberg Kravis Roberts (KKR) and by Stefano Pessina, was carried out before the liquidity crisis – in April, and reached EUR 17.19bn, down EUR 5.31bn compared to the 2006's greatest deal. Seven out of ten greatest deals of 2007 were realized in the first half of 2007. The center of the activity is to move back to the mid-cap market and it will certainly take long before the debt market will be able to finance the mega or jumbo[37] deals again.

A change has occurred concerning the *structure of the debt*. While second lien debt has been expanding at the expense of the mezzanine debt since 2003, it became practically dead since the liquidity crisis and we can see the comeback of the mezzanine loans as it was already discussed.

Graph 6.3: Distribution of Private Equity Transaction Volumes in Europe 2000–2008



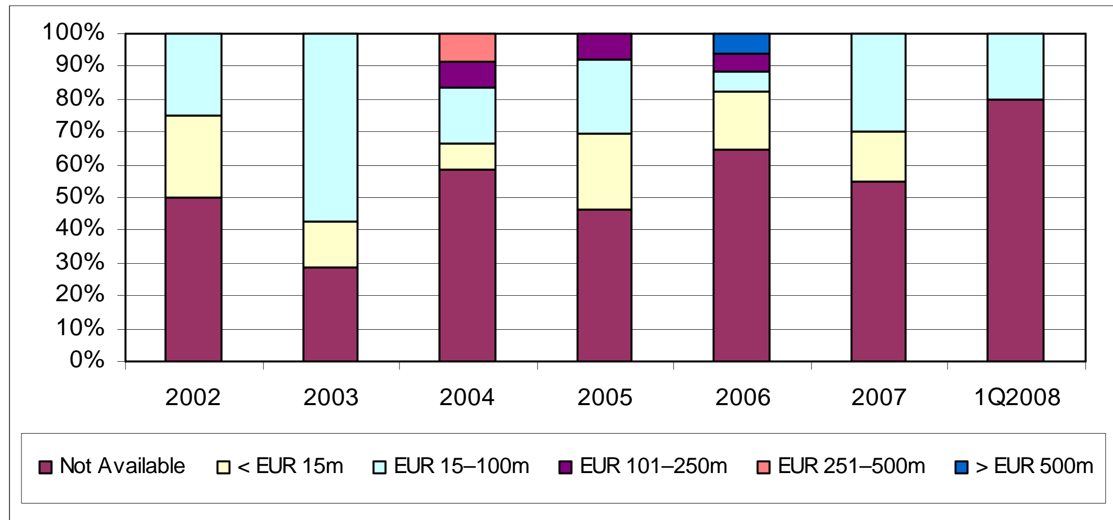
Source: Mergermarket, own calculations

In the Czech Republic, the *distribution of volume of investments* has been quite variable over the past six years. It was not so much caused by the changing preferences of investors, but given the small number of investments, rather by the particular investment opportunities that arised every year. The most common value of investment, however, remains below 100m on the long-term basis. The only deal exceeding

[37] Mega deals are deals with volume of over EUR 500m, while jumbo deals' volume surpasses EUR 1bn.

EUR 500m so far was the acquisition of České Radiokomunikace in 2006. The expected decrease of mega deals is therefore not going to have any major influence on investment activity in the Czech Republic. Unfortunately, the share of undisclosed deals remains quite high, averaging 57% between 2002 and 2007, which complicates the trend-seeking process.

Graph 6.4: Distribution of Private Equity Transaction Volumes in the Czech Republic 2002–2008



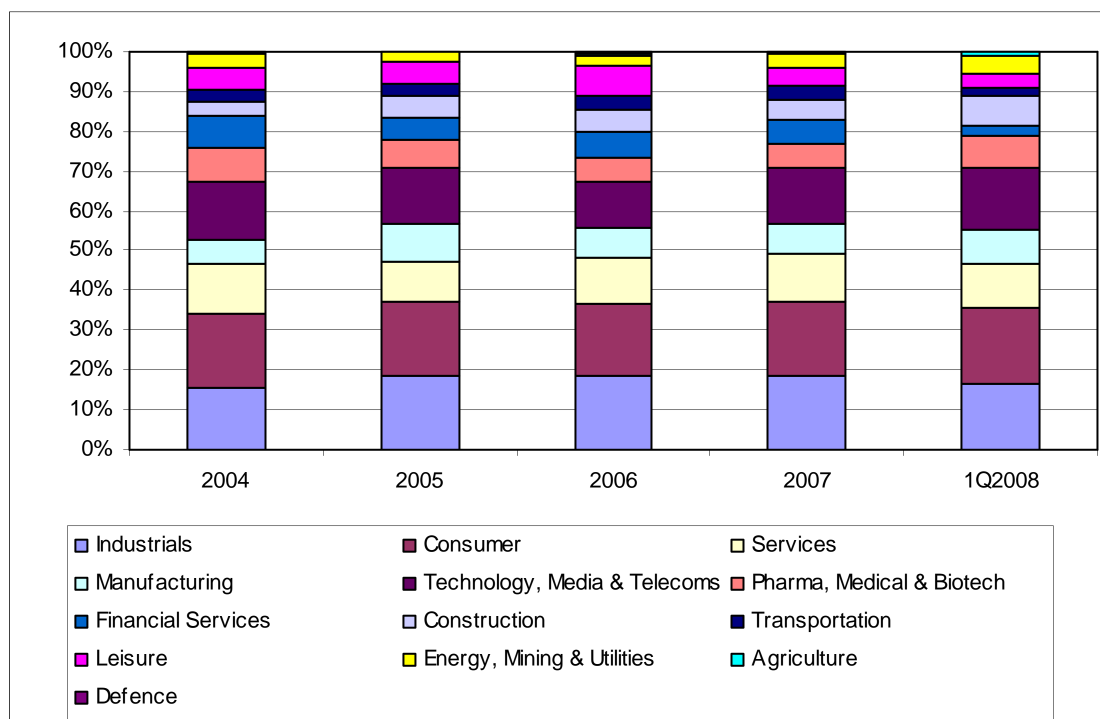
Source: Mergermarket, own calculations

Concerning the *leverage levels* and volume, certain tightening can be also observed in form of recommendations given to the Czech banks by their foreign owners, even though we cannot talk about a credit crunch, which did not hit the Czech Republic. While in mid-2007, the debt levels reached to around 4.5x EBITDA for the senior debt and 6.0x for the total debt, the figure now dropped to about 4x EBITDA for the senior debt. Concerning the debt structure, no dramatic changes has occurred as in case of Europe because second lien loan was not very much expanded in the Czech Republic; there has been less than five such loans extended so far. No more expansion of second lien is expected now.

As a consequence of the European credit crunch, *the preference of industries* of private equity investors has changed. They became more involved in the more stable industries so far preferred rather by strategic investors: energy sector, medical & pharmaceuticals, construction and infrastructure. However, the greatest share of investments still went to industrials, consumer and technology, media & telecoms. Such a change has not occurred in the Czech Republic, where the

energy and medical & pharmaceutical sector has already been quite favorite with investors especially within the buy & build strategies.

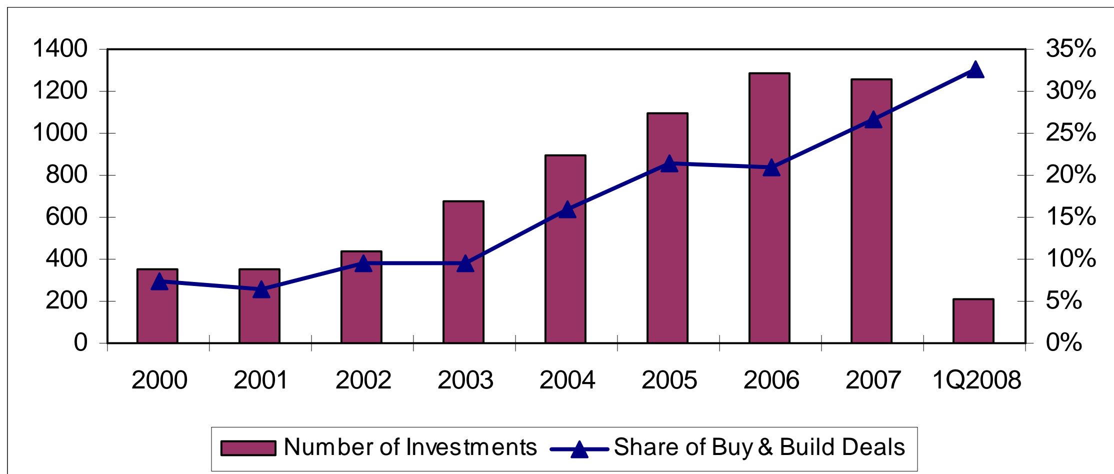
Graph 6.5: Distribution of European Investments 2004–2008 by Sector



Source: Mergermarket, own calculations

Concerning the *buy & build strategy*, it has become a very popular strategy in the past few years. If we take the set of the buy & build deals since 2000, we see that the share on all PE deals has been gradually increasing from 7% in 2000 to 27% in 2007 in Europe. The number of buy & build deals in the first quarter of 2008 represents only 20% of number of the investments in 2007; however, it made 33% out of all PE transactions so the liquidity crisis has relatively strengthened the position of buy & build based deals. This assumption is confirmed by the Mergermarket study (2008, p. 10): *"Alongside an increased focus on long term reliable sectors like infrastructure, and mid market deals where debt financing is less crucial, it can be expected that many private equity funds will pursue buy & build based deals as a way to make money post credit-crunch. The main rational is that buy & build deals allow private equity buyers to tap into merger synergies usually reserved for trade buyers."* The investors can be also expected to focus on longer-term projects, which again corresponds to the buy &build strategy.

Graph 6.6: Number of Buy & Build Deals on All Transactions in Europe 2000–2008

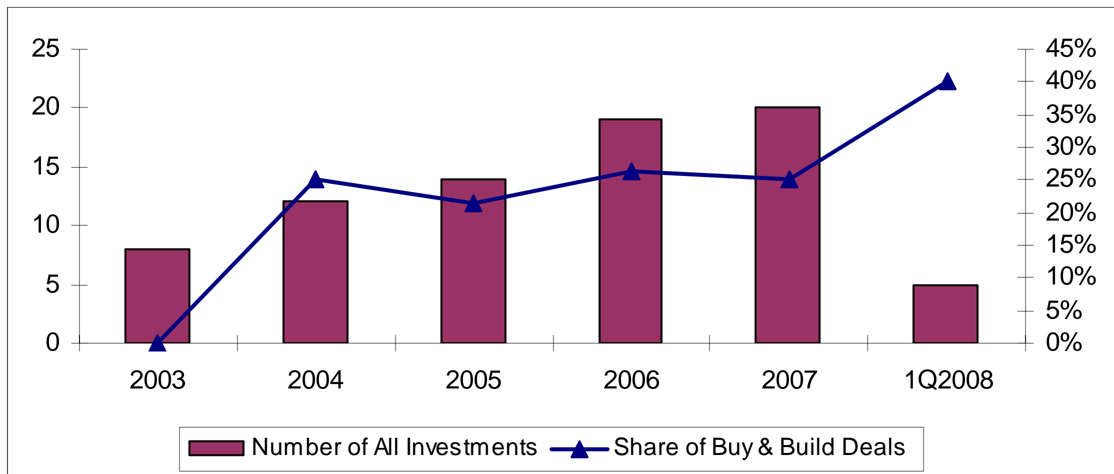


Source: Mergermarket, own calculations

In the Czech Republic, the *buy & build strategy* has been a new concept; however, it is becoming more and more popular. Nowadays, major financial groups that pursue this strategy are J&T Financial Group in the energy and industrials sector and Penta Investment in the pharmaceutical sector. The share of buy & build deals on all PE transactions has been growing since its appearance in 2004 and has reached the same average as on the European markets.

Given the fact that in the first quarter of 2008, the number of buy & build based deals reached almost half of the investments in 2007, it is very likely that the total in 2008 will surpass the number in 2007. As in case of Europe, the number of buy & build deals in the first quarter of 2008, made up a larger share on all PE transactions; it reached 40%. But due to low number of transactions, this new reinforcement of the trend is not as evincible as in case of Europe. Nevertheless, we do expect the share of buy & build deals on all PE deals to increase thanks to the potential synergies that some of the Czech private equity groups have already discovered some time ago. The reinforcement of the trend may therefore not be so tightly connected to the liquidity crisis as in rest of the Europe.

Graph 6.7: Number of Buy & Build Deals on All Transactions in the Czech Republic 2003–2008

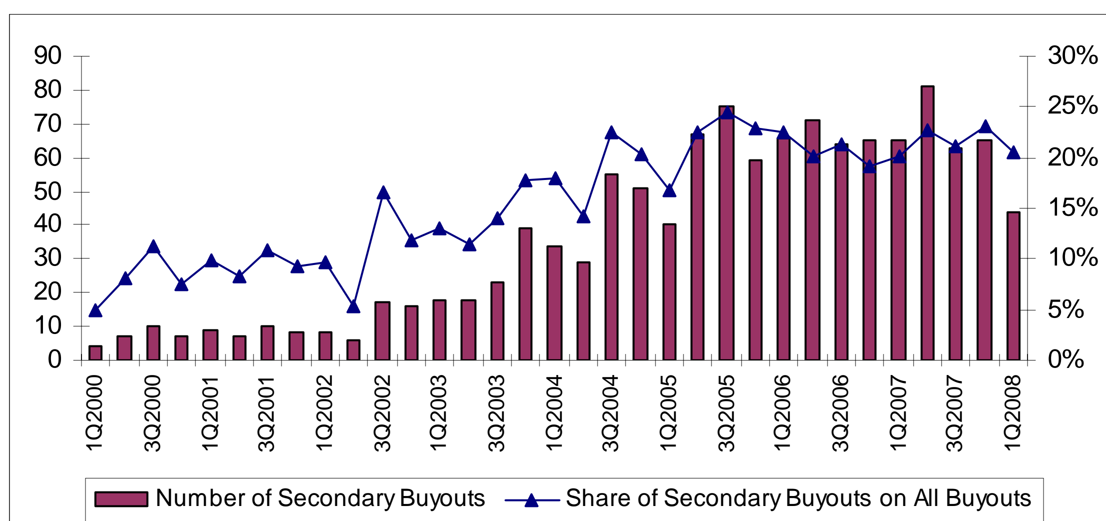


Source: Mergermarket, own calculations

The changes on the debt market are likely to further support another trend of the past few years – *secondary buyouts*. Secondary buyouts became a widespread investment and exit strategy as the investors were not always able to e.g. find an appropriate strategic investor or to launch an IPO, when the best time for exit from a company came. Therefore they started to search buyers among other PE investors. The supply met the demand thanks to the fact that the investors, having raised the funds, were searching for projects to quickly invest in, in order to be able to reach high IRR. However, as there are not always plenty of investment opportunities given the investors' requirements concerning the industry, strategy or price, they started to look at companies already being managed by PE investors.

A significant increase in number of secondary buyouts and their share on all investments can be observed in 2003, which can be connected to the reviving economy after the 2001 fall. The overall economy has suffered for two years so when the investors wanted to exit their projects, they did not find sufficient number of strategic investors that could afford to buy the companies. At the same time, other investors still possessed funds that they needed to invest; it was a mutually advantageous business. Since 2004, the average portion of secondary buyouts on all buyouts made around 21% and 42% on all exits.

Graph 6.8: Number of Secondary Buyouts in Europe 2000–2008



Source: Mergermarket, own calculations

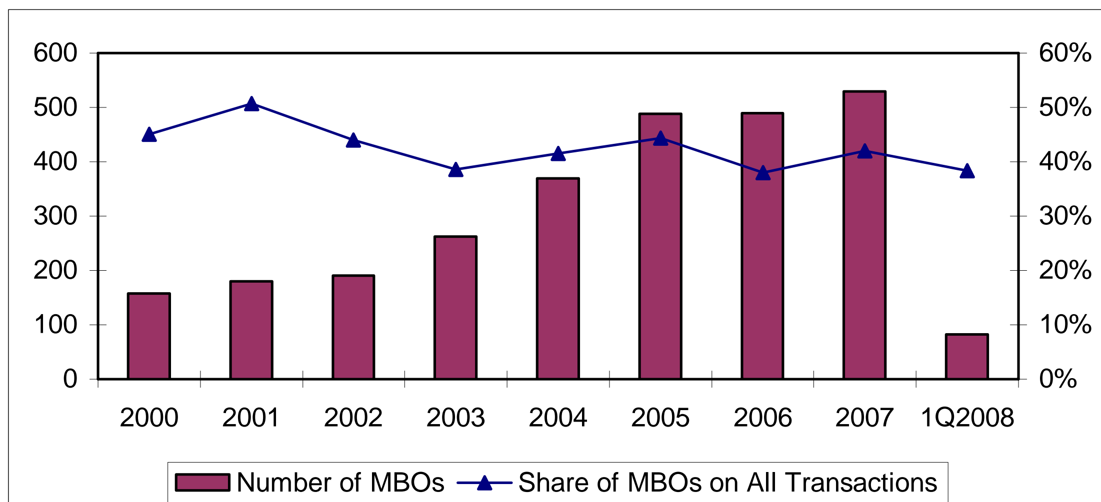
The last two quarters of 2007 and the first quarter of 2008 have recorded a decreasing number of secondary buyouts, the first quarter of 2008 even dropped to the level of 2005; however, the share of secondary buyouts on all deals remained on average unchanged. This fact together with the experience from 2003 encourage us to say that the number of secondary buyouts should actually start to increase in a little while even though it will take several months or years before they reach the mid-2007 level again.

According the Mergermarket database, there has been on average three *secondary buyouts* per year in the Czech Republic since 2004. They were approximately half-and-half carried out by Czech and by foreign investors, even though the Czech-made deals were slightly prevailing. Their share on all investments averaged 18% in the past four years, while their average share on exits amounted to 50% for the same period. The most favorite industries for secondary buyouts were industrials and chemicals, internet and services. In the first quarter of 2008, there has not been any secondary buyout; however, due to their low absolute number in the Czech Republic, this should probably not be connected to the liquidity crisis but rather to the fact that no such opportunity arised. On the contrary, we expect the number of secondary buyouts to increase in the 2008.

Now we will focus on *MBOs*. The number of MBOs has been rising more than the number of secondary buyouts and buy & build deals in Europe. In 2005, there was a record number of 529 MBOs in Europe; however, the last two quarters of 2007 recorded a fall, which continued in the first quarter of 2008, when the number of

investments dropped from 126 to 82. In addition, its share on all investments decreased by 3% below the 3-year average.

Graph 6.9: Number of MBOs in Europe 2000–2008



Source: Mergermarket, own calculations

As the volume and number of loans extended has decreased, it will be very important for funds to find a target with a good growth potential to be able to meet the debt obligations. MBOs represent and advantage for the PE investor, as the internal management knows the background of the company and its functioning better than a external acquirer; the management can be aware of a comparative advantage of the company, which may not be visible to external market players; which all can contribute to better profitability of the company. We would expect the number of MBOs to increase after the liquidity crisis but the current numbers do not allow us to be as optimistic as in case of the buy & build strategy or secondary buyouts. So their future development is hard to predict.

In the Czech Republic the number of publicly disclosed *MBOs* has averaged 1 in the past six years. The MBO trend has not been as strong as the buy & build or secondary buyout trend. While the buy & build strategy is favored by domestic financial groups operating on the private equity market, the MBOs remains the domain of private equity funds. MBOs have been carried out with the help of Genesis Capital, Riverside, Pamplona Capital Management or Arx Equity (formerly DBG Eastern Europe). We do not expect any dramatic change but the number of MBOs should be gradually increasing.

The last trend we consider to be important is delisting of the companies from the public stock exchanges, so called *public to private* transactions. These have lately become quite popular, especially in the USA and Western Europe. *"In 2006, more companies were delisted from the New York Stock Exchange and taken private than had IPOs, due in large part to private equity. In London, the same is true for domestic British companies."* (McKinsey & Company, 2007, p. 147). As a consequence of the financial crisis, the number of IPOs decreased as the stock exchanges fell, therefore the trend of increasing number of take private deals compared to IPOs should continue. This trend should be also more expanding in the CEE countries, where first transactions have been carried out only in the past two years.

So far we have talked about investments, but are there at the moment and are there going to be any funds to be invested? How does the situation look like concerning the *fundraising activity* of private equity funds? Concerning the small funds, they will find it difficult to raise new financing now. On the other hand, some extraordinary funds have been raised in 2007: AIG Capital Partners closed a New Europe Fund III with EUR 522.5m, above the initial capitalization. Pamplona raised a new fund Pamplona Capital Partners II of EUR 1.3bn in September 2007, which will focus on LBO opportunities throughout Europe. In October, Mid Europa Partners announced a closing of Mid Europa Fund III, the largest private equity fund focused on buyouts with capital commitments of EUR 1.5bn.

According to the EVCA statistics for fundraising, it fell from EUR 112.3bn in 2006 to EUR 74.3bn in 2007 in Europe, a little above the 2005-level. However, in the long-term the fundraising should keep on growing. The reason is that pension funds and other institutional investors – the major investors in Europe, are still placing their assets to private equity, which will further fuel the activity. However, the large funds should be moving more eastwards towards great investment opportunities, and the Czech Republic should be targeted rather by the mid-cap funds.

As the private equity firms are searching for more stable source of capital, which is up to date especially now within the liquidity crisis, more PE groups shall be listed on public stock markets. The first private equity group to have launched an IPO was the Blackstone Group in July 2007. Since then number of private equity groups have been listed worldwide. The greater stability of sources is offset by the limit on the companies; being publicly listed brings about the requirement of greater transparency and disclosure, which may prevent private equity investors to undertake more risky

operations, which, however, generate greater returns, which are required by the investors.

As we could have seen, there has been no significant influence of the liquidity crisis on the Czech private equity market. It is given by two facts: firstly, the Czech private equity market lagged behind the European market concerning certain trends, e.g. growing share of mega deals, MBOs, and public to private share on all transactions, or composition of debt instruments used in leveraged buyouts. Therefore the liquidity crisis, which negatively influenced these major trends of the European private equity market, did not touch the Czech Republic profoundly. Secondly, the particular situation on the Czech banking market, which will be described later, played an important role, too.

The Czech Republic could on the contrary expect the private equity related activity to increase, as the private equity firms will be looking for *companies with good growth perspective*, which will be able to generate enough cash flow to repay the debt. The Czech Republic, having a GDP growth rate surpassing the EU average, will surely be one of the targets. The international PE investors will also look for countries, where the *density of competition is not so tough*, which could again lead them towards the CEE countries. Apart from possible expansion to *new geographies* and *more stable industries,* as already discussed above, European private equity firms may also start *taking minority blocks of shares in companies listed on public stock markets*. The PE firms will be able to improve performance of the company with a smaller possible risk, which will be, however, offset by smaller possible return.

6.4 Impact of the Liquidity Crisis on the Czech Republic

Unlike its Western counterparts, the young European economies including the Czech Republic do not seem to be heavily hit by the liquidity crisis as they are not directly connected to the international capital markets. The direct impact of the mortgage and later the liquidity crisis have not influence the Czech banks thanks to several factors: the banks did not invest into subprime mortgages; there is a different structure of the banking market, where banks usually hold all instruments until maturity; investment banks that are dependent on liquidity are not the market makers in the Czech Republic; and the existence of two European Directives concerning the Basel II accord, which have been incorporated into the Czech legislation

in May 2007 and brought uncertainty about computation of capital requirements. However, the Czech Republic has experienced certain tightening of rules for loan applicants and if the liquidity crisis turns into the economic crisis in the USA, it will influence Europe and the Czech Republic through the exchange rates and export, which could slow down the activity on the PE market.

6.4.1 Direct Impact of the Crisis

The Czech *banks did not invest into American subprime mortgages*. Majority of Czech banks has a foreign owner, which in some cases did invest into the mortgages (e.g. Société Générale, Citibank); however, the Czech banks were not forced to do so as they were supposed to focus entirely on the Czech market. The Czech Republic as well as other CEE countries, disposed of 1.1times higher client deposits than client loans by the end of 2006. Therefore compared to the EU 15, Czech banks were not forced to search sources on the interbank and the international capital markets.

At the same time, thanks to low interest rates set by the Czech National Bank, *majority of Czechs extended loans in Czech crown*, while clients in Poland, Hungary or Romania, demanded loans in euros or dollars because of the more advantageous interest rates. Now, as a result of the liquidity crisis, banks of these countries have hard times to obtain these currencies on the world markets.

The Czech banking market differs from its Western counterparts. Not only that the greatest Czech banks did not invest into the subprime mortgages, but they are also used to *hold securities such as bonds mostly until maturity*, therefore the secondary market is not developed. On the Western markets, banks are lively trading with all kinds of instruments, which interconnects the markets and contributed to the transmission of the crisis worldwide.

The new *accord on capital adequacy* known as *Basel II*, has been integrated in the European Communities Law via two directives: Directive 2006/48/EC and Directive 2006/49/EC, revisions of two directives from 2000 and 1993 respectively. These two directives were incorporated in the Czech legislation as a Decree no. 123/2007 on Prudential rules of banks, credit unions and investment firms in May 2007. Basel II differs from Basel I in involvement of the operational risk (in addition to the credit risk and market risk) and in greater flexibility that was given to the banks to determine capital requirements. Within Basel II, banks are allowed with consent of the regulator to choose a method corresponding the best to their risk profile and capabilities

(Mejstřík, 2007). By this accord, the banks were given freedom to deliberately choose a method to compute the capital requirements, which was a hard task for them due to their weak experience. Therefore the banks were generally not willing to undertake risky projects, whose risk weights and other components of the computation they were unsure of.

6.4.2 Indirect Impact of the Crisis

Naturally, the Czech Republic was not totally saved from the shock as it was hit by the wave of stock exchange prices decrease as many investors were getting rid off their shares, temporary lower liquidity on the Czech interbank market, tightening of the underwriting procedures in banks and the possible impact on export. Czech banks were facing lower liquidity at the end of 2007 together with other European and American banks; however, thanks to the financial injections of FED, the Bank of England and the European Central Bank, the panic was suppressed, and the liquidity problem reduced. The increasing prices of loans on the Czech market are nowadays given by the restrictive monetary policy of the Czech National Bank and banks' efforts to increase returns after the Basel II adoption.

The Prague *stock exchange* (PSE) has been heavily hit by the *turbulences* on the international market, which caused that the prices of shares dropped by about 20% since last year and the volume of trading has considerably lowered. Even thought PSE is influenced by the development on the major stock exchanges in Europe and in the USA, it is expected that it may grow faster than its Western counterparts, thanks to the fact that the financial system remained healthy in the Czech Republic. Between March 31 and May 15, 2008, PX has grown by 8.8% while the NYSE Composite only by 8.6%.

The Czech banks may, however, face *stricter rules for loan applicants* as recommended by the foreign bank owners as a sign of their uncertainty. These measures have already been taken by e.g. Česká spořitelna, who has also limited the number of mortgage loans extended through partners such as real estate agents or other banks, so called *multibrand*. The second bank that has admitted the impact of the mortgage crisis was the UniCredit Bank that did not launched the mortgage loan with no evidence of income, which it had been readying. The corporate loan's applicants are subject to more detailed analysis as well. However, a real credit crunch has not occured in the Czech Republic and is not expected to come.

Even thought the credit crunch did not directly hit the Czech Republic, it is expected to have an *indirect impact on the overall economy*. The Czech Republic is a small open economy, which has generated around 55% of its GDP by export between 1999 and 2005. A slowdown in Western Europe, especially in Germany, to which the export between March 2007 and February 2008 represented 31% of total export, will reduce the growth of economy in the Czech Republic as well. So due to the slow down of Western Europe, which will lower the exports, strengthening Czech crown, and the impact of the Czech governmental reform the GDP growth rate is anticipated to decrease to 4.5% in 2008.

7 Conclusion

The private equity market went through tremendous development in the Czech Republic since its appearance in the 1990's. The increase of private equity activity, which followed especially after 2003, can be accounted to the overall good macroeconomic conditions, existence of perspective target companies, generation problem, consolidation of sectors, oversupply of liquidity on the world markets, EU accession, attractiveness of the CEE countries for their possible higher returns and risks comparable to Western Europe, low capital market activity and the banking environment.

The analysis of the Czech private equity market, which was, however, limited due to low disclosure rate of deals, proved that it had mirrored the development of the Western Europe not only concerning the slowdown of activity in 2001 but also in its revival after 2003 and the investment trends. The Czech Republic's popularity as a target has grown up but due to persisting non-optimal legal and tax regulation, it is not a country, where PE funds would be established in large numbers. And there are no signs that the situation should change soon. Despite the fact, the overall legal framework has improved and as well as the perception of entrepreneurs of the private equity financing. The Czech Republic has also recently seen an increasing activity performed by the local financial groups, who are also operating on the private equity market and represent a tough competition for the PE funds.

In the summer 2007, the global private equity markets found themselves at a turning point. The subprime mortgage crisis and the following credit crunch have negatively influenced the American and European financial markets, which was projected into the private equity market activity decrease in the three consecutive quarters. The growing power of PE investors, which was strengthened by easy access to debt financing thanks to low interest rates and strong bargaining position, good performance of the target companies and the overall favorable environment, has suffered.

The development of the market has changed its direction, and some of the latest trends have weakened and the others, bringing certain value added for the investors, should be more on the increase now. Some PE investors will now see lower returns on their investments and the small PE investors may have difficulties to raise new financing. At the same time, strong PE investors are experiencing unique investment

opportunities as the “losers” are selling their best assets at a discount, and the value of all private and public companies has also decreased.

The private equity investors will now have to focus on mid-market deals as the banks have tightened the conditions for loan applicants, lowered the debt multiples and changed the structure of debt financing, which will no longer be so easily accessible as before. This may be perceived rather positively as the balance between lenders and borrowers will be restored again, and the borrowers will no longer have such unduly strong bargaining power. At the same time, the fundraising for the CEE region remains high with the largest funds moving eastwards.

The Czech Republic stood apart from these great changes due to the fact that it had been still behind Europe in trends such as increasing share of mega deals and MBOs on all transactions, preference of second lien loan in the debt structure in LBOs, different banking system and relaxing of bank documentation, which helped it to survive the year 2007 without a major breakaway from its expected development. The Czech Republic may even expect the private equity related activity to go on increasing in the near future.

The European private equity market has slowed down since the summer 2007; however, more than a dramatic fall in number of deals, we should witness a change in preferences and focus of the private equity investors. They will be now looking for companies with a good growth prospective, which will be able to generate enough cash flow to repay the debt. Countries from the CEE region are certainly promising candidates. The international private equity investors will also look for countries, where the density of competition is not so tough, which could again lead them towards the CEE countries. Apart from possible expansion to new geographies and more stable industries, focus on buy & build based deals and secondary buyouts, European private equity firms will also focus on mid-market buyouts, which will be more feasible given the persisting liquidity constraints.

It is still short after the liquidity crisis; therefore our conclusion, which is based on a limited amount of information, may turn out not to be corresponding to the real future development. It will undoubtedly be interesting to observe the private equity markets in the coming months to see.

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Used Abbreviations

CAPEX	Capital Expenditures
CDO	Collateralized Debt Obligation
CEE	Central and Eastern European
CVCA	Czech Private Equity and Venture Capital Association
EBITDA	Earnings before Tax Depreciation and Amortization
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EVCA	European Private Equity and Venture Capital Association
FDI	Foreign Direct Investment
FQI	Fund of Qualified Investors
GP	General Partner
HVCA	Hungarian Venture Capital Association
IPO	Initial Public Offering
IRR	Internal Rate of Return
JEREMIE	Joint European Resources for Micro to Medium Enterprises
KKR	Kohlberg Kravis Roberts
LBO	Leverage Buyout
M&A	Mergers and Acquisitions
MBI	Management Buy-in
MBO	Management Buyout
OECD	Organization for Economic Co-operation and Development
PE	Private Equity
PIK	Payment–in–kind
PSE	Prague Stock Exchange
PwC	PricewaterhouseCoopers
R&D	Research and Development
SIV	Structured Investment Vehicles
SME	Small and Medium Enterprises
SWF	Sovereign Wealth Fund
TEA	Total Entrepreneurship Activity
TIW	Telesystem International Wireless
WC	Working Capital