Private Equity in The Balkans and SEE: Green Shoots are Visible

By Hugh Larratt-Smith, MBA

In the 1870’s when the British Empire was the epicenter of the financial universe, the Editor of *The Economist*, Walter Bagehot observed “In England, after a great [credit] calamity, everyone is suspicious of everybody. As soon as that calamity is forgotten, everybody again confides in everybody”

Leading up to 2008, indeed the lending marketplace was a place where “everybody confides in everybody”. The liquidity in the corporate and SME loan markets was jaw-dropping. Fast forward to 2014 in South Eastern Europe: ‘everyone is suspicious of everybody’.

Trust – or rather the lack of it, as Mr. Bagehot observed, is the problem. (The word “credit” comes from the Latin for “I believe”).

Like a bicycle going full-speed, things were very smooth when the economy was expanding at a rapid clip. The deleveraging by banks and the large amount of non-performing loans in South Eastern Europe has made the bicycle’s trajectory very wobbly.

**You bring them a chest of gold and they tell you it’s too heavy**

Banks are struggling to navigate the various cross-currents between the European bond markets and Brussels politics. Many cross-border banks voted with their feet – exiting from countries in SEE when they realized that the prognosis for predictable recovery was challenging. The withdrawal of these banks, coupled with high levels of non-performing loans at the local banks and excessive leverage levels in many companies, has choked off loan growth in most of the Balkan countries.

Some long-standing relationship borrowers are getting shown the exit doors through no fault of their own. In many cases, the lender’s capital tightness prevents it from funding the loan. Even some strong borrowers are saying that when they ask for new credit from some lenders, they feel like “you bring them a chest of gold and they tell you it’s too heavy”.

Private equity groups and IFIs like the EBRD and The International Finance Corporation are stepping into the financing gap left by banks in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Kosovo, Montenegro, Romania, Slovenia and Serbia.
Private Equity’s Role in the Balkan’s Financing Gap

Some industry experts estimate that up to 80% of global private equity capital needs to find a home. Capital from pension plans ranging from the State of Texas to the Austria Development Bank has poured into the private equity sector at an unprecedented rate, searching for yield. In many private equity asset classes, the deal flow has been insufficient to begin to absorb the capital.

This has led to a compression in IRRs for many PE funds. The recent monetary stimulus steps in Europe may exacerbate this problem.

On many PE buyout transactions in London and Continental Europe, PE groups feel like they are hearing a “hog call on a farm in Kansas”. Investment banks and Financial Advisors send out deal books to armies of PE groups, then sit back and watch as the PE groups battle each other. In some cases, the transactions are priced on pro-form EBITDA that will be challenging to achieve. The pricing on many buyouts is now unsupportable solely with organic growth.

With this large surplus of un-deployed capital, many private equity groups are finding that Continental Europe and the UK are the proverbial hole in the doughnut. As private equity groups and their Limited Partners search for yield, Spain, Italy and Greece have appeared on the radar screen of some of the larger PE groups. Pariahs in the credit markets a scant twelve months ago, the shares and credit instruments of many banks in these countries have taken off like rocketships to the moon.

For example, to many peoples’ astonishment, the shares of some Italian banks have soared in the past six months. The recently announced KKR-Alvarez & Marsal investment in Italian pool of non-performing loans is a harbinger of market sentiment. KKR opened an office in Spain in the past six months to get in on the ground floor of Spain’s recovery. The data rooms at Ireland’s bad bank, NAMA have witnessed a stampede of buyers for non-performing loan portfolios in the past twelve months.

Another symptom of the surplus capital with many PE funds is that their minimum investment size has dropped. Two years ago, you always heard that the minimum investment size was €10 million – now, many funds admit they will start at €2.5 million, if the target company promises rapid growth.

Consequently, some PE groups are starting to look at the periphery of the EU. And companies in South Eastern Europe are starting to attract attention.
The historic paucity of deal flow is one reason why many PE funds are unfamiliar with The Balkans – some Mayfair and New York PE investors have never laid eyes on a deal from The Balkans. Additionally, the majority of companies in The Balkans are mid-cap companies ranging in size from €20 million to €100 million in annual sales, which is below the “snack bracket” of the major PE players such as KKR. In the rescue capital asset class, laws which have historically favored incumbent owners versus creditors have hindered the efficient sale of distressed but viable going concerns.

Additionally, deal flow has been restrained because of opaque corporate laws in many countries. Recent reforms in some SEE countries have given investors a growing degree of trust and comfort. Insolvency procedures have been significantly improved in some countries in the region, but continue to take time and can be prone to unpredictable outcomes.

In the past five years, enormous attention has been placed on the adoption of new less formal, consensual resolution procedures and the use of prepackaged plan to help accelerate restructurings, while placing much of the control back into the hands of the true stakeholders. In particular, Serbia’s adoption of U.S. style Chapter 11 cram-down procedures has paved the way for quicker restructurings. These new processes work better than the old, and complement turnaround strategies. However, in many other jurisdictions, hold-out banks continue to impede restructuring.

An important development for the region is the growing presence of the Turnaround Management Association. Three chapters of The Turnaround Management Association are in the early stages of formation. Chapter formation efforts in Serbia and Slovenia are well underway, with a chapter formation in Croatia commencing in June 2014. TMA has been a catalyst for distressed PE and alternative lenders in many countries, and these three new chapters will undoubtedly increase investor awareness of opportunities in The Balkans. TMA Europe’s Annual Conference in Munich on June 12-14, 2014 will focus on alternative financing, which will be vital for the rebound of the region.

All of these developments are encouraging signs for the PE sector in SEE.

**Who are The Players?**

Headline PE transactions such as KKR’s purchase of Serbian telecom operator SBB Telemach, and GSO Capital/Blackstone financing of Slovenian chemical company Helios are the bow of the icebreaker. PE groups which are focused on smaller transactions in the range of €2 million to €20 million will follow in the jetstream of the larger funds.
The jet fuel for many mid-cap South Eastern European PE funds has been provided by IFC and The European Bank for Reconstruction and Development. In particular, EBRD has primed the pump for EMSA and Bancroft Capital in Vienna, Bulgaria Mezzanine Capital, ADM CEEDAT in Istanbul, Darby Private Equity, Romania Foundations Fund, Advent, and Emerging Europe Convergence. EMSA is the closest to the “U.S. style” turnaround investment fund, seeking control positions in “broken wing” middle market companies (EMSA has its roots in Boston-based The Recovery Group, one of the founding supporters of TMA and a pioneer in turnaround consulting).

Croatia has robust middle market private equity sector, led by the Croatia Private Equity Association in Zagreb. Players include ZB Invest, Prosperus Invest, Honestas Private Equity Partners, Ascendant Capital Partners, Quaestus Private Equity Partners and Nexus Capital.

Croatia’s accession into the EU in 2013 has attracted the interest of many PE groups. While NPLs are relatively high at an estimated 15% of bank assets, Croatia’s banking system is well capitalized, and the cross-border banks are open for business. Spurred by Croatia’s EU membership, infrastructure building alone will top €1 billion, representing significant opportunity for PE funds. Distressed real estate PE funds are focused on Croatia’s Dalmatia region, known for its spectacular scenery and historic cities such as Dubrovnik and Split.

Smaller private equity funds in the region include MPE Equity Management based in Bled, Slovenia. This fund has invested in SMEs since 1996, and has achieved an enviable IRR exceeding 30%.

**Putting Make-up on a Corpse?**

Turnaround PE investors avoid companies with significant operating losses that are “dying from 1,000 cuts”. When sizing up a turnaround, rescue capital investors determine if the projected cash flows are realistic and achievable. They zero-in on whether the company has a broken wing, and if it can heal over time. They won’t invest in a turnaround where the capital structure gets re-jigged, but the operating metrics of the company are unchanged. They call that **“putting makeup on a corpse.”**

A key criteria for turnaround PE investors is that all unprofitable activity can be eliminated from the company over some reasonable period of time. In many turnaround situations, the owner is wedded to unprofitable products, lines of business, customers, suppliers, factories and business processes – ”sacred cows” that can’t be touched. Quite often, a quick turnaround can be achieved by getting rid of the losers. Most
turnaround investors think a company has turned the corner when there’s six to nine month stability in monthly EBITDA. To get rescue capital from a PE fund, a turnaround needs a path to profitability that’s understandable, such as eliminating unprofitable lines of business, facilities, customers or products. In the words of one veteran turnaround investor “I need to understand the story in three sentences”.

New York based NCH Capital, with regional offices in Romania, Albania and Bulgaria has been an active player for years in Eastern Europe with €3 billion under management. NCH has an appetite with deals that have hair on them as long as the deal is asset-rich. They like agribusiness and real estate in the region.

Another New York player, Siguler Guff has always shown an interest in The Balkans and the larger SEE region. Siguler Guff Capital Partners has a unique program in which Siguler Guff will co-invest with its individual investors in top quality, best of breed private equity funds - both domestically and internationally – across the range of private equity opportunities, including special situation/turnarounds and buyouts.

On large cap transactions, MidEuropa has been the dominant fixture on the scene for many years. Their recent sale of SBB Telemach to KKR is an important “green shoot” in the marketplace.

Middle Eastern PE investors are starting to invest in mid-cap companies. In Slovenia, EMKAAN Investments from Dubai recently invested €5.5 million to restart a shuttered paper mill. This producer of specialty paper for bank notes and passports, Radece and Muflon Paper, had been mothballed for six months when EMKAAN bought the assets on a distressed basis in late 2013. The operation has been restarted with 90 new employees.

Mezzanine Management in Vienna has played the long game in SEE. Focusing on lower middle market companies, this debt fund is interested in financial restructurings, but has limited appetite for operational restructurings unless the problem can be ring-fenced quickly and cost-effectively. Mezzanine capital is an effective growth capital solution to the perennial problems of owners’ concerns over ownership dilution.

Another encouraging development is the recent announcement that APS Holding, headquartered in the Czech Republic, will buy up NPLs in Bulgaria, Montenegro, Romania, Serbia, and potentially other countries in Eastern and Southern Europe. IFC signed agreements with APS Holding, a distressed asset investment management and servicing company, to acquire NPL portfolios and restore access to finance for businesses and consumers.

IFC will provide up to €20 million to co-purchase distressed asset portfolios, including
loans to small and larger companies. In Romania alone, the partnership could resolve up to 30,000 problem loans, remove these assets from banks' balance sheets, and free up capital for new lending. The initiative is part of IFC’s Debt and Asset Recovery Program (DARP), which focuses on the acquisition and resolution of non-performing assets, refinancing of viable entities, and restructuring of SMEs. To date, IFC has committed in excess of $1 billion for its own account and mobilized $2.7 billion. Through DARP, IFC has allowed banks to off-load up to $25 billion in NPLs.

EBRD has recently established The Local Enterprise Facility, which is a €405 million proprietary vehicle for investments in small and medium-sized enterprises in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Kosovo, Montenegro, Romania and Serbia; Turkey and the SEMED region (Egypt, Jordan, Morocco and Tunisia). It provides a wide range of flexible financial Products, including equity, quasi-equity and debt financing to companies, whose needs are not sufficiently addressed by existing financing sources.

PE funds in formation, such as RougeFil in Ljubljana, are another green shoot in the PE marketplace.

On a final note, The European Investment Bank is rumored to be in the policy stage of a reputed €1-2 billion funding commitment for rescue capital PE funds targeted at The Balkans. The initial approach of EIB may be a €30 - €50 million investment in the summer of 2014 to seed one rescue capital fund. EIB will draw a line of demarcation Slovenia/Croatia and The Western Balkans in its investment strategy.

**Why Invest in The Balkans?**

The huge portfolios of non-performing loans in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Slovenia, FYR Macedonia, Kosovo, Montenegro, Romania and Serbia have created investment opportunities for PE funds. It will be a process of one-off, cherry-picking acquisitions. Large purchases of NPLs across the region have been impeded by the lack of homogeneity between countries – each country is intensely local in its laws, languages, cultures and business practices. Unlike the recent multi-billion NPL acquisitions in Ireland by Lonestar, Apollo and KKR which are largely governed by English law (and can be explained in three sentences), SEE NPLs are like a large tapestry – a multitude of individual knots and threadings.

The recent establishment of Slovenia’s ‘bad bank’ has ring-fenced an estimated €4 billion in bad loans, many of which could be the subject of distressed acquisition by PE
groups. The World Bank’s NPL mapping initiative is another harbinger for positive outcome in NPL resolution. Montenegro is taking important legislative steps to address its NPL problem with its recent international conference “Podgorica Approach Launch – Conditions For Success”.

Agribusiness is a sector which is high on the list of Middle East PE funds. The Balkans represents a geographically strategic source of food production for The Middle East. One investment thesis for Middle Eastern PE funds is that The Balkans could do more value-added food manufacturing (as opposed to the historical practice of exporting food that is largely unprocessed). PE funds are searching for investment candidates who can quickly transition to shelf-ready food brands.

Another investment thesis for many PE funds is that SEE is ripe for industry consolidation. Many industry sectors were fragmented after the breakup of Yugoslavia. There is significant potential for industry roll-ups in a wide range of industries from dairy to logistics; these opportunities have piqued the interest of a number of PE funds. Atlantic Gruppo based in Serbia, whose industry consolidation was financed by EBRD and others, is the poster child of the industry consolidation investment thesis.

PE funds are also interested in the investment thesis that EU - accession countries have comparative advantage in wages and local currencies which will entice many high labor cost companies in Italy to move their operations across the Adriatic.

For example Serbia’s currency, the dinar, has depreciated significantly over the past six months owing to concerns about high levels of non-performing loans. The good news is that Serbia’s comparative labor cost advantage over Italy has dramatically increased. Faced with high labor costs, inflexible labor laws and bureaucracy, many leading Italian companies are setting up operations in Romania, Bulgaria, Albania and Serbia. A recent study indicated that Romania’s labor costs (on a fully loaded basis) are 10% of Italy’s.

Some PE industry observers posit that Serbia holds significant promise for PE funds over the next decade. With its 2020 EU accession on the calendar, a majority-controlled parliament, reformed bankruptcy laws which expedite restructuring, comparative advantage in labor costs over Italy, Austria and Germany, and a close trading relationship with Russia, Serbia could surprise its skeptics.

While impossible to quantify, the huge diaspora of former Balkans and SEE represent a potential source of growth capital for the region in the coming years. Many of the
citizens of Serbia, Croatia, Slovenia, Romania, Bulgaria, Montenegro and Albania now live in Western countries such as the US, Canada and the UK. Some of this diaspora have the motivation, affluence and technical skills to invest in SME’s and mid-cap companies.

Foreign direct investment from individuals has transformed the former naval bases in Montenegro into luxury marinas, hotels and villas. The Canadian businessman and founder of Barrick Gold, Peter Munk, is the chief investor in the luxury yacht marina Adriatic Marinas/Porto Montenegro, a €165 million development. Other investors include The Rothchild family, Bernard Arnault, CEO of Louis Vuitton, Hungarian real estate developer Sandor Demjan and Oleg Derispaka, CEO of the Russian aluminum giant Rusai. In a nearby luxury development, Azmont Investment is investing €500 million in Porto Novi.

No one is expecting an immediate return to the era that echoes Walter Bagehot’s words in The Economist which were written one hundred and fifty years ago, but levels of trust and confidence are returning, driven by EBRD, EIB, The World Bank, the cross-border banks and the International Finance Corporation. As PE groups continue to search for yield and get more comfortable with the region, the current crisis of capital-starvation will fade into black.

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