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PRIVATE EQUITY MARKET IN CEE: CHALLENGES AND OPPORTUNITIES

The article discusses the current stage of private equity (PE) market development in the Central and Eastern Europe (CEE) region and potential opportunities of its growth, having regard to its specific features and characteristics. The positive impact of PE investment flows on the recipient economies is confirmed by several authors in their studies and is evidenced through high levels of patent filings, creation of new businesses and diffusion of innovations. Determinants, challenges and major obstacles associated with investment activities are further investigated in this paper. The study concludes that high corruption levels, underdeveloped financial markets, political and epidemiological instability in the CEE region result in significantly higher investor expectations in terms of returns on investment and limit the supply of the funds on the markets. Possible solutions may include pension reforms, prioritization of high-yield projects, governmental support of SME, etc.

Keywords: private equity, venture capital, Central and Eastern Europe (CEE)

1. Introduction

Private equity may be broadly defined as an investment of equity into private companies which are not quoted on a stock market (EVCA, 2007). An alternative approach endeavours to define private equity through other types of investment. For example, Sami (2002) suggests that private equity may be expressed as a part of foreign direct investment (FDI), namely the capital to the enterprises that are not quoted on a stock market. Venture capital (VC) is a form of private equity, specifically employed in the early stages of business development.

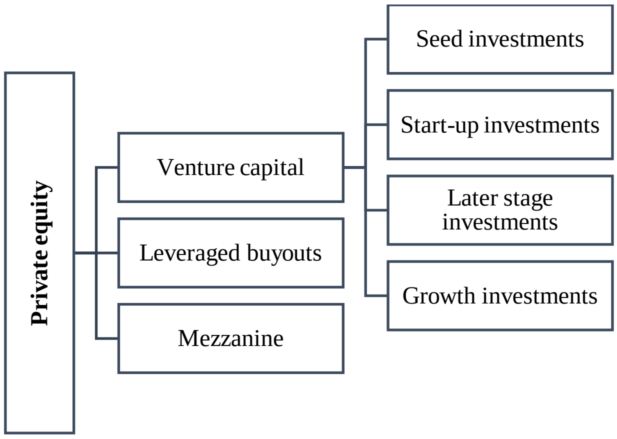
Private equity markets provide an alternative to internal financing and ‘traditional’ sources of funds (public equity and debt instruments), playing a pivotal role for firms with a high growth potential and the need for advice throughout various stages of their development. There are several types of private equity (PE) funds. Venture capital (VC) funds focus on start-ups, young and high-growth companies in order to fulfil a specific purpose – ranging from the launch and early development of a business to its expansion. Buyout funds usually focus on mature companies and use both debt and equity financing. They are usually larger in size.

Within the buyout frameworks, leveraged buyouts (LBOs) are the most common type of funding. The LBO mechanism implies the acquisition of a firm by a specialized investment firm, using a relatively small proportion of equity and a relatively large proportion of outside debt financing (Stromberg, 2009). The mezzanine capital refers to financing composed of both debt and equity (Meyer, 2006). The table summarizing PE market segments is presented below (Figure 1).

Cendrowski et al. (2012) mention that apart from VC and buyout transactions, investments in hedge funds, FOF, PIPEs, distressed debt funds and other securities may also be classified as PE. Another approach to PE market segmentation defines two main categories of PE investment: capital placed in portfolio companies (direct investing) and capital placed in funds (fund investing).

Several economic articles suggest that PE industry provides benefits to the economy. For instance, Mollica and Zingales (2007) found out that VC had a positive impact on innovation and creation of new businesses. Popov and Roosenboom (2008) emphasized that PE investment caused a significant increase in patent filings. Later, Gudiškis and Urbšienė (2015) found out that PE investments induce economic growth by commercializing granted patents.

Figure 1 The structure of PE market



Source: Gudiškis, 2015.

The purpose of this article is to consider the dynamics and specific features of PE sector in the CEE region, having regard to the absolute and relative amounts of investment, trends, as well as challenges and opportunities inherent in the market discussed at its current stage of development. Due to the large discrepancy regarding which countries are included in the region of Central and Eastern Europe, in the framework of this study, we consider the following countries: Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, North Macedonia, Moldova, Montenegro, Poland, Romania, the Russian Federation, Serbia, Slovakia, Slovenia and Ukraine.

2. Literature Review

The issue of PE market development in the CEE region and globally has been extensively discussed in the scientific literature, even though PE has a relatively short history as an asset class in the emerging markets and CEE region (Lerner, 2016). First papers published in the 1990s and at the beginning of the 2000s were focused on privatization and market economy transformation and their impact on FDI environment. During this period articles discussed the necessary mechanisms for further emergence and development of national private equity markets – for instance, Aghion and Carlin (1997) and Krkoska (2002).

Further research focused, predominantly, on either statistical analysis of trends and development of the PE market in the CEE region or the determinants and impact of such capital in general or in the particular region. Stromberg (2009) summarizes and attempts to structure the existing articles studying the links between private equity investment and innovation. He finds out that such investments make companies grow faster, improve operating performance, increase productivity and innovativeness, etc. Overall impact of PE on economic growth was discussed by

Gudiškis and Urbšienė (2015), as well as by Popov and Roosenboom (2008). Other researchers focused their efforts on confirming the effects of PE investments: new businesses creation – Mollica and Zingales (2007), patent filings – Amess, Stiebale et al. (2016), bvcx etc.

The main source of statistical data on PE market is the European Venture Capital Association (Invest in Europe), local venture capital associations and consulting companies, issuing periodical industry reviews having regard to investment funds size, divestment mechanisms, etc.

During the last decade, an increasing number of papers aim to discover determinants of PE investments in the CEE region and potential ways to increase private capital inflows into the region. According to Stofa and Soltes (2020), investment determinants include economic growth, taxation, funding availability, labour market and business environment. There is a clear consensus that excessive bureaucracy, corruption, legal and administrative burden are the main hindrances to the further growth of PE sector in the given region, as evidenced by Diaconu (2017), Reininger et al. (2020) and others.

3. History of Development

PE market in the CEE region is considered a very young one compared to its Western European peers. At least until 1989 or the beginning of the 1990s, the private capital seemed to be an unknown term, since all the ownership was placed in the hands of governments. First PE investments in the region came from the developed markets (Western Europe, the USA, etc.) after the collapse of socialist regimes and the fall of Iron Curtain. Completely new market economies were a promised land to Western PE fund managers.

The U.S. government was one of the earliest investors in the region, investing through the Enterprise Funds Program. Loans and investments effected by the U.S. Agency for International Development (USAID) established many businesses in the CEE during the 1990s and 2000s (Lerner, 2012).

Transition from centrally planned to market-based systems has led to the consumers seeking consumer goods, sectors, which turned out to be underfunded (EMPEA, 2018).

Russian default in 1998 damaged the prospects of steep PE market growth in Russia, delaying its development (Lerner, 2016). Another aspect of concern is that investments in emerging markets are frequently so-called fly in and fly out operations without an established network in the host countries with Western fund managers not understanding the nuances of PE investments in such markets (Lerner, 2016). Consequently, PE investments in the CEE region are extremely volatile and depend on capital flows from abroad, mirroring the investor perceptions and concerns.

In 2004 the Baltic countries, Poland, the Czech Republic, Slovakia, Hungary and Slovenia joined the European Union (EU), finishing the long process of their European integration and changing the PE market landscape. That resulted in higher fundraising and investing activities due to the lower policy uncertainty and riskiness in those markets. Further accessions to EU involved Bulgaria, Romania (2007) and Croatia (2013) accelerating PE investments in these countries.

CEE experienced a significant inflow of PE before the Global Financial Crisis, receiving a record fundraising from 2006 to 2008, especially in the light of accession of the number of CEE countries to the EU. However, the aftermath of the crisis made investments curtail dramatically. In the 2010s, there was an upward trend with predominantly big-ticket EU investors returning to the region. But the trend was not uniform across all countries. For example, the Russian Federation and Ukraine experienced significant outflows of capital due to the political and resulting economic crisis. In 2020, the PE market was hit by COVID-19 pandemic. The economic growth in the EU part of the CEE region gives a hope to the future development of the PE investments in the CEE. Another positive driver of changes in the region is the global process of digitalization. For instance, due to the faster digital transformation of businesses and public sector, fuelled by COVID-19 repercussions, particular ventures and start-ups have been flourishing since the spring of 2020, especially those operating in the fields of online conferencing, automation, delivery/takeaway services, cybersecurity and e-health.

Throughout its history of PE market development, CEE region has been known for several success stories associated with such business stars as Avast (the Czech Republic), Prezi (Hungary), UiPath (Romania), and Skype and TransferWise (Estonia). Such kinds of stories create a precedent for their region and countries of origin, reassuring and inspiring investors, both nationally and internationally (Pison, 2020). However, the mechanism of such companies' development in most cases is associated with the acquisition of CEE companies by larger players from the West, or the transfer of their operations and facilities to the US or Western Europe. Therefore, apart from private investment, CEE countries need to establish favourable conditions for the full life-cycle business development.

4. Investment Activity

The total amount of PE and VC investments in 2019 reached €4.1 billion in monetary terms, a 10.6% increase from the 2018 result and 14.5% higher than the previous 4-year average. CEE had a total population of about 315 million (170.6 million without the Russian Federation) and registered a total GDP of almost €3.3 trillion in 2019 (World Bank). In relative terms, CEE countries drew up 4.1% of global population and 3.8% of the global GDP. Worldwide, the PE investment market reached the 6-year high in 2020, reaching the total deal value of $3.2 trillion (Bain & Company, 2020). Nevertheless, the share of CEE countries in the global PE market is only around 0.15%, suggesting the disproportional development of that market in the given region.

CEE region has recently seen only modest level of PE and VC financing (Table 1), which has tended to focus on the Western Europe. As mentioned earlier, the PE industry is still a young one in the area being discussed and experiences a continuous development.

Table 1 Private equity investments in the CEE countries, 2015-2019, € million

	2015	2016	2017	2018	2019
Belarus	n/a	n/a	n/a	n/a	37*
Bulgaria	45	27	18	17	13
Croatia	13	41	3	82	94
the Czech Republic	16	168	67	769	65
Estonia	21	81	8	160	683
Hungary	194	101	209	351	136
Latvia	26	26	175	10	9
Lithuania	49	156	6	68	327

Poland	896	805	2505	879	585
Romania	166	148	493	326	551
the Russian Federation	1,170	916	1,673	968	1,141
Serbia	229	48	2	34	417
Slovakia	17	17	4	26	33
Slovenia	11	73	22	1	1
Ukraine	17	11	20	27	34
Other**	n/a	0.1	1	13	2
CEE Total	2,870	2,618	5,206	3,731	4,128

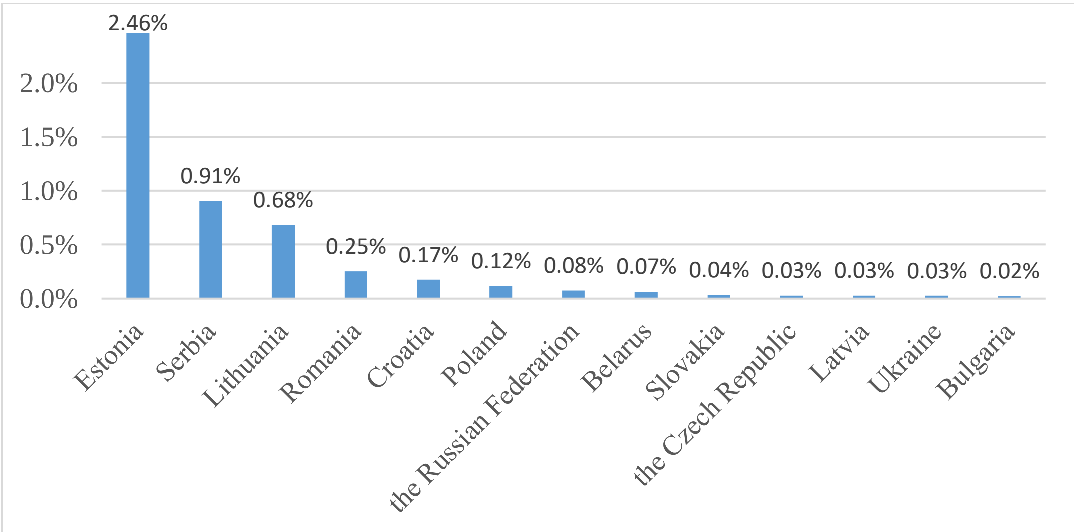
*For Belarus only venture capital data are available for 2019
**Other includes Bosnia and Herzegovina, Moldova, Montenegro and North Macedonia

Sources: Invest Europe, Russian Venture Capital Association, BIK Ratings

Therefore, the Russian Federation and Poland receive the largest PE investments. Other significant markets are the Czech Republic, Hungary, Romania, Estonia and Serbia. All markets in the CEE region are characterized by extreme volatility and varying relative and absolute position on the year-on-year basis.

Comparison of PE markets should be performed not only in absolute, but also in relative terms. The percentage of PE investment in the GDP of the CEE countries demonstrates another pattern, presented in the chart below (Figure 2).

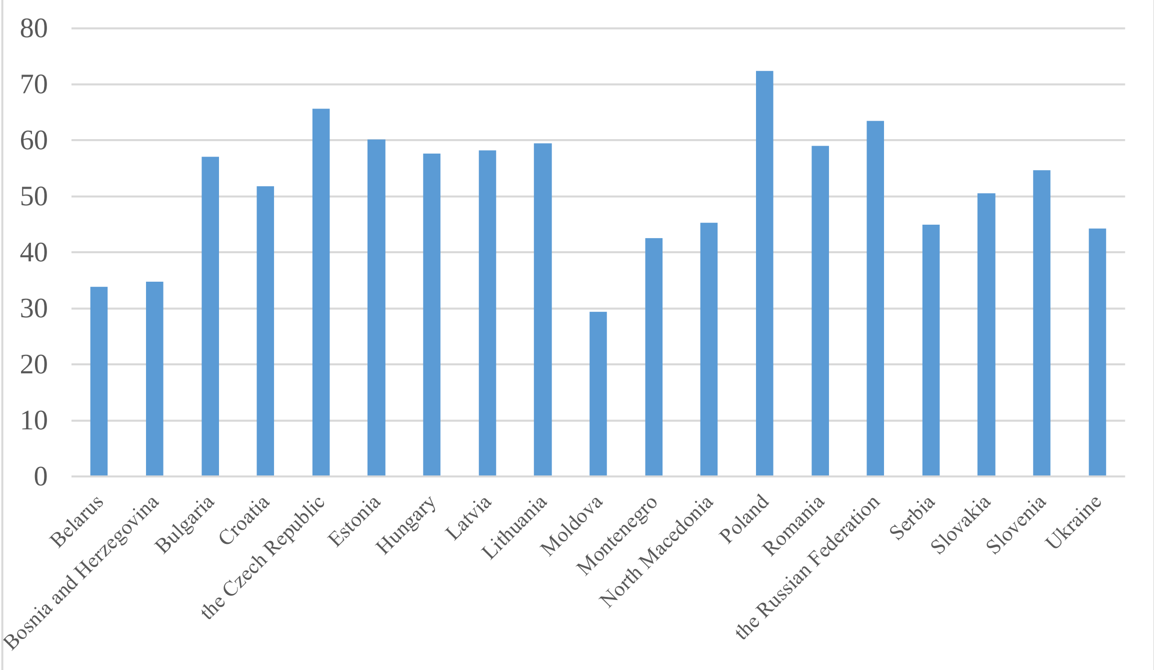
Figure 2 Private equity investments as a percentage of GDP, 2019



Source: Invest Europe, World Bank, Russian Venture Capital Association.

An important metric for measuring PE and VC industry attractiveness is called The Venture Capital and Private Equity Country Attractiveness Index (Figure 3). If we look at the specific countries within the CEE region, this index shows that the most attractive destination for PE/VC investors in 2018 was Poland, ranked 26th globally, with a 72.4 score. The second market in the region was the Russian, ranked 39th globally with the score of 63.5. The third place in the region belonged to the Czech Republic. At this point, one may notice that the position of selected countries in the Venture Capital and Private Equity Country Attractiveness Index is almost entirely consistent with the ranks of countries according to the amount of PE investment in monetary terms for the respective year.

Figure 3 CEE countries' scores for 2018 based on the PE and VC industry attractiveness Ranking



Source: The Venture Capital and Private Equity Country Attractiveness Index

Most of CEE countries remain far behind EU-15 in areas such as economic activity, entrepreneurial opportunities and depth of capital markets. Other weak sides are associated with scarce patent registration, low R&D expenses by both public and private sector institutions, excessive administrative burden and instances of corruption (Stefanova, 2015, pp. 51-52).

5. Challenges and Prospects

Generally, private equity and capital markets in the CEE region are still far below their presumed potential. The description of potential challenges and issues which impede the development of those markets presented in this article is neither exhaustive, nor universal. Another aspect of concern is that it cannot be applied to all of the CEE countries at the same time and at the same extent. The magnitude of the existing constraints varies across CEE countries significantly.

5 main groups of determinants of PE investments include:

- economic growth
- taxation
- funding availability
- labour market
- business environment (Stofa, 2020)

The primary reason, encompassing all of the PE investment determinants, is a socio-cultural environment and historical factors. During the socialism era, companies and banking systems in the CEE countries were state-owned. Therefore, there was little information and transparency relating to the financing decisions. During the economic transformation the region experienced severe levels of inflation, financial fraud schemes, currency, political and banking crises. This resulted in the low level of trust from investors (Reininger, 2020). Therefore, these markets were traditionally overlooked by many investors.

The major obstacles and barriers for investors are unstable political situation, fluctuating currencies and opaque legal systems. The positive side in this region is its growth potential. Particular constraints, which are specific to the CEE region, include the lack of local investors, high risk perceived by foreign investors, insufficient loan finance for private equity transactions and shortage of experienced local management teams. Legal, regulatory and tax issues pose further difficulties during operation of businesses related to the PE transactions and markets (Diaconu, 2017). For example, investors often complain about slow legal and regulatory processes, and inexperienced and understaffed judiciary and bureaucracy (Diaconu, 2017).

Moreover, dynamics of PE/VC market in the CEE region is shaped by the political and macroeconomic events as well as by Covid-19 pandemic and its implications since 2020.

Nowadays, private equity investment in the companies from the Central and Eastern Europe region is a key factor to the development of innovations, know-how and other intangibles. However, the ever-growing problem for such firms is fundraising, exacerbated by the current Covid-19 pandemic. For emerging capital markets, such as the CEE countries, fundraising and investment attraction is increasingly complicated, since they are associated with a higher level of risk for international investors.

This requires an additional component called a country risk premium when determining the required rate of return on investment made in these markets (Table 2). Therefore, for the CEE region, specifically, the cost of equity is calculated as follows (Nenkov, Damodaran, 2016):

$$\text{Cost of equity}_{\text{CEE country}} = \text{Risk-free rate}_{\text{US}} + \beta \times \text{Basic risk premium}_{\text{US}} + \text{Country risk premium}_{\text{CEE country}}$$

Table 2 Ratings, Spreads and Country Risk Premiums, January 8, 2021

Country	**Moody's rating**	**Rating-based Default Spread**	**Total Equity Risk Premium**	**Country Risk Premium**
Belarus	B3	5.75%	11.02%	6.30%
Bosnia and Herzegovina	B3	5.75%	11.02%	6.30%
Bulgaria	Baa1	1.41%	6.27%	1.55%
Croatia	Ba1	2.21%	7.14%	2.42%
Czech Republic	Aa3	0.53%	5.31%	0.59%
Estonia	A1	0.62%	5.40%	0.68%
Hungary	Baa3	1.95%	6.85%	2.13%
Latvia	A3	1.06%	5.88%	1.16%
Lithuania	A3	1.06%	5.88%	1.16%
Macedonia	Ba3	3.18%	8.21%	3.49%
Moldova	B3	5.75%	11.02%	6.30%
Montenegro	B1	3.98%	9.08%	4.36%

Poland	A2	0.75%	5.54%	0.82%
Romania	Baa3	1.95%	6.85%	2.13%
Russia	Baa3	1.95%	6.85%	2.13%
Serbia	Ba3	3.18%	8.21%	3.49%
Slovakia	A2	0.75%	5.54%	0.82%
Slovenia	A3	1.06%	5.88%	1.16%
Ukraine	B3	5.75%	11.02%	6.30%

Source: NYU Stern University (2021). Country Default Spreads and Risk Premiums. Available at: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

The data in Table 2 suggest that the Czech Republic, Estonia, Poland and Slovakia are the less risky countries for investing purposes, while Bosnia and Herzegovina, Moldova, Ukraine and Belarus are considered to be the most risky markets, where return rates on the investment should be higher to cover the risk of investors. We may also see wide gaps within the CEE region – e. g. the country risk premium for Ukraine is more than ten times as high as for the Czech Republic.

Consequently, higher interest rates have the same impact, increasing the overall cost of equity for investors. This issue is considered in a number of studies. For example, S. Bonini and S. Alkan (2009) discuss a remarkable adverse effect of the interest rate on the offer of VC. While interest rates soar, riskier investments tend to lose their attractiveness and investors start searching for assets associated with the lower returns and risk-free position.

One of the important conclusions, following from the above brief illustration is that managers of companies in CEE countries, regardless of their size, should be prepared to raise capital under significantly worse conditions in comparison with developed European markets. This implies the need for developing high-yield investment projects to overcome the high hurdle rates.

As mentioned earlier in this paper, a lot of CEE markets are still nascent, especially those in South Eastern and Eastern Europe. Countries in this region will likely benefit from timely development finance institutions (DFIs) and regional institutional support, as well as through specific financial instruments available in the region (Strusani, 2020).

A viable option to attract PE investment inflows to the CEE region would be to focus efforts on the key determinants on the aggregate, as well as state-wide level. K. Amess et al. (2016) highlight the necessity to frame the business environment with the individual countries adopting appropriate measures independently through the legislative and executive branches of power.

Potential ways to the development of CEE private equity market include continuous development of national capital market strategies, development of stable legal system and business environment, establishment of strong financial market systems, easing of investment regulations, assistance to SMEs in their access to private equity market, adoption of supportive tax measures and efforts to increase financial literacy among all stakeholders.

A positive record of stimulating effect on the PE market growth is associated with pension reforms. Deregulation of pension funds and the growth in AUM of private pension funds allows for riskier investment decisions and drives PE investment. Hungary, Poland and the Czech Republic have undergone such de-regulative measures in 1998, 1999 and 2013 respectively, demonstrating a positive example of PE market growth.

Nowadays, EU members within the CEE countries have a larger potential for PE market development in the context of the EU project to build a capital markets union. Measures proposed under this plan integrate member states into a single market attractive to foreign private investments (Reininger, 2020). Development of PE is one of the principles embodied in the EU-wide strategies, namely the Innovation Union Strategy "to create an innovation-friendly environment that makes it easier for great ideas to be turned into products and services that will bring Europe's economy growth and jobs" (European Commission, 2010). The implementation of strategy has been performed through financial institutions, governments, COSME and HORIZON Programmes (Gudiškis, 2015).

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