SYNTAXIS CAPITAL

Leveraging Innovation

Przemek Szczepanski, partner at Syntaxis Capital in Warsaw, looks at the current investment opportunity in the CEE region

At the risk of making us all feel old, it has now been some 25 years since the fall of Communism and subsequent rise of the market economy in Central Europe. Much has changed since then, including the private equity industry itself, which emerged soon after the fall of the Berlin Wall, and has evolved alongside changes in the region's economies.

Looking briefly at the types of transactions that have taken place, we can identify a number of trends in the market which evolved over time. At first dealflow was fuelled by the huge wave of privatisations, though this source of transactions has now all but disappeared. In the late 1990s a wave of start-up companies, modelled on proven US or Western European concepts - video rental chains, casual dining restaurants, bowling alleys etc – gave hope that Western-style businesses could generate Western-style returns. These deals though were typically unsuccessful, as the concepts proved to be either too far ahead of their time, or unsuited to local tastes. Attention then turned to profiting from operational improvements at entrepreneurial businesses, which had grown quickly and reached the point where their scale demanded the professionalization of internal functions (the classic low-hanging fruits within sales and marketing departments, finance etc). At the time of the accession to the EU of the first group of CEE countries, there was much enthusiasm for the concept of "nearshoring", with the hope that the region could become a low (labour) cost production base for the EU. Money consequently flowed into the manufacturing sector. Finally, at various times, certain sectors - consumer finance, cable TV, healthcare - have attracted a disproportionate amount of capital (in many cases following trends seen in Western Europe), and generally delivered impressive returns.

Przemek Szczepanski

WHERE ARE WE NOW?

With the benefit of hindsight, it is all too easy to romanticise the past, but those early days offered a very different, and very attractive, economic and competitive environment: economies were fundamentally inefficient; major businesses were predominantly state-owned, with the private sector still nascent; the supply of goods and services was erratic and inadequate; and there was significant and largely unmet consumer demand.

This environment provided fertile ground for growth, with most sectors rapidly expanding, and fragmented competition allowing entrepreneurial businesses to grow despite lacking best practice in many areas.

Alas all good things come to an end, and, having grown up over the past few decades, the markets of CEE are now little different to the longer-established ones of the West. They are now generally mature, with a plethora of goods and services available, catering to all possible needs and preferences at various price points. This may cheer the consumer, but the investor will frown at the market saturation evident within most sectors and lacklustre growth rates a far cry from the 10 to 30 percent of the golden age.

We are thus presented with an entirely different competitive landscape. No longer will a rising tide lift all boats, the big and the small, the good and the bad, alike. Instead we now have consolidated markets with clear, established and well-managed leaders, whether these be locally grown players or units of large multinationals.

This of course poses a number of questions to the CEE investor. How does a manager nurture, or better still grow, a mid-market company in such an environment? How is expansion possible in maturing markets, where growth has tapered off, and the competition is fiercer (very often part of a major multinational)?

With transactions in the mid-market in the region still however predominantly about growth, and looking at some recent investments which we at Syntaxis have completed, is it possible to identify any recurring themes? Put another way – and this is not the beginning to the world's worst joke - what do a motor insurance broker, fire-resistant glass manufacturer, and an online travel agent have in common?

The answer is a simple word: *innovation*

It may seem trite and simplistic to sum up our companies in a single word, but innovation is increasingly the key to our investments. But what do we actually mean by innovation?

What may immediately spring to mind is an IT company, perhaps in the internet or mobile space, with a revolutionary application or service that has the potential to one day change the way we live or do business. That however entails burning cash for a long while with no certainty of success, so how can you leverage this?

Innovation – more broadly defined – sees companies involved in a continuous quest to do business differently, to do it better, and by doing so to gain an edge over their competitors. Through such innovation – a small incremental improvement to internal processes, better customer service, more targeted and effective marketing, an innovative route to market, improving a product's features or the manufacturing process – companies can achieve growth in a relatively mature market. Growth has to be earned however, it is no longer a given.

At Syntaxis then we are increasingly investing into and leveraging strong companies in diverse markets or niches that thanks to their innovation have not only secured a strong and defendable market position, but also have sustainable competitive advantages which translate into high profitability and cash generation and strong growth prospects (often in new geographies).

> WHAT DO A MOTOR INSURANCE BROKER, FIRE-RESISTANT GLASS MANUFACTURER, AND AN ONLINE TRAVEL AGENT HAVE IN COMMON? THE ANSWER IS A SIMPLE WORD: *INNOVATION*

SO WHAT DOES THIS MEAN IN PRACTICE?

To give some concrete examples, we can take a closer look at our recently closed transactions.

BIK, a specialist motor insurance broker servicing the B2B segment we backed last year, successfully competes with large international players already established in Poland (AON, Gras Savoye) thanks to an innovative approach to customer service using its proprietary, internally-developed, IT system and its new ways to market and distribution channels.

Most recently we invested in Glass-Team, which became the number 1 fire-resistant glass supplier in Poland within a few years of production commencing, again thanks to its proprietary, internally developed technology. Fire-resistant glass is a highly technical product which needs to meet strict specifications and certification requirements due to its safety-critical nature. Again the company successfully competes with industry giants such as Saint-Gobain or Pilkington, and is now firmly on a growth trajectory, ready to begin expanding into other EU markets.

Another good example is eSKY, the largest online travel agent in Central Europe focused on airline tickets. With early mover advantage, continuous IT investment into a state-of-the-art transactional platform, and smart, highly efficient online marketing, the company has gained a dominant position in a number of countries across the region, keeping strong international competitors at bay. It has further shown that its innovation can flourish outside Europe, with notable success in Brazil, a market eSKY entered just two years ago, but where it is already the number 3 player, competing successfully against long-established local companies (all with significant US PE/VC backing).

POLE POSITION

Innovation is thus increasingly the key driver of the deals we see in Central Europe. This offers the potential for high growth, a key source of value creation in mid-market deals in the region (typically 80 percent of the projected value creation in our transactions comes from top-line growth).

These solid growth prospects, combined with the natural benefits of our mezzanine lending - we are increasingly the sole lender in a deal, effectively holding a senior position in the capital structure, always with equity upside – confirm our belief that Central Europe should generate attractive returns over the years to come. ■

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