SYNTAXIS CAPITAL

A roller-coaster ride

Syntaxis Capital Partner **Przemek Szczepanski** assesses the mezzanine opportunity in Central and Eastern Europe, and argues that it's a market now made for local, specialist players.

It has now been five years since the Lehman collapse, a long period in the life of a typical private equity fund, especially given the very turbulent times the industry has gone through over the last few years. All the funds that were actively investing in 2008 have come to the end of their investment periods, and many still hold assets where GPs are working hard to recover the value of their original investment (completed at the peak of the market). While some managers have managed to raise subsequent funds, some less successful GPs have struggled to attract LP commitments in recent fundraising.

The mezzanine market, traditionally very closely correlated with private equity, has gone through a similar roller-coaster ride in this fast-evolving landscape.

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PRETTY GLUM AT FIRST SIGHT

With European LBO deal values skydiving from the peak €140-160 billion per annum in 2006-2007 to €40-50 billion range in 2011-12 (according to S&P LCD), the CEE region did not remain unaffected. Based on our market size estimates, value of the CEE LBO market has dropped by over 70 per cent since 2007. Moreover, with only a limited number of transactions, private equity houses are looking to put more money to work into each deal they can find, potentially compromising on equity returns rather than striving to squeeze the last euro from a capital structure.

With lower overall LBO volumes coupled with PE firms' pressure to deploy capital, the use of mezzanine financing in CEE buyouts has also dropped, again resembling the same trends seen in Western Europe (where only 9-12 per cent of LBOs had a mezzanine layer in 2011-12, compared to 48-72 per cent in 2006-08).

...BUT A CLOSER LOOK CHANGES THE PERSPECTIVE

While the above statistics paint a pretty grim picture for CEE mezzanine, they do not reveal the full story. Indeed, while demand for mezzanine in buyouts has almost disappeared, that is only correct for larger transactions (in CEE terms meaning EVs above €100-150 million), which are targeted by both large dedicated regional PE houses as well as international players investing out of pan-European/global funds.

Conversely, in the small/mid cap space populated exclusively by dedicated regional funds, private equity capital is still a scarce resource and thus investors are much more inclined to use mezzanine to leverage their investment (giving them the ability to pursue larger transactions, optimise equity returns and improve portfolio diversification).

Additionally, as there is also considerably weaker competition at the lower end of the market, those transactions tend to have lower valuation multiples and be more conservatively leveraged, clearly improving risk/return profile for mezzanine lenders.

Mezzanine investors have evolved and adapted to the new environment, focusing less on typical PE-led LBOs, and are instead pursuing self-sponsored, often self-originated transactions, across a variety of deal types ranging from partial recapitalizations, partial shareholder's buyouts, acquisition financing through more typical growth financing. We believe this is where the strong attraction of CEE mezzanine lies.

A PERFECT STORM FOR INVESTMENTS

Though regional economies have been impacted at varying levels, paradoxically the prolonged economic slowdown has also had a positive effect on the transaction environment in CEE:

- Valuation expectations have been adjusting downwards from the peak 2006-08 levels and entrepreneurs are now more open to consider potential transactions (rather than wait another few years for a major recovery).

- Banks are more cautious, and whereas historically they might have been queuing to offer yet another banking product (and expand balance sheet/ gain market share), they now have a more conservative approach to leverage (even more so in the small/mid cap segment), leaving more space and need for mezzanine.
- More clear-cut investment opportunities are easily visible, as robust companies have remained profitable and cash generative, and have continued growing, standing out from the crowd (while less established/efficient businesses that were previously riding a rising tide either disappeared or are struggling). Those recently emerged champions are poised to benefit when GDP starts recovering.
- Private investors are re-gaining appeal, away from local public stock and/or high-yield markets, which may have been viewed as holy grail by many mid-market companies looking for expansion capital or owner's partial exit (particularly in Poland), but their allure has vanished given often low liquidity and poor post-IPO stock price performance, disclosure requirements, or imminent refinancing risk for typically 2-3 year bond programmes.
- The private equity market has become "cosier", with much of the hot money that poured into the region during the peak of the cycle now de-emphasizing CEE or pulling out entirely, reducing significantly the value of private equity capital targeting deals in the region, and as a result increasingly shifting focus to dedicated local/regional players.
- Geographical differentiation is growing, with some countries, such as Poland, faring much better throughout the economic slowdown, and now emerging as clear winners with attractive markets for investments (compared to a much more homogenous regional market a few years ago when perceived risk for most CEE countries did not vary considerably).
- Western European mezzanine investors have practically abandoned the region, leaving the space to dedicated locally established players, who have the ability to source and execute attractive mid-market transactions. Importantly, institutional private debt investors, which have proliferated in Western Europe do not feature in CEE and do not pose any threat to purely regional mezzanine funds.

TYPICAL DEAL ATTRACTIONS

Alongside a fast-evolving market environment, CEE mezzanine deal types and characteristics have also changed, shifting away from traditional pure-play private equity sponsored buyouts. Typical regional mezzanine transaction would share many if not most of the following features:

Self-sponsored – increasingly mezzanine providers tend to be the only institutional investor, partnering with entrepreneurs and/or management and benefiting from a much stronger position.

Self-originated – given the size of potential market and a limited number of regional players, in most cases mezzanine investors do not compete with their direct peers when pursuing a transaction, resulting in stronger negotiating position and lower price pressure.

Senior position – very often mezzanine is the only leverage in a company after close, effectively taking senior risk with senior security package, but priced at mezzanine rates.

Much higher growth component – value creation is mostly driven by revenue growth (also in buyout and recapitalization transactions), not just de-leveraging or cost-cutting/efficiency improvements.

Potential for add-ons – concrete plans for bolt-on acquisitions feature in most transactions, allowing for additional upside driven by market consolidation.

Equity component – use of warrants is firmly established in CEE mid-market transactions, which often coupled with direct equity co-investment, makes mezzanine investors well positioned for an over-performance potential.

We believe that the combination of the above deal characteristics makes CEE an attractive mezzanine market that should generate solid returns over the years to come.

SET FOR GROWTH

Some sceptics might have predicted the end of the mezzanine market as we knew it, but it is clearly premature and ungrounded in Central and Eastern Europe, where local, well established mezzanine investors can source attractive investment opportunities outside the traditional buyout space. Those typically have much lower financing risk, are in strong cash generative and growing companies and offer over-performance potential given the exposure to equity appreciation (through warrants and often equity), which is an intrinsic characteristic of the CEE mezzanine mid-market. This makes us believe that mezzanine has good prospects in the CEE region, and should deliver attractive returns for both the current and next generation of funds. ■

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