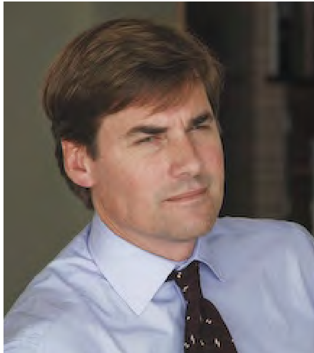
A Focus on Mezzanine in Central Europe: A Historical Perspective | Ben Edwards, Managing Partner, Syntaxis Capital



In 1981 Bill Gates purportedly said, "640k RAM ought to be enough for anybody," which, if true, shows that even the best and the brightest can get their predictions wrong. While few would have foreseen the extent to which microchips changed the way we do things today, the development of private equity and leveraged finance—and the mezzanine sub-segment in particular—in the United States in the 1980's and Western Europe in the 1990's, was certainly more predictable (albeit less life-altering). This trajectory carried over to Central Europe at the beginning of the last decade, increasing the ways in which our regional private equity industry was able to create (and sometimes destroy) value over the last 15 years.

The arrival of mezzanine in Central Europe followed much the same path as it did in developed markets, starting with a promising cycle of growth-driven private equity investment, which led to GPs subsequently raising larger funds due to robust investor appetite. To achieve returns in line with those generated in the preceding cycle, managers of these now larger funds looked to lever their investments. Leveraged buyouts emerged, not only because the credit conditions were better for lenders, but crucially, managers were able to achieve these returns in a much shorter timeframe. High profitability encouraged banks to invest in leveraged finance teams, and credit became abundant, leading to greater leverage, increased valuations, higher returns, robust investor appetite, bigger funds, etc. In this environment, mezzanine emerged as a means of increasing leverage (but not necessarily financial risk). The first mezzanine funds dedicated to Central Europe (primarily focusing on markets such as Poland, Hungary, Bulgaria and the Czech Republic) were established in the early 2000s. By the middle of the decade, some of the international fund managers had expanded to the region and local banks were beginning to structure mezzanine financing, increasing the overall level of competition.

Interestingly, the evolution of the mezzanine sub-asset-class led to a bifurcation in the market in developed markets. The development of the U.S. high yield and junk bond market in the 1980s and the arrival of independent mezzanine funds in Western Europe ten years later defined the large-cap segment. At the other end lies the lower- to mid-market. The hallmark of the traditional mezzanine players focusing on this latter segment is their equity bias and direct involvement with entrepreneurs and equity funds to finance corporate expansion (not as syndicatees on bank-led deals). In the early years, the bulk of mezzanine investing in Central Europe was in this traditional mid-market segment, which has always been the focus of Syntaxis.

Private equity and leveraged finance markets in the United States, Western Europe and Central Europe experienced similar highs and lows, with the biggest boom and bust occurring pre-, then post-Lehman. A key difference, however, is that due to its later arrival on the scene, the amplitude of the swings in Central Europe was possibly greater. The promise of high equity returns in Central Europe led private equity fund sizes to double and sometimes treble from 1995-2005, while deals done at greater than 5x leverage levels equalled those in Western Europe (and were sometimes higher due to the "trophy" status ascribed to certain participants' first big buyouts in the region). The evolution from mid-market mezzanine deals to very large, widely syndicated transactions occurred in an instant.

Post-2008, macro uncertainty, and the fact that most of the lenders active in Central Europe saw the market as attractive but ultimately peripheral, meant that liquidity in the private equity markets disappeared just as swiftly. When pre-crisis structures needed fixing post-crisis, few lenders were prepared to be flexible (being too busy putting out their own fires), with a devastating impact on returns.

One thing the credit-crunch and euro crisis did was to differentiate those stronger companies from their weaker rivals. As such, for many remaining industry participants, the competitive marketplace is now much more attractive; their positions are solidified, and consolidation opportunities remain relatively abundant. This is a feature we are seeing in our portfolios and in new deals across industries, most notably in Poland—which is dominating current activity due in part to its size, stability and relatively advanced stage of development, as well as to entrepreneurs' mentality toward buying and selling businesses—but also in the Czech Republic and parts of the Balkans.

Additionally, the relative lack of liquidity has meant that the investments we see are particularly compelling. With less buyout equity capital available in the lower- to mid-market segment, entrepreneurs looking to expand are not necessarily selling out, while the relative lack of bank finance means that we can often originate opportunities to provide senior-secured financing at low leverage levels, and with equity upside.

Samuel Goldwyn advised, "Never make forecasts, especially about the future." But in this instance I am prepared to take the risk. We think the Central European private equity market will generate highly attractive returns going forward, especially in the mezzanine segment in which we are active. Our economies (Poland in particular) are recovering quickly—for the right reasons—underpinned by favorable demographics, while the relative scarcity of alternative capital means that leverage levels and valuations remain relatively low. These all point to an appealing risk/return opportunity, a forecast that even the great movie mogul might have been comfortable making.

Syntaxis Capital is a leading provider of mezzanine finance for mid-market buyouts and similar transactions in Central and Eastern Europe. To date, the firm has raised two mezzanine funds for the region with aggregate commitments of approximately EUR245 million.

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