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“Don’t Waste a Perfectly Good Crisis”



13th Annual CEE Private Equity Forum

Event Summary by Squire, Sanders & Dempsey L.L.P.

Spring 2009



INTRODUCTION

The global downturn has caught up with Central and Eastern Europe and then some. The transactional scene in CEE is pin-drop quiet, LPs are spooked and several CEE stalwarts are wrestling with political and economic turmoil.

In short, it is an opportunity in the making for private equity. As put by **Daniel Lynch of 3TS Capital Partners**, “don’t waste a perfectly good crisis.”

C5 and global law firm Squire, Sanders & Dempsey L.L.P. are pleased to bring you an overview of perspectives and insights from the 13th Annual C5 CEE Private Equity Forum held in Vienna on 23-24 March 2009. We would like to thank all presenters for their thoughtful comments on the current state of private equity in Central and Eastern Europe, and the Forum delegates for demonstrating continuing interest in private equity’s future.

Squire Sanders’ CEE Private Equity Team

Spring 2009



C5 CEE PRIVATE EQUITY FORUM: EXPLORING OPPORTUNITIES IN UNCERTAIN TIMES

Private equity in Central and Eastern Europe is bearing its share of fallout from the global downturn. Deal flow isn't even at a trickle, governments and economies are in turmoil and businesses are collapsing, not to mention the overarching anxiety caused by the ongoing financial crisis. But amid the gloom spark some new prospects for private equity.

- There has never been a one-size-fits-all solution for private equity in CEE. The financial crisis has highlighted regional winners and losers, although debate continues on final designations. Some conference presenters named the Czech Republic, Poland, the Slovak Republic and Slovenia as winners, while the Baltic states, Bulgaria, Hungary, Romania, Russia and Ukraine were generally named losers. Hobbled by higher debt and unstable currencies, the losers are expected to be slower to recover. In any case, private equity must have players on the ground who understand each country's economic, social and political fundamentals before selecting investment targets.
- Crisis notwithstanding, private equity firms are believed to be sitting on US\$3 billion to US\$4 billion of dry powder, and supply and demand for regional capital is bound to converge. While many observers urged private equity to go back to basics and get this capital into play, others noted that the industry needs to obtain clarity from banks about the availability of leverage or come up with financing alternatives.
- Fund managers need to evaluate the relative strength of existing portfolio companies with a view to managing towards increased efficiency and, as concerns non-performing or troubled assets, developing a realistic plan to address these problems.
- Highly leveraged mega-buyouts may be a dead model, so private equity needs to be creative and flexible. At the same time, private equity has to play it safe and smart, increasing diligence efforts, forcing valuations to match market realities and forecasting realistic exit opportunities.
- Private equity should be on the lookout for distressed assets, mezzanine finance opportunities, small deals in the €10-25 million range and family-owned companies with succession issues. The industry should also beware of potential difficulties caused by the call for increased governmental regulation.



WHAT THE EXPERTS SAID

Winners and Losers

While the “easy money” years (2004-2008) are gone, **Nikolaus Bethlen of Mid Europa Partners** observed that talk of gloom and doom in CEE doesn’t provide a complete picture. A more accurate view of CEE would focus on regional winners and losers instead of a unified region of equals. As a result, private equity needs to develop distinct strategies for each CEE country.

Although debate continues on final designations, the winners were identified as Poland, the Slovak Republic, Slovenia and the Czech Republic. **Jaroslav Hascak of Penta Investments** is “very optimistic” about investing in CEE and believes that, on a macro level, the so-called winner countries will provide good opportunities for private equity.

The so-called losers – those countries with unstable currencies and high rates of debt to GDP – were generally identified as Russia, Ukraine, the Baltic states, Hungary, Romania and Bulgaria. These countries are predicted to have a difficult time luring new investors. Mr. Bethlen noted that the losers have taken a double capital flight hit: as investors became more wary, banks also expatriated money from the region. Russia and Ukraine are particularly hard hit, he said.

Michael Tojner of Global Equity Partners Beteiligungs-Management AG echoed that perspective, noting several short-term challenges that the region faces. He said he is very wary of investments in Eastern Europe, particularly Russia, where financing is hard to come by. Mid Europa’s Bethlen noted that while, for example, Hungary- or Ukraine-based deals will be hampered by financing difficulties, there are significant opportunities for managers who have been in and understand the region. He also stated there is at least US\$3 billion to US\$4 billion in dry powder awaiting investment opportunities in CEE that will surface as valuation levels align with expectations. As a result, private equity activity should pick up by late 2009.

From the investors’ perspective, **Roy Baumann of Partners Group** said that his firm is earmarking 5 to 10 percent of its European program to CEE investments, but that he is much more cautious about Russia and Ukraine. **Thorsten Paul of Investkredit Bank AG** predicts that Russia will be the last CEE country to find new investors, as he believes the bubble in Russia is bigger than in any of the other CEE countries. He added that he does not see a lot of fundraising activity in the region and observed that the funds his firm has invested in are sitting on cash. Paul does not expect a big shakeout in the market, although he does predict that the number of LPs investing in CEE will decrease over the next couple of years. **Henry J. Owainati and Hannes Ambacher of Bank Gutmann Group** explained the importance of choosing the right private equity fund manager, due primarily to the great disparity in performance between the top-tier fund managers and bottom-tier fund managers. Owainati and Ambacher suggested that the most important factor an investor should consider is the management team.



Global Equity Partners' Tojner also sees opportunities in CEE, specifically real estate funds and restructuring funds targeting real estate assets. Tojner also said the niche market of high-tech companies – his organization's target – presents excellent opportunities as valuations come down. Likewise, **Vinarom Vilaihongs of SGAM Alternative Investments S.A.**, comparing CEE to Western Europe, sees opportunities arising from the fact that CEE is a very fragmented market with less competition. **Jan Dewijngaert of Gimv**, in contrast to many other speakers, found positives in the Russian market. While the macroeconomic indicators are certainly not good, because of low governmental debt, high foreign currency reserves and relatively modest unemployment, he believes Russia's current troubles are different from the 1998 Russian crisis. Dewijngaert also predicts that the power of the oligarchs will decline as they are forced to restructure, consolidate or sell assets. He continues to see many interesting investment opportunities, particularly in consumer-oriented businesses.

Private Equity Landscape: Where Are We Now?

Country-by-country winners and losers notwithstanding, the speakers provided a frank assessment of the state of private equity in CEE in 2008 and early 2009, including analyzing the roots of its current troubles.

Armando D'Amico of Acanthus Advisors attributed CEE's problems to "too much investment, too quickly." In that vein, **Joanna James of Advent International** cautioned that private equity in CEE had become accustomed to "instant gratification." She stated that the industry as a whole must relearn that "debt is a burden to be paid off" and not an asset to be bought and sold. **EIF's Ulrich Grabenwarter** stated that a review of deal dynamics over the past three years provided "warning signs" of the current crisis. He noted that the impact of the crisis will be larger in CEE than in Western markets because there will be a "flight to the more conservative risk/return profiles" typically found in more developed markets.

David Bernard of Thomson Reuters provided grim statistics for 2008 and 2009: M&A activity in 2008 was down 35 percent in Europe and 45 percent in CEE. Worse yet, Bernard noted that M&A activity is down 98 percent in 2009, demonstrating how few deals have been reported during the first quarter of this year. He indicated that no sector is safe, as all industries have been affected while PE-backed buy-side transactions decreased 93 percent over the past six months. There have been no syndicated loans this year and fundraising is also very quiet. At the same time, the exit market is suffering, with equity issuances down 29 percent in CEE and 17 percent globally. According to Mr. Bernard, the capital markets are "closed, for all intents and purposes."

Mid Europa's Bethlen observed that now is the time to focus on portfolio companies and to contemplate strategies for investing amid a lack of acquisition financing. "We are still in a time lag," remarked Bethlen, predicting that it may take a few more months for people to realize that the new valuations are here to stay. He advised being creative and opportunistic to achieve results. **Brian Gimotty of Paul Capital Partners** agreed that there is "a lot of disconnect in the market." He believes that secondary valuations have started to "come down to earth" and that private equity firms are taking a more sober view of risk/reward scenarios.



A number of speakers expressed concern that investment capital has been flowing out of CEE and is not being replaced by new investors. At the same time, **Robert Manz of Enterprise Investors** expressed “strong concern” that investments in CEE have fallen out of favor, with investors not currently in CEE fearful of committing to the region. Though **Alessandra Pasian of the European Bank for Reconstruction and Development** confirmed that EBRD is committed to continue funding in CEE and is looking at new funds coming to market, **Peeter Pihö of Hansa Investment Funds**, observed a lack of domestic institutional LPs, which is “an issue in CEE and an issue for the industry.”

Compounding the problem of capital flight is the lack of clarity from banks about their ability and willingness to lend. **Thomas Wilfling of AXA Private Equity Eastern Europe GmbH** believes that a number of banks claiming to be open for business are, in fact, “not really open” or have not seriously tested their credit committees for some time, lacking internal guidance in terms of what can be achieved. He predicts that the lending situation may become somewhat clearer in a few months when banks know and have digested 2008 data. **Supriya Saxena of UniCredit Markets & Investment Banking** acknowledged that many banks do not have a defined lending strategy yet for this year, thereby contributing to the lack of visibility around liquidity. That said, she emphasized that banks are more critically assessing risk and there is generally more focus on due diligence. Given overall constraints on capital, and volatility in funding costs, banks are requiring higher up-front fees and margins to put money to work. Many banks have retreated to their home markets, and relationship and ancillary business has become increasingly important in the overall investment decision. Saxena said that in addition to liquidity provided by local lenders in each regional market, there is a very limited number of global banks still actively involved in LBOs in CEE. Some of the main players include UniCredit, ING and RZB. The model where arranging banks underwrite and syndicate is no longer viable, she observed. In 2009, most transactions are likely to be in the form of club deals, with three or four banks working together to provide financing without any one lender assuming a significant amount of underwriting risk.

Bad news notwithstanding, conference presenters also expressed optimism about the prospects of private equity in CEE.

Bethlen of Mid Europa claimed that the “portrait of doom and gloom” painted in the media about CEE is exaggerated. Comparing the current environment to Asia’s crisis in 1996, he observed that CEE is in a much better state of health because debt levels of CEE companies are fairly moderate. As a result, he forecasts the crisis “will be much better absorbed” in CEE than it was in Asia. Penta Investments’ Hascak reminded the audience that while you must be selective, there are “excellent opportunities” to find interesting companies at a good price. EIF’s Grabenwarter stated that the crisis can also be seen as a “tremendous opportunity for private equity” as it can demonstrate its real role in company building and strategic development of businesses. He added that those fund managers that prove they are capable of generating returns not only in times of “macroeconomic tailwind” will prevail.

Another prominent theme was the role that mezzanine finance will play in private equity deals in 2009 and beyond. **Chris Buckle of Mezzanine Management GmbH** observed that deal flow is beginning to improve compared to the past six to nine months. New deals include LBOs of distressed sellers. Buckle noted that distressed LBOs offer a significant role for mezzanine finance firms. Another speaker noted that returns are less squeezed than before the crisis and that deals are now being more conservatively leveraged.



From the perspective of local mezzanine providers, Mezzanine Management's Buckle also noted that the downturn has reduced competition for deals. In particular, many Western European funds are now staying in their home markets and no longer straying into CEE. A less competitive landscape is good news for local players. However, with LPs also shunning the region, specialist mezzanine funds in CEE now face the challenge of raising enough capital to finance the significant number of available opportunities anticipated. This view was echoed by **Dr. Matthias Unser of Sal. Oppenheim Private Equity Partners**.

Advent's James drew parallels between the tortoise-and-hare fable and private equity's leverage-fueled growth. She said the industry must "redefine success" in order to manage expectations created by the unsustainable returns achieved during the boom years. Since private equity is flexible and creative, James said she has faith the industry will adapt to a new landscape that demands private equity to be cautious, methodical and to truly take a long-term view. In addition to her advice to "get back to basics," James predicted that, in the near term, funds would target smaller companies holding not more debt than they can pay off, and that expansion capital investments, as compared to leveraged buyouts, will become increasingly common. EIF's Grabenwarter agreed that private equity will see new deal dynamics going forward, with leverage as a value driver off the agenda and private equity going "back to its roots, which is value creation through strategic positioning and organic growth."

Manz of Enterprise Investors also expressed optimism about the future of private equity in CEE. "Private equity thrives on distortion," he said, predicting that private equity's current crunch will be relieved by decreases in both valuations and competition and bolstered by improved access to talented management. Manz expects valuations to come down to more acceptable levels within six to 12 months.

Finally, participants highlighted current regulatory trends and those on the horizon.

Maurits Tausk of Baker & McKenzie advised that the new EU proposal to regulate private equity firms should be monitored closely. Advent's James echoed this concern, noting that there is virtually no chance that the private equity industry will be allowed to self-regulate. Observing that there are no CEE representatives on the regulation task force, she expressed concern about the current talk of delegating oversight responsibility to local authorities or venture capital associations.

Marc van Campen of Baker & McKenzie noted the recent attacks by the United States on tax haven jurisdictions and predicted that we are likely to see changes that affect private equity structuring, not all of which may be rational.

Trends to Watch

In the short term, Mezzanine Management's Buckle sees many private equity funds focusing on portfolio companies while considering smaller acquisition opportunities in the US\$10 million to US\$25 million range. That view was echoed by Lynch of 3TS, who noted that now is the right time to make any changes that need to be made to portfolio companies. Lynch also advised looking at consolidation and "bolt on" opportunities. Buckle does not envision many larger LBOs. UniCredit's



Saxena indicated that her bank remains committed to investing in LBOs in the region. The appetite for commitment to any particular transaction depends upon a number of factors, but institutionally the bank's focus is on home markets and key sponsor relationships.

AXA's Wilfling predicted that future acquisition financing packages will see significant changes from deals structured just a year or two ago. For example, he does not expect to see many deals with much more than five times EBITDA debt multiples in the near term. Observing that "cooling off is a good thing," Wilfling said that the current environment will force private equity to find creative ways to deal with the lack of debt and emphasized that private equity needs to be highly selective in these times. **Brian Wardrop of ARX Equity Partners** envisions a greater role for mezzanine finance due to banks' changed incentive models.

Johan Bastin of Darby Private Equity sees local banks still willing to provide senior debt, although they are considerably more selective and focused on defensive factors. With respect to the post-crisis leverage ratios, Bastin said, "In 2007 six became the new five and now four is becoming the new six." Additionally, covenants have come back in fashion and equity kickers are no longer anathema. Bastin stated that he is much more interested in credit quality these days, "even at the cost of lower returns than could be realized elsewhere in the market."

Other speakers highlighted developments in the region that may result in new investment opportunities. According to Penta Investment's Hascak, many family companies purchased out of privatizations are facing succession issues. He observed that private equity houses with local offices and knowledge can exploit the opportunities created by these changes.

Anticipating increased interest from private equity in distressed investments, a panel of experts from **Squire Sanders** emphasized the importance of conducting speedy due diligence of financially troubled companies. "Review the metrics of the business and do not get hung up on minutiae as time is of the essence", advised Squire Sanders partner **Kevin T. Connor**. As bankruptcy financing options are extremely limited in CEE, the panel advised that acquiring a target prior to entering into formal insolvency proceedings is "critical." Additionally, acquirers of distressed companies should restrain themselves from bidding high early in the process. Squire Sanders partner **Tomasz Z. Ujejski** recommended reserving sufficient resources to outbid any later bidders that directors may seek to include in order to satisfy directors' duties to maximize share price.

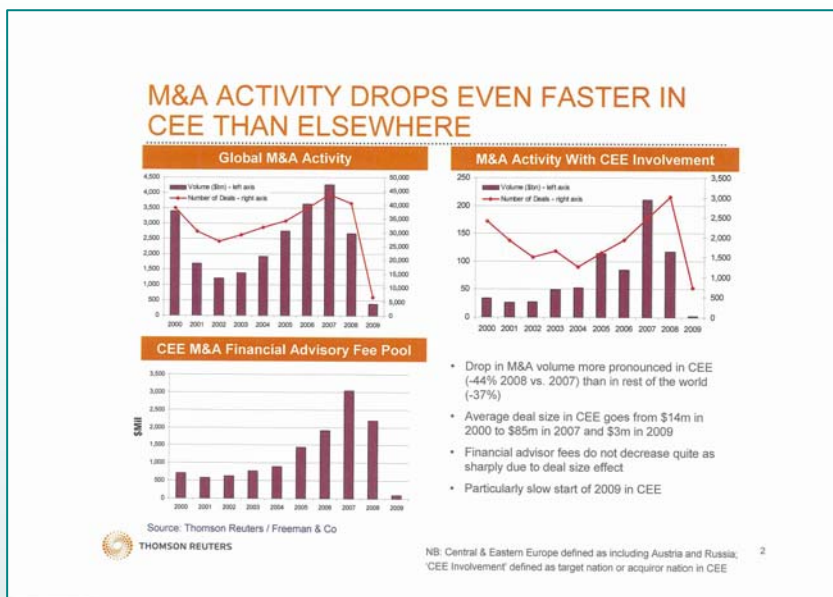
Discussing exits, Manz of Enterprise Investors does not expect conditions to improve substantially until 2010.

"We're living in unprecedented times, which means there are no definitive answers on how private equity will fare in the economic landscape being reshaped by the global financial crisis," concluded Squire Sanders' Kevin Connor, chairman of day one of the Forum. "But we do know that private equity thrives when the stakes are high and the odds are long. Our best practice now is to explore all opportunities and make the most of them."



WHAT THE NUMBERS SAY

Below is a sampling of the statistics that were shared by the speakers in their presentations. Thank you to David Bernard of Thomson Reuters, Nikolaus Bethlen of Mid Europa Partners, Henry J. Owainati and Hannes Ambacher of Bank Gutmann Group, Joanna James of Advent International and Brian Gimotty of Paul Capital Partners for permitting us to include these in our event summary.



EUROPEAN PRIVATE EQUITY FUND PERFORMANCE AS OF 31-DEC-2008

	Since Inception	3-year IRR	5-year IRR	10-year IRR	20-year IRR
Early Stage	-1.1%	-1.7%	-0.2%	-2.4%	-1.1%
Balanced	3.3%	1.7%	2.7%	0.6%	3.3%
Development Stage	7.4%	0.3%	4.2%	3.7%	7.4%
All Venture Funds	3.1%	0.0%	2.1%	0.4%	3.1%
All Buy-Out Funds	14.2%	8.5%	14.1%	13.3%	14.1%
Generalist	9.1%	5.5%	7.9%	8.0%	9.2%
All Private Equity	10.3%	6.3%	10.5%	9.3%	10.4%

Based on cashflows from 1314 funds

Source: Thomson Reuters / EVCA



New Issuance Equity Markets Effectively Shut...

Equity markets are effectively shut – sellers have not yet adjusted expectations to reality while buyers staying away due to uncertainty

- Preceding period 2005-2008 were boom years for IPOs in emerging markets
- Current drought in equity issuance implies:
 - No near-term exit opportunities through the public markets for private equity owned companies
 - Possibly significant overhang when valuations recover – buyers' market extended beyond the current downturn?



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Difficult Near-Term Outlook for CEE Credit...

Credit will be hard to come by in 2009-2010, especially compared to the „easy“ money years. However, credit flow and economic growth expected to recover in 2011-2012

- Pace of reduction of credit expansion expected to be significant: Credit emission expected to be down 75% although some credit growth likely to remain, although no growth expected in Hungary and credit contraction forecast in Ukraine
- However loans to GDP ratios suggest credit contraction likely to be less severe than in Asia 1997-98
 - Wide discrepancies and only EU countries seriously affected are Hungary and Baltics
 - Solution to Asian crisis was contraction in lending and clearing out of bad debt, much akin to the present situation

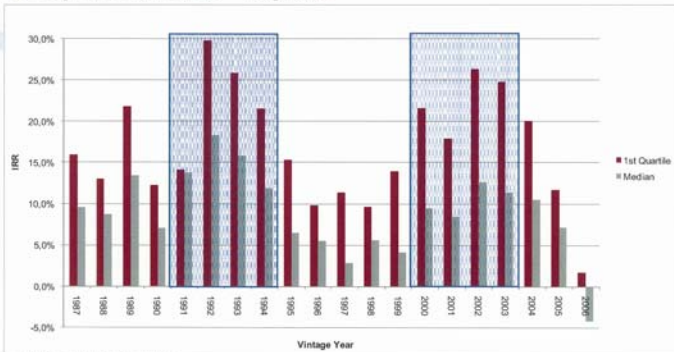


Source: Unicredit

Source: Unicredit

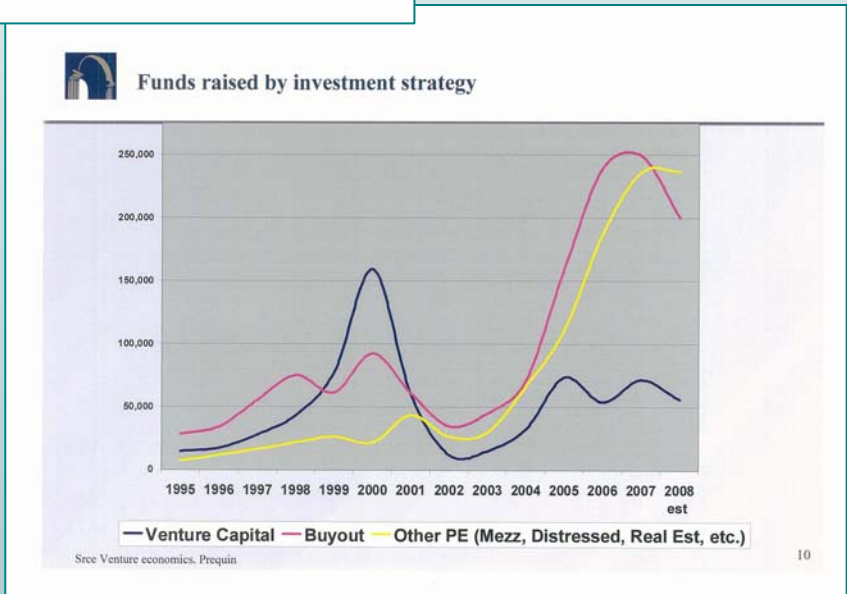
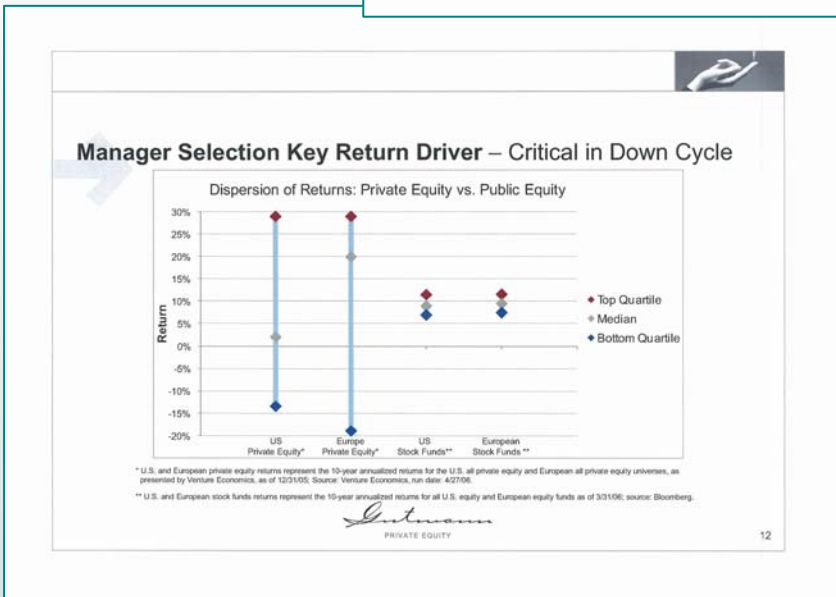
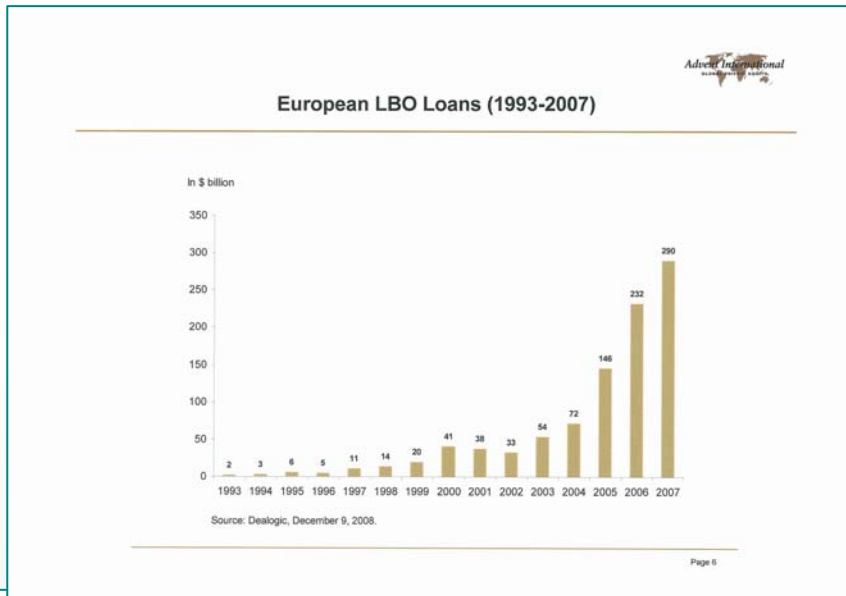
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Timely Investments – Buyouts



Source: Thomson, Bloomberg and Hamilton Lane

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About Squire Sanders

Founded in 1890, Squire, Sanders & Dempsey L.L.P. has lawyers in 32 offices and 15 countries around the world.

On the ground in seven CEE countries, and backed by the global expertise of our Emerging Markets Private Equity Group, our tightly integrated CEE Private Equity Team works together to seamlessly serve our clients' transactional needs – whether the deal is undertaken in one of our resident countries or across multiple borders.

We advise on all types of private equity investments and exits and have a deep understanding of the issues peculiar to key industry sectors including chemicals, communications, energy, food and beverage, financial services, hospitality and leisure, logistics and infrastructure, media, natural resources, real estate and technology.

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About C5

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