SECTOR ANALYSIS CASE FOR COUNTRIES

Private equity in the Czech Republic:
Deal flow remains steady, but market presents challenges.

Strategic deals remain limited by market's size. IPO market remains moribund.

Reprinted from **AltAssets.net,** 13 August 2008.

Source: **Michael C Alcamo and Marc P Baudry**, M.C. Alcamo & Co., Inc**.**

Private equity managers in the Czech market are seeing steady deal flow of smaller opportunities. However, the market provides a unique set of limitations, due its size and the legacy of the post-1989 path to privatisation. ***Michael Alcamo*** *and* ***Marc Baudry*** *provide a survey of recent private equity investment in the Czech market with lessons learned from 'best practices'.*

The first thing the Czech tour guide tells you is that Prague is farther west than Vienna. This typically poetic Czech metaphor is meant to remind you that the nation "faces west" for its economic and cultural references, seeking the entrepreneurial energy and transparency of the free markets. Unstated of course, is the Czech determination to throw off the lethargy of a communist past.

While the metaphor is correct as a matter of geography, in reality, Czech financial markets remain a region of risk and uncertainty. Smaller companies have a constant need for capital for growth and consolidation; private equity has thus encountered a steady stream of profitable, smaller opportunities. However, the unwary may nonetheless encounter a set of structural challenges in this dynamic market.

Background, 1989-2004

The most important limiting factor in the Czech market is its size. The Czech Republic is about as large as South Carolina, and its population is about one-fourth that of Poland. Czech GDP was roughly $225 billion last year. By comparison, U.S. corporations Wal-Mart (revenue $387 billion) or ExxonMobil (revenue $389 billion) are each more than 50% larger than all of the income-producing power of the entire Czech economy.

The second important parameter is that the country still has a financial and legal infrastructure that is under development. Czech retail investors, moreover, still hold unhappy memories of the post-1989 period of privatization. The process was relatively haphazard and rife with corruption or "tunneling" of mutual fund assets. Regulators were unable to bring to justice the many corporate raiders; investor confidence in the public markets was shaken for a generation, and remains low.

It's useful to remember as well that the "Velvet Divorce" of January 1, 1993 separated the Czech and Slovak regions for political (and monetary), purposes. This had the effect of weakening the relative strategic importance of the former Czechoslovakia, which had gained its independence in 1918 after a private appeal to Woodrow Wilson. Today, the Czech Republic (comprising the provinces of Bohemia and Moravia) is the more dynamic of the two countries.

Recent developments, 2004 to present

In recent years, it was thought that the Czech Republic's accession to the EU in 2004 would lead to stunning economic growth, and attract massive amounts of foreign investment. In fact, the increasing rate of investment can be seen in the steadily appreciating Czech crown, but EU accession has yet to lead to business transformation.

Today, unfortunately, the European Private Equity and Venture Capital Association ranks the Czech Republic as among the three worst tax and legal environments for the development of private equity and venture capital among all European countries. The slow pace of reforms has continued to hinder the Czech Republic's economic growth and its appeal for foreign investors.

For example, investors should recall that western-style accounting is a relatively new concept. Prior to 1989, Czech accounting did not recognize concepts for "depreciation" or "amortization" because "profit" was not a priority under communism.

Instead, the system had a lot of rules for tracking inventory. An accountant once explained to us that, under communism, it was more important to make sure that people did not walk off with the inventory than to track something inchoate like "profit".

Even today, the larger Czech companies will run two separate sets of accounts: one under Czech GAAP (required for tax purposes) and the other under IFRS/IAS for purposes of reporting to any foreign parents and investors, for consolidation under IAS.

Moreover, for 45 years as well, banks were not seen as lending institutions, but as vehicles for state subsidies. A "bank" was understood to be a firm that provided Czech industry with capital; it was not necessarily a firm to which one paid interest. Balance sheets in the late 1990s would typically list layer after layer of "loans" which really represented non-callable and non-payable monetary allocations from state entities.

Despite these historical challenges, the Czech market has important strengths. Czech professionals are highly educated, well-trained, and highly-motivated, and often hold engineering as well as business or law degrees. The country has made advances in training a new generation of enterprising business leaders, but change comes slowly.

Recent private equity victories appear to be coming from manufacturing or specialty companies launched after 1989. We are following eighteen private equity groups, many of whose fund sizes are less than E 150 million. Notably, several are the investment groups of individuals, such as PPF's Petr Kellner and KKCG's Karel Komárek; these sponsors are putting a substantial amount of private capital to work, thus lowering the agency cost of capital for outside limited partners that also participate.

Growth of Leveraged Finance Markets

The typical LBO model of an acquisition paired with leverage has been catching on gradually in the Czech market. For example, in November 2006, Mid Europa Partners raised €750m of senior and mezzanine debt to help finance its €1.19 billion deal for telecommunications firm Ceske Radiokomunikace a.s. Credit distress in western markets tends to have a disproportionate effect on emerging markets, however, and many investments in the East that would have been completed with leverage are now in the process of being reformulated.

Farther down the balance sheet, mezzanine financing has become increasingly available but does not appear to be meeting with widespread utilization. It is offered currently by most major banks, including CSOB, ING, and Erste Bank. While a more common instrument in the West, mezzanine finance frequently requires aspects of corporate governance to be limited by contract (prohibitions on the payment of dividends during the term of the investment, for example), and these can be novel concepts to borrowers in the Czech Republic, where shareholder action at an AGM or EGM usually trumps all other considerations.

In time, we expect mezzanine finance to provide an important, additional layer of available financing, but absent a well-developed tradition of the prompt enforcement of creditors' rights, we think it will likely remain of limited use.

Private Equity Activity

Private equity in the Czech Republic tends to focus on niche areas of specialized manufacturing, technology, and transportation. Investments tend to be smaller, and target companies might be fairly recent corporate spin-offs and may not have full management teams or audited financials; equity investing can have a venture capital nature to it. Investors have to be prepared for a higher level of involvement and supervision than they may be used to in the west.

The Czech Republic has seen substantial activity in several specific sectors:

- **"Web 2.0."** Notable in this area have been 3TS Partners' €28 million minority investment in Internet Mall a.s., MCI Management's acquisition of Invia.cz, the

Czech Republic's largest online travel retailer, and the sale of the largest and third largest internet portals, Centrum.cz and Atlas.cz, to Warburg Pincus.

- **Energy.** Recently, for example, Penta Investments bought energy and engineering company TES Vsetín Ltd. and Kilcullen Capital Partners acquired a 96% stake in Tesla a.s.

- **Manufacturing.** From windows to cleaning supplies, this segment has represented the core of Czech private equity. For example, in February 2008, Jet Investment, acting through its investment vehicle Cerberus Capital, acquired a 68% stake in film foil producer Rolofol s.r.o. Nový Fund bought 80% of window manufacturer VPO Protivanov a.s. Benson Oak bought electrical appliance manufacturer ETA a.s. and cleaning supplies company Bochemie s.r.o.

The larger global private equity groups will most likely continue to allocate their capital to larger markets. Warbug Pincus's Joseph Schull recently told The Financial Times in April this year that "A large firm that needs to invest $500 million per transaction will struggle for the foreseeable future in central and eastern Europe." Yet even as investment slows in other regions, we forsee steady growth and investment in the CEE zone.

At the same time, small funds can find many Czech opportunities. In April, 2008, Franz Hoerhager, who looks after the Czech Republic for Mezzanine Management, told the Financial Times that "In the medium-sized transactions, we don't see any slowdown in activity."

Strategic and Financial Exits

In the Czech market, private equity funds generally seek to steer their portfolio businesses toward sales to strategic purchasers, as the Czech public markets have been relatively moribund for some time.

Growth and activity on the Prague exchange are hindered by several factors. First, listed Czech companies are still considered to be too small to elicit the interest of institutional investors. Second, and equally important, non-Czech investors lack confidence in both the transparency of financial reporting and in the predictability that public company managers will maximize shareholders' interests.

Moreover, the Warsaw Stock Exchange has recently created a small-company platform, "New Connect Exchange." The PSE saw only two IPOs last year, a mere fraction of the 81 IPOs public listed in Warsaw during the same time.

An analyst at Atlantik FT in Prague, Milan Vanicek, told The Prague Post last August that the lack of IPOs was "due to low interest rates which make bank loans accessible and affordable" while PSE spokesman Jiri Kovarik cited the "lack of a stock listing culture among businesses in the Czech Republic, the complicated structures of many companies, as well as the limited pool of suitable candidates due to the small size of the market" as further reasons.

In the west, a public listing carries with it the challenges of compliance costs and the difficulty of gaining liquidity for all of the shares held by the selling shareholder. However, market valuations in the East can often be high enough to support taking these steps. As of this writing, there are reportedly three Czech companies (two in the energy sector) preparing for a listing in Warsaw, not Prague.

While the PSE is ignored almost completely by most European financial investors, it continues to play a small role for domestic Czech investors. Activity on the PSE is dominated by a few firms, with energy giant ?EZ and Erste Bank comprising almost half the capitalization of the PX Index. ?EZ, moreover, with 2006 revenues of approximately $10.3 billion (about one-tenth of IBM's revenue), accounts for 50% of all trading on the PSE.

Active Private Equity Participants

A number of funds operate successfully in the Czech Republic, ranging from international private equity firms to local investment teams to bank-sponsored groups. While sector specialization is rare because of the small market size, some investors deliver superior gains by concentrating on niches: for example, **KKCG Investments** focuses on investments in the tourism, media, and real estate sectors.

And, notwithstanding structural constraints, 2007 and 2008 saw some important private equity activity and some notable successes for investors.

In November 2007, **3TS Capital Partners** launched its new venture capital fund, the 3TS-Cisco Growth Fund III, to target investments in the technology and media sectors. In May 2008, in conjunction with Intel Capital, 3TS made a € 28 million investment in Internet Mall a.s., a major regional online retailer, the latest in a series of recent acquisitions of Czech internet companies.

Global private equity group **Advent International** opened a Prague office in 2007 to capitalize on the growing number of opportunities in the country. Advent increased its CEE deal team in 2007, bringing on Albena Vassileva, formerly a senior investment manager at ABN Amro, as a Prague-based Principal. In 2008, Advent closed the fundraising for its fourth CEE fund, Advent International ACEE IV, at a monumental €1 billion. And that's in Euros… real money…

Arca Capital focuses on private equity and venture capital and is led by investor Pavol Krúpa. Headquartered in Slovakia, Arca has offices in the Czech Republic, Ukraine, and Great Britain. Arca's major investment sectors include engineering, energy, information technology, and biotechnologies. Arca realized ten investments in the past two years, eight in the Czech Republic alone. In 2007, Arca acquired a 30% stake in Kasa.cz s.r.o., a Czech online sales company for €1.2 million, with an option to purchase another 30%. Arca was also part of a €20 million buyout of Czech food company Marila Balirny, a.s. in 2007, a significant deal for a group that targets the range of €500,000 and €10 million.

ARGUS Capital Group has been active in Central and Eastern Europe since 1997. It has employed a typical buy-and-build strategy with success. For example, Argus built the top multiplex chain in the Czech Republic, Slovakia and Hungary starting with its 1999 investment in Czech startup Palace Cinemas B.V..

Arx Equity Partners is the spin-off of DBG Eastern Europe, effective May 2008. The enterprise opened its first office in Prague in 1998 and has since expanded throughout the region. Prague Investment Director Tomas Lansky said that the Czech market is viewed as being "less fashionable than say Poland or Romania," but he is confident of superior deal flow and investor returns.

Arx's Czech investments have been opportunistic, with its latest investment made in 2006, highlighting the still-limited quantity of deals in the Czech market. Arx went to the market in May 2008 to raise a third fund, ARX CEE III, with a target of €125 million for further investments in the CEE.

In August 2007, the international private equity group **The Carlyle Group** established a Warsaw-based CEE team, headed by Ryszard Wotjkowski, who joined from Enterprise Investors. The team also includes Janusz Guy, Managing Director, Aleksander Kacprzyk, Director and Piotr Nocen, Director. The team's focus is on the EU accession nations in the region. We understand the team has several important deals in the pipeline.

In April 2008, the U.S. private equity group **Cerberus Capital**, through its Austrian banking subsidiary BAWAG P.S.K. sold Czech unit to German bank Landesbank Baden Württemberg (LBBW) for approximately € 160 million.

Czech and Slovak mainstay **Genesis Capital** has been working in the market since 1999. It targets investments of €1 million to €3 million. Genesis is a middle market affiliate of Advent International. Its managers supervise the €30 million Genesis Private Equity Fund covering the Czech and Slovak markets. The group is currently fundraising for a new €60 million Czech fund.

Genesis has had three notable transactions in the last two years. In April 2007, it acquired Czech cleaning company Nový úklid a.s. In December 2007, it acquired truck container company CTS-Servis, and in 2007 it organized the leveraged buyout of Roltechnik s.r.o., a manufacturer of bathroom fixtures. The Roltechnik transaction also involved Austrian group Invest Equity as a co-investor. Roltechnik had 2006 sales of approximately CZK 343 million (€12.1 million). It employs 130 people and focuses on Central and Eastern European markets.

Vienna-based **Invest Equity** has been an active middle-market investor since its founding in 1998. While the firm's primary target market has been Austria, its newest fund, the Greater Europe Fund, also focuses on neighboring EU countries such as the Czech Republic. Invest Equity was a co-investor with Genesis in the Roltechnik s.r.o. deal.

The **Karel Komárek Capital Group** is the investment group of Czech entrepreneur Karel Komarek. The group administers nearly CZK 7 billion in assets (€293 Million). KKCG holds stakes in several leading Czech companies, including the CK Fischer Travel agency, Grossmann Jet Service s.r.o., the publishing group Stanford a.s., (owner of the *Czech Business Weekly*), and Javien Digital Payment Solutions Inc.

In May 2007, KKCG acquired a 6.5% stake in Unipetrol a.s., a Prague-based petrochemical company, and sold the holding in September to Slovakian J&T Group.

Belgian banking group **KBC** has long been active in Central Europe. KBC Private Equity, the group's investment arm, has over 70 active investments, including stakes in Hungarian toy company Gulliver Group and Polish scooter distributor ZIPP Sp. z o. o. **Enterprise Investors**, primarily a Polish group, owns stakes in Slovak transportation company STD Donivo and Baltic tour company Novaturas.

Based in Prague, **Kilcullen Kapital Partners** has made several recent Czech acquisitions. In April 2007, the group became a majority shareholder in automotive components manufacturer TNS Servis s.r.o. In December 2007, it acquired a 96.8% stake in Czech engineering company Tesla a.s.

MCI Management is a Polish-based regional group managing three investment funds: MCI TechVentures, MCI BioVentures, and MCI EuroVentures. While Poland remains the group's primary market, MCI recently made several significant acquisitions of Czech "Web 2.0" companies. In June 2007 the group acquired a 51% stake in Geewa s.r.o., a prominent gaming and online network company. In May 2008, MCI acquired a 50.1% stake in Invia.cz, a Czech E-tourism portal, and is currently planning for an IPO on the Warsaw Stock Exchange.

Penta Holding's investment arm, **Penta Investments**, was created in 1994 to focus on the Czech, Slovak, and Polish markets. In May 2008, the Czech competition authorities cleared Penta's acquisition of Czech engineering and energy group Tes Vsetín, Ltd.

PPF Investments is the investment group of Czech PPF Group, led by billionaire Petr Kellner. Kellner began investing in the Czech markets shortly after the first wave of privatizations took place in 1992; he currently ranks #91 on Forbes' list of billionaires with a net worth of $9.3 billion. PPF Investments targets the CEE, Russia, and China. In March 2008, the group reported a realization on its successful sale of Czech IT company Vegacom a.s.

Quinlan Private is an Irish-based international private equity real estate group. It has made several significant investments in the Czech Republic, including its €60 million 50% stake in the Palac Flora mall, a major fixture of the Vinohrade district in Prague and it is developing the Most City Centre Its team is hard at work sourcing more Czech opportunities. Quinlan recently raised €725 million from US, Irish, and UK investors for the Quinlan Private European Strategic Real Estate Fund, resulting in nearly €2.5 billion in investment capital. Last year's sale of the Charles Square Center building in Prague for €90 million yielded a €34 million profit for the group.

Riverside Europe Fund has had a team in the Czech market for nearly ten years. It owns computer books publisher Computer Press a.s. It also owns MK Zary Sp. z o.o., a Polish chimney producer, and Diatron, a Hungarian hematology products company. Riverside Europe closed its third European fund in July 2007, with €320m, exceeding the fund's €250m target. The group focuses on the smaller end of the middle market. The partners report that by the end of November 2008, Riverside Europe Fund III will be 80% invested.

Investment group **RPG Industries** had an important exit in 2007 when its portfolio company, the coal and energy holding firm New World Resources B.V., was listed on the London, Prague, and Warsaw stock exchanges. The flotation raised €1.65 billion, yielding the company a market capitalization of about €4.4 billion. It was Europe's first private equity-backed flotation of 2008 and one of Europe's larger IPOs to date.

Summary

It would truly be remarkable if the state of South Carolina were to yield even a fraction of the private equity opportunities that we noted above. For managers who know how to turn over stones, therefore, the Czech private markets present dynamic growth opportunities. Smaller funds (under € 200 million) actually hold a strategic advantage in this market, because they can maneuver rapidly to take advantage of these smaller opportunities.

Institutional investors may wish to seek exposure to a seasoned fund group, with a good track record of attracting opportunities, navigating the unusual business and law environments, and guiding portfolio businesses toward profitable exits.

[continued…]

Moreover, given the size limits of the market, Czech fund managers should do what they can to offer their LPs valuable co-investment opportunities. When an institutional investor can balance the relative stability of a portfolio of GP positions with several higher yielding direct investments, the Czech market can offer superior returns.

Michael Alcamo *is President of* ***M.C. Alcamo & Co., Inc.****, a New York-based investment bank.* ***Marc Baudry*** *is an associate at the firm. The firm works with institutional investors and business owners in the United States and in the emerging markets. From 2005 to 2008, Mr. Alcamo was president of Baltic Investments Limited, an institutional fund that has recorded four successful exits from real estate and corporate investments in Central Europe. More information at www.mcalcamo.com*

Click here to view "2007-2008 Summary of Major Investments in Central and Eastern Europe" (pdf 55KB)

You need Adobe Acrobat to read this document. If you do not have it, you can download it free from www.adobe.com/products/acrobat/readstep.html