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Master Thesis

Leveraged Buyouts in Central and Eastern Europe

Relationship Lending and its Impact on Leveraged Loan Terms

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Declaration of Authorship

Hereby I declare that I compiled this thesis independently, using only the listed resources and literature.

Prague, May 16, 2010 Ingrida Malatinská

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I would like to thank all who supported me during writing this Thesis - either at an academic level or emotionally.

Abstract

This Thesis complements existing literature in two main research areas: First, the Thesis provides a comprehensive overview of the evolution of leverage lending in the CEE region, describe loan structures which are common in regional deals, analysis of size and volume of CEE deals follows and special attention is paid to current trends and changes associated with the impact of financial crisis on the LBO market in CEE. Second, the Author analyzes the impact of tighter relationship between a private equity firm and a lending bank on terms of European syndicated LBO loans provided by the bank for financing an LBO transaction from 1995-2005. The main finding of this analysis unveiled that banks with stronger long lasting realtionship with private equity firm tend to charge higher interest rates on LBO loans. This supports the exitence of theoretical concept called a hold-up phenomenon and its stronger presence in Europe compared to the USA.
Key words: Private equity, Leveraged buyouts, Bank debt, Relationship lending

Abstrakt

Tato práce obohacuje existující literaturu ve dvou oblastech. Práce poskytuje komplexný prehled o vývoji dluhového financování LBO transakcí v regionu strední a východní Evropy, popisuje dluhové struktury specifické pro regionální transakce, analyzuje objem a množství LBO transakcí a speciální pozornost je venovaná soucasným trendum na trhu a zmenám vyvolaných vlivem financní krize. Na datech Evropských syndikovaných úvéru z let 1995 až 2005 autor taktéž analyzuje vliv užšího dlouhodobe trvajícího vztahu mezi private equity firmou a bankou na úrokové sazby úverú poskytnutých na financování LBO transakcí. Analýza odhalila, že takovéto úvery nesou vyšší úrokové míry, což podporuje existenci teoretického *hold-up* konceptu a jeho silnejšího zastoupení v Evrope v porovnání s USA.
Klícové slova: Private equity, Leveraged buyouts, Bank debt, Relationship lending

"I must be cruel, only to be kind."

William Shakespeare, Hamlet, Act 3, Scene 4

("Undoubtedly written about the private equity industry, to compare vintage years 2006 – 2008 with years 2009 – 2010").
NB Alternatives Advisers [2009, p.1]

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Chapter 1

Introduction

There is no doubt that leverage has become a standard feature in private equity deals on a global scale. In Europe alone, the value of leveraged buyout transactions reached almost EUR 120 billion in 2006 (Private Equity Insight). Until the crisis hit all parts of the financial world, private equity firms were raising billion-funds to seize the opportunity of acquiring a company with relatively small amount of equity and significant portion of debt.

Increasing competition between European banks and expansion of institutional investors such as CDO and CLO managers or hedge funds pushed the pricing of loans down. Moreover, traditional layers in leveraged deals, equity, debt and mezzanine, were accompanied by new emerging structures such as second lien and PIK notes. In the boom years, covenant-light structures became a standard in the market. However, this situation has changed in the post-crisis era and private equity houses were forced to redirect their strategies and to adapt to changing deal-making environment.

The CEE region was not an exception. The time when international private equity houses were opening their local offices in the region i sover, raising new funds became extremely difficult and leverage turned out to be a scarde commodity. The history of leveraged buyouts in the region is relatively short compared to Western Europe. Before 2003, banks were not comfortable with leverage lending from several reasons. First of all, after the privatisation process took off, stabilization of existing loan portfolios and basic operations was the first step on the agenda. Only afterwards a potential for leverared buyouts lending could emerge. An EU accession played a significant role as well and though the level of CEE leveraged buyouts has never reached the level of those in Western Europe, leverage has found its standard place in regional buyouts and their volume exceeded EUR 4.5 billion in 2007 (Private Equity Insight). Since leveraged transactions represent an important part of private equity market, it is of high interest and importance to fully understand their nature and the way they are structured in different parts of the world.

This Thesis has two main goals, both unique in their nature. First, the Author's aim is to provide a comprehensive overview of the evolution of leverage lending in the CEE region, describe loan structures which are common in regional deals, analysis of size and volume of CEE deals follows and special attention is paid to changes associated with the impact of financial crisis on the LBO market in CEE. In order to emphasize main differences between the Western European LBO model and the CEE LBO model, description of overall European leverage loan market complements the analysis and direct comparison to situation in the CEE market is provided. Although there is a number of articles discussing situation in the CEE LBO market, to Author's best knowledge, there was no in-depth study on this matter dedicated to CEE region in existing literature yet.

Second, the Author analyzes the impact of tighter relationship between a private equity firm and a lending bank on terms of syndicated loan provided by the bank for financing an LBO transaction. Before the process of an LBO transaction starts, private equity firm establishes a contact with particular bank which expresses interest in participating in a proposed deal and which offers the best loan terms possible. It is of high interest to study what determinants influence terms imposed on these loans. There has been a lot of attention paid to relationship lending in the recent research, both theoretical as well as empirical. The majority of literature available focuses on analyzing relations between the bank and the target company itself. The Author argues however that sponsor of an LBO transaction (the private equity firm) and its repeated interaction with the lending bank can influence resulting terms of the contract. To prove the proposed hypothesis, the Author collected uniqe data set on European syndicated LBO transactions ranging from 1995 to 2005. To Author's best knowledge, this is the first study which uses data on European syndicated LBO loans with an aim to assess the impact of above described relationship structures on loan interest rates. Initially, in order to restrict all parts of this Thesis to the CEE region, only CEE specific syndicated loans were taken into consideration. However, the number of CEE LBO deals recorded by the database was very limited and such analysis would suffer from biases. From this reason, the range was broadened to all European LBO transactions.

To understand the process behind leverage buyouts and structure of loans provided to finance such transactions, Chapter 3 provides theoretical insights to LBOs. The forth chapter is dedicated to CEE LBO market. It starts with broader overview of private equity in the region and continues with description of main exit channels used by investors to divest particular investment. Analysis of emergence of leverage in the region follows with overview of deal structures, value and volume with insights to impact of the financial crisis provided in each subsection. Chapter 5 is dedicated to study the impact of relationship between private equity firm and lending bank on European syndicated loan interest rates. The last chapter summarizes and concludes findings from the whole Thesis.

The introductory chapter which is dedicated to theoretical insights into the world of leveraged buyouts (Chapter 3) does not provide an overview of literature dealing with the same topic. Though such academic research listing at the beginning of a thesis is a common practice, the Author decided to follow a different approach: relevant literature is cited through the entire Thesis and special section dedicated to literature overview is provided in Chapter 5.

In next section, the Author describes main sources of data used in this Thesis more in detail.

Chapter 2

Methodology

Private equity market, especially it's lower- to mid-market part which is characteristic for the CEE region, is known for the lack of transparent information about funds and deals executed. Target firms are mostly private companies without publicly disclosed financial statements and funds themselves have small incentive to provide such information to the public.

In order to provide the most reliable statistics possible, the Author employed several sources of information in this Thesis: Thomson Reuters LPC Dealscan database, Thomson One Banker database, Private Equity Insight database, EVCA papers and yearbooks, survey conducted by European Central Bank in 2007 and survey conducted by the Author (terms *Survey* and *Survey results* are used throughout the Thesis and both refer to the survey conducted by the Author, see description below).

Description of main sources of data follows:

Thomson Reuters LPC Dealscan Database (Dealscan) Dealscan is an extensive database owned by Thomson Reuters covering more than 220,000 global loan, high-yield bond and private placement transactions to date. The majority of data available were gathered from commitment letters and credit agreements from SEC filings. In recent years, information collected via relationships with major banks and from news complement the existing database. The database tracks deals from

1988 (for specific coverage even from 1981) and provides users with access to deals detailed terms and conditions. Dealscan focuses primarily on deals from the USA and Western Europe, therefore the use of his database for the purpose of this Thesis was quite limited. The Author used information from the Dealscan database to collect data on European syndicated LBO deals in order to analyze the impact of relationship banking on loan pricing (see Chapter 5).

Thomson One Banker Database Thomson One Banker is used primarily by investment banks as an analysis tool and source of critical information such as quotes, earnings estimates, financial fundamentals, market news, transaction data, corporate filings, etc. For the purpose of this Thesis, information about private equity companies and funds they raised was of the highest importance. Information about fund sizes was used as one of independent variables in the regression analysis in Chapter 5.

Private Equity Insight Database Private Equity Insight is a database created by market researchers from private equity journal *unquote"*. The database focuses specifically on private equity fundraisings and deals in Europe from 1990 onwards. The database provides users with information on GP portfolios, industry trends and analysis as well as market activity in specific regions and industries. Focus of the databasis lies on the Western part of Europe which the Author consider to be a shortcoming for the proper assessment of the LBO market activity in CEE. Moreover, data collected from the database used for creating charts might differ from data collected via other sources of information, such as news articles and other industry research papers.

EVCA The majority of statistics available for private equity funds activity in the CEE region are provided by EVCA. This institution brought together a special team, *Central and Eastern Europe Task Force* in 2003 with an aim to develop and promote private equity and venture capital in the region. The platform conducts an analysis of private equity market in the CEE region on an yearly basis since 2003. EVCA statistics provides information on overall private equity market in Europe as well as specifically in the CEE region. Fundraising activity, investment activity in particular segments and countries as well as exit environment are covered in the EVCA papers and year books. Consistently with EVCA, CEE countries include Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia and Slovenia.

Large Banks and Private Equity Sponsored LBOs in the EU The study conducted by the European Central Bank in April 2007 was carried out with an aim to assess the degree of large banks involvement in LBOs within the EU. Furthermore, the European Central Bank wanted to better understand potential financial stability implications which could rise from such involvement. The survey included a set of qualitative as well as quantitative questions and 30 banks domiciled in the EU together with 11 non-EU financial institutions were selected upon their size and relevance. From the group of non-EU banks, only their activities conducted by affiliates in London were considered. The sample of this survey covered only large banks with total assets over EUR 80 billion. Since the results of this survey provide very informative overview of European LBO market and the manner in which EU LBO deals are carried out, the Author of the Thesis has decided to use key findings thouthough the Thesis.

Private equity in the CEE region (Survey) As a part of this Thesis, the Author decided to conduct a survey among private equity firms in the V4 region. The aim of this Survey was to show the investors appetite within the region in a direct manner and their expectation about future development of private equity industry, specifically LBO market, in the CEE region. This Survey comprised of quantitative as well as qualitative questions submitted to 41 participants, out of which 29% replied. Participants were chosen according to their stage of investments - venture capital investors and business angels only were omitted from this survey, only those investors with strategies in the later stages of development were identified as suitable participants. The survey has been conducted electronically in December 2009 and January 2010. Results of this Survey are provided through the entire Chapter 4. See Section A in Appendix for characteristics of Survey participants. In order to make it easier for reader to distinguish between charts constructed from the Survey results and charts created from other sources, the Author decided to use different formatting for Survey results.

Interview In order to obtain information about CEE LBO market activity and development of debt structures in the region from market insiders, the Author interviewed an Investment Director at Prague-based private equity firm. The knowledge gained from this interview was leveraged throughout the Thesis.

Chapter 3

Theoretical Introduction to Leveraged Buyouts

3.1 Introduction to Private Equity

Private equity[1] is an alternative asset clas, which has gained on importance as a part of global financial markets - especially in the last decade. Committee on the Global Financial System estimates that *"as of 2006, there were 2,700 private equity funds, which accounted for 25% of global mergers and acquisition activity, 50% of leveraged loan volume and 33% of the high-yield bond market."* (CGFS [2008, p.5]) Metrick & Yasuda [2009] state that private equity firms manage approximately USD 1 trillion of capital worldwide. Private equity attracts investors with its returns and diversification benefits that claim (in average) to outperform investments in publicly traded eq-

[1]CVCA stresses that the term *private equity* may have different meanings - according to some definitions private equity describes only buy-outs and buy-ins; alternatively the term may be a synonym to *venture capital* in some European countries - in opposite to the USA where the term *venture capital* describes only investments into start-ups or emerging companies. Private equity may also be a term covering the whole industry - which is the case throughout this Master Thesis.

uity[2]. There are nowadays thousands of private equity firms that specialize by segment (from angel stage to large buy-outs and buy-ins), geographies or industry focus. And what private equity firms basically do? They raise capital from investors, invest it subsequently in chosen companies, stay with the company for a couple of years and afterwards collect proceeds from an exit.

Noel [2008, p.3] defines private equity as *"equity capital invested in a (private) company for a significant period of time, through a negotiated process resulting in a shareholder agreement (this can involve debt leverage)."* EVCA further differenciates three subcategories of private equity: Venture capital, Replacement capital and Buyout (see Table 3.1 for a basic description[3]).

Since it is crucial for next section to understand how private equity firm works, the Author will describe this more in detail.

A private equity firm raises capital through a special fund - called *private equity fund*. This is organized as limited liability partnership where investors in the fund represent limited partners (LPs) and a private equity firm serves as a general partner (GP). Most funds are *"closed-end"* which means they have predetermined fixed life (usually ten years, but if the majority of shareholders agree, the life time can be extended). After the fund matures, GPs are obliged to liquidate all investments and return proceeds to investors.

GP manages the fund and the power or LPs in investment decisions depends on the fund's structure type. There are generally 2 possibilities. Either the decision power is concentrated in hands of the fund management or there could be an investment committee which decides on the final investment. This investment committee can have different structure, see below:

1. An investment committee is a mixed structure built-up from GPs and LPs. The final decision is then a compromise between investors and the management.

[2]Moreover, Masulis & Thomas [2009] argue that the main reason for such success is in corporate governance advantage of private equity over that of the public corporation. See Masulis & Thomas [2009] and GAO [2008] for further research

[3]For more detailed description see Sedláková [2008]

	Private Equity				
	Venture Capital • Young companies (start-ups) with low profits (if some) and minimal cash-flows (but with strong growth potential) • Transactions usually include high portion of equity			• Established companies with substantial profits and cash-flows • Transactions usually include high portion of debt	
Stages	**Seed**	**Start-up**	**Expansion/ Development**	**Buyout**	**Replacement capital/ secondary purchase**
Company age	1 to 2	2 to 3	3 to 5	5+	5+
Next step in a life of company	Develop and finalize initial business concept	Launch business activity and start selling the product commercially	Expansion and growth	Bring company to the next level	Bring company to the next level
Capital is used to	Finalize research and develop business plan	Finalize product and start initial marketing	Finance increased production capacity, new market or product development	Acquisition of business or business unit with new/existing management	Acquisition of a business from a private equity or other financial owner

Table 3.1: Description of PE stages
Source: Noel [2008, p.4], completed by the Author

2. An investment committee comprises only of investors. Fund management takes over a role of proposing new investment targets and the agreed majority of investors subsequently decides. In case the initially agreed majority of investors was not reached, an investment into the target proposed by the fund management can be refused.

However, the decision making process for particular private equity fund can have various forms depending on initial agreements with investors.

Common covenants include restrictions on amount of capital which can be invested in one company (typically this does not exceed 10% of fund's total committed capital in order to diversify the risk), types of securities fund can invest in or a portion of debt in the fund. Investors in the fund belong to various groups ranging from institutional investors (such as banks, insurance companies, pension funds, endowments etc.) to fund of funds[4], wealthy individuals (often called *high-net-worth individuals*), corporates or other institutions (see Figure 3.3)

In the first years of the fund life (usually first 5 - 6 years), GPs make capital calls or so-called *take downs* to LPs. This situation occurs if there is an investment opportunity. LPs are subsequently obliged to provide the required amount of capital within pre-agreed period of time, typically within 14 days. After the first large enough amount of capital is raised, private equity fund starts to invest in target companies.

Structure of an investment can vary from transaction to transaction - for buyouts, it is common to use substantial portion of an outside debt alongside with fund's equity (for detailed description of how leveraged buyouts work, see section 3.2.). This, on the other hand, is quite impossible when speaking about venture capital investments, since young start-ups have only little financial track record and banks are not willing to provide a debt financing for such transactions.

After an investing phase, next three years represent a holding period[5] in which the added value is created - strategic, operational and organizational changes are implemented in order to realize required returns on investement. Divestment phase follows and proceeds (net of fees and other costs) are distributed to LPs.

Private equity firm generally manages several funds which overlap in their life time. A new fund is raised 3 - 5 years after closing of the fundraising process for the previous fund. Such sequence of closed funds with their historical performance can serve as an important tool in a situation when an investor is deciding whether to invest in a fund or not. For this reason, GPs have a strong incentive to demonstrate good results in order to attract investors for their new fund (see Figure 3.1).

GPs are compensated in three ways:

[4] A fund which invests in other funds instead of investing directly.

[5] The holding period is longer for venture capital investments, usually up to five years

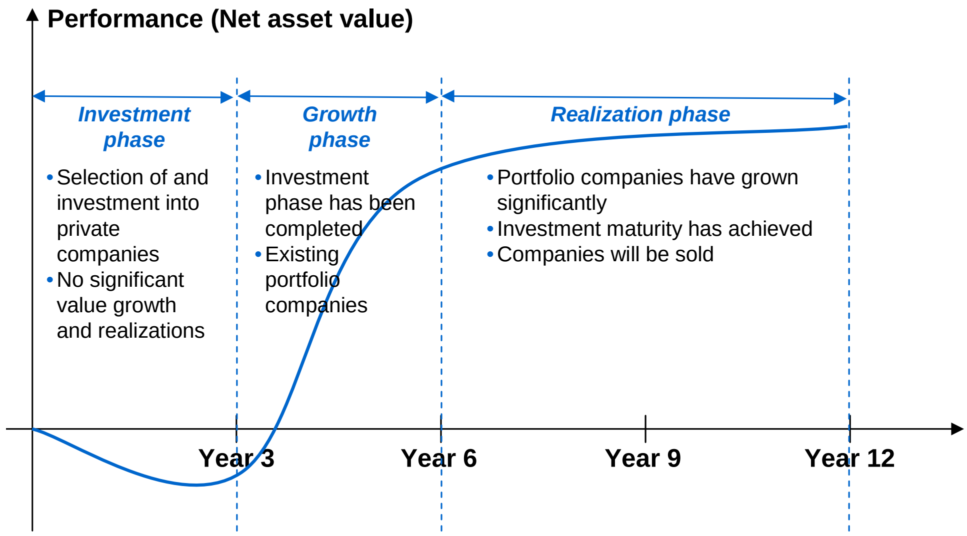

Figure 3.1: Private Equity Funds and Fund-of Funds go through a "J-curve" (12 years fund life is assumed)

1. They obtain a management fee which usually represents 1 - 3% of total capital committed and decreases with the life of a fund.

2. The second fee is a percentage of profits realized from the investments, so-called *carried interest* and represent 20% of all net gains. As EVCA [1999] stresses, carried interest often does not take effect until investors are repaid the invested money, plus some basic return on the investment.

3. Some GPs charge also deal and monitoring fees to investee companies.

Some critics question the positive effects of private equity investments. They say that *"funds' profits are driven by favourable tax treatment of corporate debt, inducing senior executives of publicly traded firms to accept deals that go against the interests of the shareholders"* (Lerner, Sorenson & Strömberg [2008], p.2). They argue that practices such as special dividends or *quick flips*[6] don't support a thesis about long-run incentive to create values.

[6] An IPO closly after a private equity investment

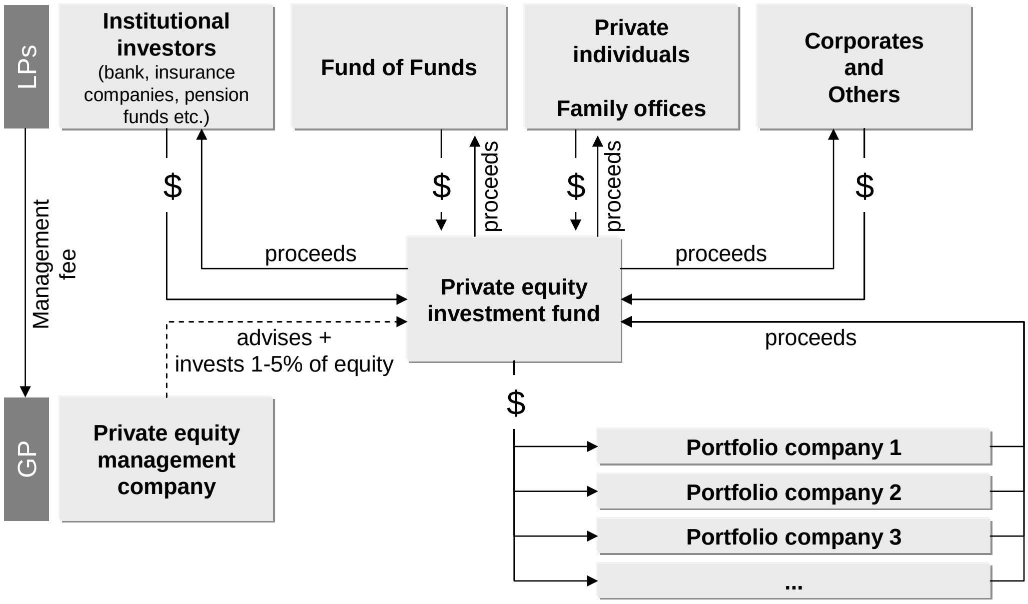

Figure 3.2: Typical structure of a PE fund
Source: Noel [2008], edited by the Author

3.2 What is a Leveraged Buyout (LBO)

A typical buyout transaction can be defined as a purchase of a controlling stake of a company or its subsidiary by a spacialized investment firm, while using relatively large portion of outside debt (a share of debt in such deals can be as high as 90%, but 65-70% is more common)[7].

Debt financing can have different forms - from traditional bank debt, bond offerings, seller financing to loan from specialized funds. Buyer's own equity constitutes the minor part of the total purchase price. Target company's assets and cash flow are used to support the loan payments and to provide a collateral. These leveraged buyout investment firms are known as private equity firms and the transactions represent the later stage investment category of private equity (Kaplan & Strömberg [2009], Gottschalg & Berg

[7]An example from 1983: debt to equity ratio in an LBO acquisition of Gibson Greeting Cards was 80:1

[2005], Blaydon & Wainwright [2006]).

Such LBO partnerships are considered to be long-term projects (usually lasting 10 to 12 years) where limited partners are obliged to participate until the end of the LBO fund's lifetime or until exit of all the investments were executed.

Debt used to finance the target acquisition can be either placed on the special purpose company set up by the LBO fund or directly on the target itself. Typical structure of an LBO transaction is depicted in the Figure 3.3.

Leveraged buyouts are not driven by expecting benefits from synergies of both acquiror and target firm, but rather by an intention to increase the value of the target beyond the purchase price (Baker & Montgomery [1994]).

History of LBOs as an important part of financial world started sometime in early 1980s[8] mainly due to favourable change in regulatory legislation. As Kaplan & Strömberg [2009, p.121] remark, Jensen in his work from 1989[9] predicted that *"leveraged buyouts would eventually become the dominant corporate organizational form"* thanks to *"concentrated ownership stakes, high-powered incentives for the private equity firm proffessionals and a lean, efficient organization with minimal overhead costs."* He argued that this type of corporate structure is superior over public ownership. Kaplan & Strömberg [2009] continue and claim that Jensen's prediction seemed to be rather premature at that time - junk bonds which dominated the debt financing used in the LBOs collapsed in late 1980s, a large portion of high-leveraged firms defaulted and had to file for bancruptcy. LBO market almost vanished in the early 1990s, but reappeared massively in the mid-2000s, when the LBO market got a second breath.

There are several reasons why leveraged buyouts are an attractive business for equity investors:

- Interest on debts is tax deductible (and thus a tax shield is created)

[8]Prior to 1980, capital inflows into private equity market represented less than USD 100 million per year (Masulis & Thomas [2009]).

[9]Eclipse of the Public Corporation, Harvard Business Review, 67(5): 61-74

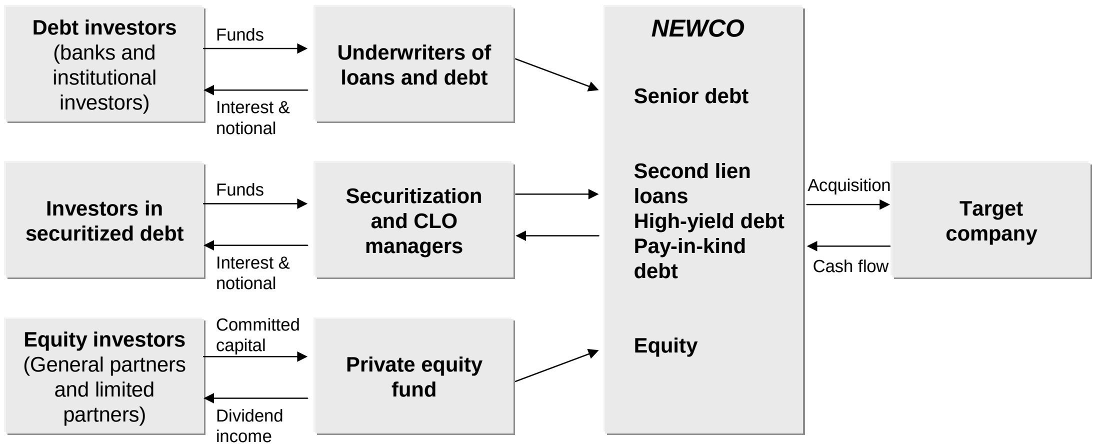

Figure 3.3: Typical structure of an LBO transaction
Source: ECB [2007], edited by the Author

while dividends are not

- In a succesful LBO, returns for an equity holder are very high, since the debt holders are locked into a fixed return

- Management of a target company has a strong incentive to increase the value of the acquired firm - whether it is an existence of debt (the necessity to pay-down interests and debt itself) or the fact, that managers of a target company usually participate on the transaction by subscribing for some portion of the equity

As the investment in the target company matures, an LBO fund will look for the most profitable exit route in order to maximize returns for equity investors. Typical exit strategies from LBOs are initial public offering, trade sale, secondary sale, buy-back, write-off and recapitalization, see Table 3.2 for further description.

When looking for an ideal target for LBO transaction, an investor has to consider several factors. Since the loan from bank will be repaid with the target's future cash flow, a proper due dilligence is necessary. Traditionally, more mature markets (such as utilities) ideally with assets deployable as

Exit strategy	Comments
IPO	Target's assets are offered to public investors via stock markets; the succes of this exit channel depends very much on the current stock market condition
Trade sale	Sale to a strategic buyer, a company which can benefit from horizontal or vertical integration; this exit route often brings higher business evaluation than IPO, since a strategic buyer is - in opposite to small shareholders - willing to pay a premium price
Secondary sale	Sale to another financial buyer, e.g. PE fund, which has strictly financial motives as opposed to a strategic buyer
Buy-back	Former seller is buying back the company; usually occurs when the target fails to meet the financial benchmarks agreed in the acquisition agreement
Recapitalization	Additional debt capital calls which increase the leverage ratio; There are several reasons for recapitalization: lack of financing for investment, need for additional cash to meet the obligations or covenants and cash flow needed to pay additional dividends to equity investors
Write-off	Least-desirable form of exit, because it means a failure of an investment

Table 3.2: Potential exit strategies for an LBO fund
Source: Author

collateral see more LBOs. However, a limited number of target companies in more stable industries with predictable cash flows is pushing investors to look at other markets. On the other hand, there is plenty of loan products offered by banks for LBO financing which are quite flexible and therefore make it possible for investors to invest also in targets exposed to cash flow swings.

3.3 Value Generation in Buyouts

Leveraged buyouts value creation has undergone several stages: from a common strategy of identifying inefficient and undervalued firms, executing leveraged buyouts and generating profits by breaking the targets up and selling off the pieces (that's why called *bootstrapping acquisitions*) to more sophisticated stragegies such as increasing an operating effectiveness.

Gottschalg & Berg [2005] summarizes six ways that determine the value generated in a buyout:

Financial arbitrage An additional value is created from differences between acquisition price and divestment price (buy low - sell high strategy); one can distinguish between financial arbitrage based on exogenous changes in market valuation ("multiple riding"), based on private information about the target ("insider information"), based on superior market information or superior deal making capabilities (e.g. negotiation skills)

Financial engineering Optimization of capital structure and minimization of after-tax cost of capital

Increasing operational effectiveness Optimization of left hand side of balance sheet - operating margins and cash flow (e.g. cost cutting and margin improvements, reducing capital requirements, removing managerial ineffectiveness)

Increasing strategic distinctiveness Redefinition of key strategic variables such as target markets, scale of products etc.

Reducing agency costs Increased leverage can lead to a decrease in agency costs through improved monitoring and controlling

Parenting effect A value is generated through parenting with a buyout firm - involvement of GPs, re-establishment of entrepreneural spirit etc.

Ivashina and Kovner [2008] add another source of value creation - an ability to borrow money on more favourable terms. They argue that a repeated interaction between LBO funds and banks creates an environment of confidence[10] and as a consequence, portfolio companies have an access to better terms for debt financing.

[10] Banks have acquired an important information about the LBO fund from the past transactions and due dilligence process which the bank subsequently re-uses in new terms negotiations.

3.4 Capital Structure of an LBO

Commited capital used to finance an LBO transaction is traditionaly comprised of 3 layers: senior debt, subordinated debt and equity. However, it is important to stress that the capital structure can vary from transaction to transaction. Other forms of debt are also known, such as second-lien loans or asset-based loans and securitizations, but they represent less common source of financing with some of them close to risk - return characteristics of equity.

Senior debt is the cheapest form of financing, the cost of capital of senior debt is the lowest among the three mentioned sources of capital. The reason lies in the fact that this type of debt is backed with the assets of the target company, i.e. if the company fails to meet the agreed obligations, the bank can acquire these assets. Thus, borrowers want as much senior debt as possible. This type of debt can have a form of several tranches, all first-ranking and *pari passu* with each other, but with different seniority, maturity and costs. ECB [2007, p. 11] charaterises the tranches as following: Senior A tranche/ Term loan A is the safest type of debt, and unlike the lower grade tranches B and C, is amortized over agreed period of time, usually 6-7 years. Tranches B and C are usually paid in a bullet in the end with no periodic payments made over time. Moreover, reflecting the higher risk involved, tranches B and C carry also higher interests.

Subordinated debt is subordinated in repayment to the secured debt and has higher risk profile (thus higher interest rates) than senior debt[11] which is compensated with higher expected return. The terms of subordinated debt are generally less stringent compared to senior debt.

One type of unsecured debt represents *high-yield debt*, also known as

[11] With this type of debt, providers may also request warrants to be provided as a compensation for higher risk. In some occasional situations, the transaction can be fully financed with the subordinated debt. This happens mainly, when there are few assets which can serve as a collateral, but the target company has predictable future cash flow.

junk bond. This financial instrument serves as a tool to increase the leverage beyond the level banks are willing to cover. It is a bond rated below investment grade (at a time of purchase) which offers higher returns (a compensation for higher risks) than investement grade corporate bonds. Depending on the rating agency, high-yield bonds usually have a rating of "BBB" (S&P) or "Baa" (Moody's).

Since 2003, new type of financing is widely used in the LBO financial structure - *second lien loans.* Hanrahan & Teh [2006] define this type of loan as *"term loan B secured by a lien on substantially all of the borrower's assets".* However, in case of bancruptcy or other circumstances that influence the life of a collateral shared with the first lien creditor, second lien creditor agrees to be repaid after first lien creditor's claims were satisfied. This type of financing offers a couple of benefits to the borrower - favourable terms on loan (since the loan is backed with the assets of the borrowing company), broader access to the lending market thanks to higher interest of institutional investors to invest in second lien loans or even the benefit of more stable investor profile because second lien lenders usually rely on the collateral provided by the borrowing company in the time of some financial distress.

Another type of loan structure - *mezzanine debt* is ranked in seniority behind both senior and high-yield debt. Mezzanine is a long-term financing product with a bullet payment at the end of maturity. It carries higher credit risk due to common equity-based options incorporated in the loan agreement, so the pricing lies somewhere between debt and equity with covenants looser than in case of senior loans.

Table 3.3 summarizes features of mezzanine financing compared to other financing products.

Payment-in-kind debt is relatively new financial instrument which took off in the time of easy money - in the pre-crunch era. This debt gives the issuer a right to either repay interest payments in cash or to *pay-in-kind*

	Senior Debt	Mezzanine	High Yield	Equity
Security	Yes – 1st ranking	Yes – 2nd ranking	Usually none	None
Ranking	Senior	Contractually subordinated	Structurally subordinated	Junior
Covenants	Comprehensive	Typically track senior covenants	Less restrictive, mostly financial	None
Term	5-9 years	6-10 years	7-10 years	Open ended
Cash Interest	Cost of funds plus 200 – 325 bps	200 – 300 bps above senior	300 – 600 bps above senior	None
Repayment	Amortizing from cash flow	Bullet at exit or maturity	Amortizing from cash flow	None
Warrants	None	Almost always	Generally not	Not applicable

Table 3.3: Comparison of mezzanine financing to other products
Source: Hoerhager [2007, p.6]

with issuance of additional debt or even to postpone these payments in some special situations. This type of financing is rather expensive with high interest rates as the PIK notes are usually unsecured or of highly subordinated nature. On the other hand, PIK bonds offer an investor a possibility to reduce cash payments in times when it's needed. TBD

Equity represents the riskiest form of capital. In case the target company defaults, equity stands in the very end of seniority queue, i.e. debt holders are prioritized before equity holders in the liquidation process. Usually, after all claims of debt holders are satisfied, there is only very little or even nothing left for equity investors who subsequently lose their invested money. On the other hand, equity investment bears the highest expected return.

Banks often privide so-called *bridge loans*[12], short-term loans which usually help to finance the period until long-term loans are issued (such as high-yield bonds etc.), i.e. they help to *bridge the gap* of cash shortage until next funds are raised. This type of financing is typical especially for larger deals and common features include relatively high interest rates as a compensation

[12]Also known as interim financing or gap financing.

for higher risks but on the other hand looser requirements for documentation. The loan is typically arranged in a short time and the maturity ranges between 3 months up to 1 year. Bridge loans represent a significant portion of European banks' LBO exposures (based on the survey conducted by ECB [2007], the portion accounted for around 10% of banks' LBO exposures).

This wide range of financing instruments opens new possibilities how to adjust the financing structure to fit needs of particular target acquisition or investor preferences. When speaking generally about seniority, it is more common to use bigger portion of senior debt and small portion of subordinated debt for smaller deals (which is the case of the CEE region).

Table 3.4 summarizes typical sources of capital for an LBO deal.

Type of financing	**Likely sources**
Secured debt	▪ Commercial banks, Credit companies, Insurance companies
Unsecured debt	▪ Public market, Insurance companies, LBO/Mezzanine funds
Equity	▪ Management, LBO funds, Subordinated debt holders, Investment banks

Table 3.4: Typical sources of capital for an LBO transaction
Source: Author

3.5 Banks as traditional lenders for LBO deals

Commercial banks represent traditional lenders for leveraged transactions. Kaplan & Stein [1993] showed that banks provided the majority of debt financing for buyouts during 1980s, mainly short-term and covenant-heavy loans and revolvers. According to Berlin & Mester [1992] and Smith & Warner [1979], LBO transactions heavily rely on this type of debt because concentrated ownership makes it easier to renegotiate loan terms. On the other hand, this is compensated with higher number of covenants or even with tighter and more restrictive covenants included in the loan agreement.

And because banks have comparative advantage in monitoring via tighter covenants, these covenants then serve as tools for lowering moral hazard problems (Demiroglu & James [2007], Rajan [1992], Diamond [1991]). Violation of covenants indicates changing behaviour of borrower and provides a first sign of potential risk shifting problems. Financing bank can subsequently punish the borrower by changing availability of credit or loan terms. Moreover, when the LBO transaction is financed mostly by senior short-term debt, an incentive for management to work harder is higher (Demiroglu & James [2007]). The management has to ensure that the company is generating enough cash and can not waste resources in the earlier stages of the LBO.

Nowadays, despite the growing power of institutional investors, banks still play a significant role in LBO financing. According to ECB [2007], surveyed banks accounted for nearly 50% of senior debt (provided in top deals) and almost 25% of subordinated debt. CDOs, hedge funds and CLOs were significant investors mainly in subordinated tranches of deals involving London affiliates of non-EU banks, whereas CDOs played more important role in deals reported by EU banks.

Financing of LBO deals is a very important business for banks since the scale of such transactions is generally beyond that of traditional clients. In 2006 alone, top 5 LBO firms paid close to USD 5 billion in investment banking advisory fees (DealLogic in Ivashina and Kovner [2008]).

3.5.1 Syndicated loans

Most of the loans provided for financing of LBO transactions are syndicated. A syndicated loan can be defined as a loan which is provided by a syndicate of lenders (banks) and is structured, arranged and administrated by a sole or several banks known as arrangers. Syndicated loans became soon after their appearance in mid-1980s very popular and are nowadays the dominant way for issuers to tap the loan market. In contrast to traditional bilateral loans, a syndicated loan is structured by a *lead* bank which then sells pieces of the loan to other participants (other banks). The rationale behind the massive popularity of syndicated loans lies in the fact that this type of loan is less expensive and less difficult to administer than the bilateral one or individual credit lines (Standard & Poor's [2008]).

The company which is raising debt capital via syndicated lending pays a fee for arranger's services. This fee depends very much on the complexity and the riskiness of the loan, eventually on the current market conditions. Traditionally, M&A transactions and recapitalizations will carry relatively high fees and thus, they represent lucrative business for banks.

The arranger of the syndicated loan serves as an administrator of the overall transactions. He is responsible for ex-ante due dilligence and ex-post monitoring of the borrower. As being already said, the arranger sells part of the loan to other banks, but he still retains part of the loan. This of course raises moral hazard concerns since after selling the loan to other members of the syndicate, the incentive for monitoring declines (Ivashina [2005]). Member of the syndicate then can be devided into two groups - lead (mandated) arrangers[13] and participants.

The specific nature of each syndicate depends on number of factors. According to Sufi [2007], the lead bank retains a larger share of the loan if the borrower is a risky one and requires more strict monitoring and due dilligence. Consistent with Sufi [2007], Bosch & Steffen [2006] showed that lack of transparency induces a mandated arranger to retain larger share and form smaller syndicates.

Syndicated loans are floated rate debt instruments with pricing above some reference rate (typically EURIBOR or LIBOR in Europe). The loans generally include number of covenants which enable the syndicate to control the borrower and his actions. The renegotiation of such covenants together with other loan terms (such as principal, interest, maturity or collateral) in most cases requires an unanimous decision by all syndicate members. Rene-

[13]It is not given that there should be only one lead arranger. The borrower can hire more than one lead arranger and they will be responsible for executing different functions.

gotiation of minor terms (such as a technical default of a financial covenant) often requires only the majority of syndicate members to agree.

Standard & Poor's [2008, p. 8] distinguishes three types of syndications:

Underwritten deal In this type of deal, arrangers guarantee the entire commitment when syndicating the loan. In case they are not able to fully subscribe the loan, they have to retain the difference. They can of course try to sell it later to investors which is rather easy in favourable market conditions but rather difficult in the opposite situation and the arranger has then two possibilities: either to end up with a loss on the paper or to be left above its desired hold level of credit. It is important to mention that underwriting a loan can increase the possibility of winning the deal, morover underwritten deals carry very lucrative fees for arrangers.

Best-efforts syndication This types of syndication is more common for risky borrowers. The arrangers here don't underwrite the loan as a whole. If the loans is left undersubsribed, renegotiation of terms needs to be undertaken.

Club deal A club deal is based of sorts on a principle of equality. This deal is premarketed to a group of relationship lenders where each lender gets an equal share of commited fees. Usually a club deal is a smaller loan (USD 25 - USD 100 million).

Syndication is a very complex process which evolves in time as new trends in lending emerge. However, it is not an aim of this Thesis to provide a detailed description of syndicated loan market, but rather to show basic principles which are crutial for understanding of following sections.

3.5.2 Risk associated with LBO lending

LBO transactions are treated with special attention taking into account significant risks associated with LBO lending. Banks have usually specialized teams or even units handling LBO transactions and special regulations and operational standards (guidelines for risk assessments, limits on exposures and tranche benchmarks) are commom. Due dilligence and credit analysis of LBO deals is usually very extensive. According to a survey conducted by the European Central Bank in April 2007 (ECB [2007]) the main focus is on analysing firm's ability to generate sufficient cash flow, service debt and on assessing bank's ability to syndicate and decrease LBO exposures to predetermined limits.

There are several risk factors which lenders have to evaluate when arranging an LBO loan. Among others, there is an assymetric information between lenders and borrowers and between lenders among each other, and moral hazard problem. A borrower has an incentive to report better quality to lenders at loan origination. Inclusion of covenants in the loan contract is one way how to limit this information assymetry (Drucker & Puri [2007]). When the loan is syndicated, before the syndication itself occurs, there is an adverse selection problem because the lead bank has an incentive to syndicate lower quality loans. After the syndication, there is a moral hazard problem present because the lead bank retains only a part of the loan and therefore, the incentive for monitoring is lower (Ivashina [2005, p.5]).

Standard & Poor's [2008] lists two most important risks associated with loan syndication: *default risk* and *loss-given-default risk*.

Default risk can be defined as a likelihood that a borrower fails to meet loan obligations - pay interest or principal on time. This risk class is determined by issuer's financial condition, industry or management among others. Unlike banks which have usually their own internal rating departments, insitutional investors heavily rely on external rating. There are basically two classes of borrowers[14]: investment grade (with rating BBB- and higher) and leveraged (BB+ or lower).

Loss-given-default risk measures how probably a loss the lender would in-

[14]Standard & Poor's rating terminology is used here.

> cur in the event of default (Standard & Poor's [2008, p.12]). Covenants included in the loan are of high importance here. They signal first difficulties when borrower fails to meet prenegotiated financial targets. Investment grade loans are generally senior unsecured with loose covenants. On the other hand, leveraged loans are usually senior secured instruments and carry tight maintenance covenants.

A situation when an individual bank is being caught with large exposure when a deal fails before distribution was said to be the main risk associated with an LBO transaction in the ECB survey (ECB [2007]). Structures such as *equity bridges* introduced in some large LBO transactions in the US are for example more dangerous for banks as they obtain much lower rank in seniority structure compared to bridge loan. Syndication failures were identified as an important factor rising risks related to LBO deals, because in such a case of syndicate failure, bank could be exposed to a very large credit loss leading further to lowering confidence level in the market. Among other trends, growing tolerance to covenant breaches or decreasing of number of covenants was another mentioned risk factor.

Chapter 4

Leveraged Buyouts in Central and Eastern Europe

Private equity investments in the CEE region have much shorter history than those in Western Europe, not even speaking about the USA market. Roughly speaking, private equity as an asset class did not exist in CEE before 1992, when a wave of privatisations and early expansion investments took off. It was a region of unstability with a high risk profile for a long time. However, the situation has changed in the last couple of years and LPs were increasingly looking at the region as a viable candidate for generating high returns. The following subsection provides an overview of main developments which drive the activity among private equity investors in the region.

First two sections (4.1. and 4.2.) describe private equity market in CEE in general and exit routes used in the region. Both sections have rather informative character. The aim of the Author was to explain the rationale for investing in the region and how investors appetite evolved in time. Since private equity market is broader than topic of this Thesis, the Author decided not to describe overall market more in detail and focuses on leveraged transactions in CEE in sections 4.3. to 4.11. For CEE private equity market overview see Sedláková [2008].

For subsections describing LBO market, participants and deals, the Author starts with overview of situation in Europe as a whole and continues with description of situation specific to the CEE region. Eventually, situation on the European level is compared to situation in CEE throughout the chapter when needed.

4.1 CEE, a Region of Opportunity

It is unquestionable that the risk-return profile of CEE countries has improved significantly since the early 1990s. Countries in the region became stable democracies, political and economical environment has improved. Large portion of them accessed the European Union - either in 2004 (Poland, Czech Republic, Slovakia, Hungary, Baltic countries) or in 2007 (Bulgaria, Romania). The EU accession brought a positive signal for outside investors. Harmonization of local legislation, regulatory frameworks, administrative as well as harmonization of economic policies followed. Moreover, as Salesny [2008] stresses, accessing the EU Monetary Union was accompanied with decreasing local currency risks. She further remarked that private equity investing in the CEE region has evolved to a level when the growth was comparable to emerging countries but risk corresponded to developed markets. This means that although CEE countries no longer belong to emerging countries, they still shared some common favourable characteristics such as strong growth (which was slowed down by the crisis which hit the region, but the growth outlook still favour CEE before traditional Western European countries), rising living standards associated with growing consumption and developing infrastructure. This all together increases the appetite of private equity players for the region. On the other hand, what brings the region closer to that of Pan-European countries regarding the market risk, is the maturity of local managers[1] and types of investments which are now (also despite the

[1]According to EVCA, there are over 80 managers in CEE of which Alpha Associates in Salesny [2008] estimates 40 to be of *institutional quality*. Regional GPs satisfy conditions such as hands-on approach, solid track record, local presence, history of operating in the region and professionality.

crisis) far away from the situation in the early 1990s. This all helps to create confidence among international investors.

Compared to old EU-15, many of the CEE countries were showing strong GDP growth: Lithuania, Bulgaria, Slovakia - were among countries with the highest growth rates; Czech Republic and Slovenia - were among countries with the highest GDP per capita in the region in 2007 (see Figure 4.1 for a comparison of real GDP development of EU first wave accession countries vs. EU-15).

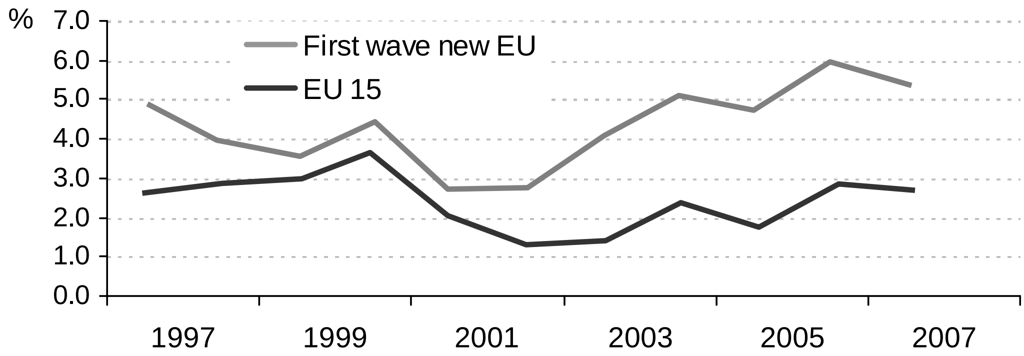

Figure 4.1: Real GDP growth in %, 1st wave new EU members vs. EU 15
Source: EBRD Transition Report Update [2007] in Salesny [2008]

The most active private equity investor in the region, EBRD (European Bank for Reconstruction and Development) stated that its funds in the region significantly outperformed those in the Western part of Europe (Wookey [2008]). EBRD has been investing in the region since its inception in 1992 and has so far invested in around 30% to 40% of all funds in the region. For the development of average returns for CEE private equity funds, see Figure 4.2.

EVCA with its special team Central and Eastern Europe Task Force estimated the total amount of funding raised for CEE private equity funds to EUR 7 billion from the beginning of transformation process in the region until 2003[2] (EVCA [2004, p. 3]). According to EVCA [2009], additional

[2]With over 900 investments made and 400 exits; there were approximately 77 fund

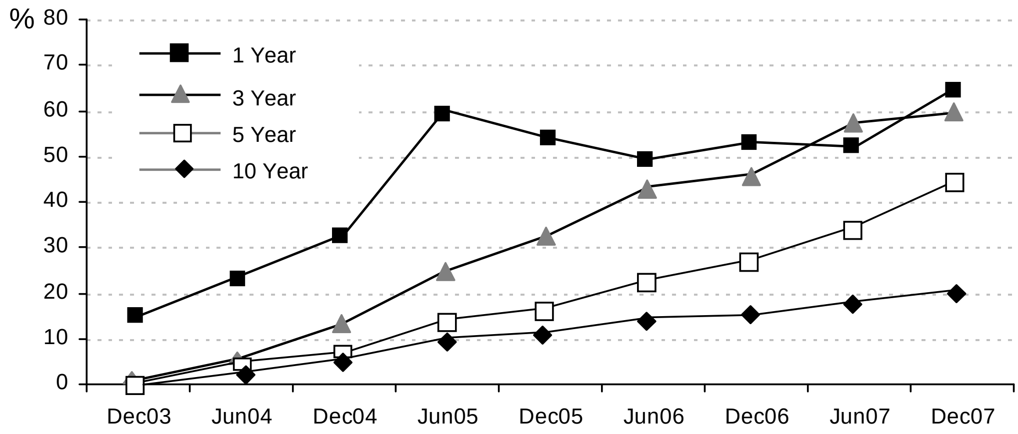

Figure 4.2: Average returns for CEE private equity funds (in %)
Source: Cambridge Associates in EMPEA [2008]

more than EUR 10 billion was raised until 2009, bringing the total amount of capital invested in the region to more than EUR 17 billion to date.

However, the portion of private equity investment as a % of GDP is still small compared to Western Europe. Despite rising trend in fund raising activity, the region is still underserved[3].

In the beginning of private equity financing in CEE, bank loans represented prevalent form of funding for many companies which changed right after the privatisation of banks had started. Though not so developed as in Western Europe or in the US, private equity plays nowadays an important role in the CEE region.

Less deal competition offers more attractive valuation multiples for investors. At the beginning, in the 1990s, only a couple of local private equity houses were playing in the region - Mid Europa Partners launched their first regional fund in 1998, Enterprise Investors established their Polish-American Enterprise Fund in 1990, and two others include Advent International and Warburg Pincus. A number of large private equity firms were setting up offices in CEE in the last couple of years in order to understand better local

managers in the region in 2004.

[3]Detailed description of the fund raising level will be provided in the subsection 2.2

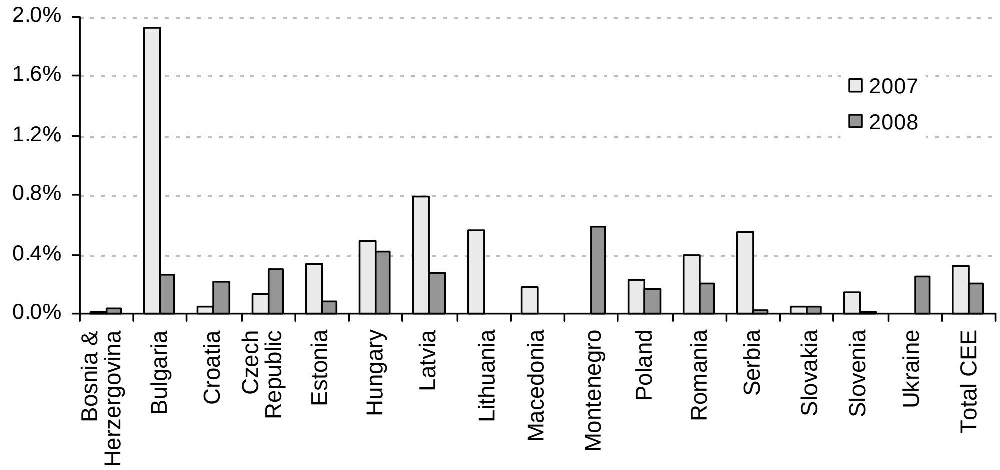

Figure 4.3: Private equity investments as % of GDP by country
Source: PEREP_Analytics in EVCA [2009]

investment environment (an example is EQT, which opened new office in Warsaw in October 2008; Bridgepoint opened an office in Warsaw in 2007; AXA Private Equity opened its new office in Vienna in December 2008 to have a better position to access opportunities in Eastern Europe; 3i hired a senior executive from Poland to strenghten their CEE buyout team in July 2007; CVC Capital Partners appointed ex-partner at Advent International in March 2008 with responsibility for the CEE business activities; Warburg Pincus, Montagu and Oaktree - they all have hired professionals with an aim to focus on the CEE region). Some of them have already raised five or six funds and are operating in the region for several years. Even those private equity houses without special regional investment teams were looking more at the region - Blackstone with an acquisition of Latvian Lattelecom or Columbia Capital and M/C Venture Partners with an acquisition of pan-regional telecom company GTS Central Europe in 2007 (PriceWaterhouse-Coopers [2009c]). With increasing number of LPs and GPs in the region, due-dilligence has become quicker and more efficient.

However, the situation quietened down for the moment - which favors local players for whom a less competitive landscape is sure good news (some big international players which set up an office in the region have on the other hand put on hold their initiatives in the region, such as Carlyle Group, which opened a new office in Warsaw in August 2007 as a hub for its CEE activities, but stopped these activities due to worsening market conditions in November 2008. The development of Carlyle's investments in the CEE region became interesting in August 2009 when ex-members of the Carlyle team formed an independent fund Resource Eastern Equity Partners I targeting EUR 200 million. The fund is said to focus on consumer goods in Poland (the rest of approx. 40% will target companies in Central and South-Eastern Europe) and held its first close in September 2009 with commitments from Radobank and EBRD as first investors) (Willmer [2009]).

As can be seen from Figure 4.4, fundraising for the CEE region was rising continuously until 2007 when it totalled the amount of EUR 4.3 billion. This represented an 89% increase compared to the year 2006. In October 2007, the largest fund dedicated for the CEE region was raised than ever before - Mid Europa Fund III (managed by a private equity firm Mid Europa Partners), closing at EUR 1.5 billion[4]. However, this amount still accounted for only about 5% of capital raised for Europe as a whole (EVCA [2008]).

In 2008, fundraising for the region fell by more than 40% compared to 2007 and hit EUR 2.5 billion which represented around 3% of total funds raised in Europe in 2008 (EVCA [2009][5]). As being already mentioned, the second fund exceeding EUR 1 billion was raised in 2008 (Advent Central & Eastern Europe Fund IV managed by Advent International, closed in April 2008 at a value of EUR 1.6 billion). Several follow-on funds held closes in 2008: Arx Central and Eastern Europe III, Innova Capital V, Mezza-

[4]Their second fund was closed at EUR 650 million in January 2006 and the first one was closed at EUR 550 million in June 2000.

[5]EVCA [2009, p.5] stresses that fundraising for CEE includes only funds raised by advisory teams based in the region and funds raised from outside but 100% dedicated to the region, excludes funds of which a part might be allocated in CEE, but their primary focus is elsewhere.

nine Management Central Europe's Accession Mezzanine Capital II, Troika Capital Partners Growth Fund III, and Horizon Capital's Emerging Europe Growth Fund II.

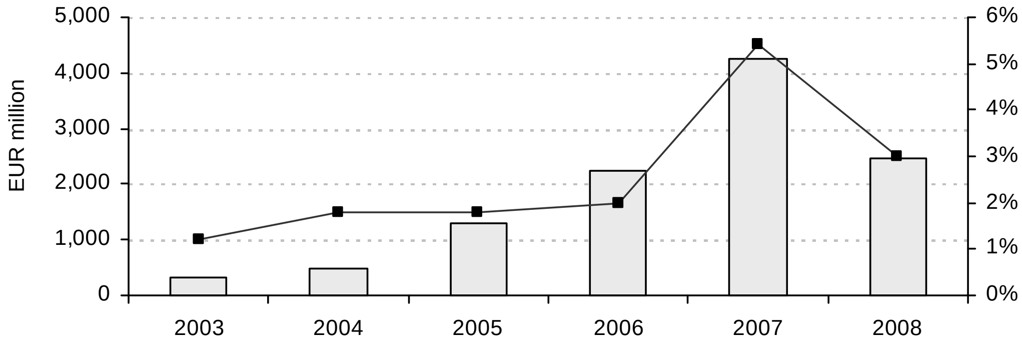

Figure 4.4: Fundraising for CEE private equity (primary axis)/ % of funds raised in Europe (secondary axis)

Source: PEREP_Analytics for 2007 and 2008 data, EVCA/Thomson Reuters/PWC in EVCA [2009]

Buyout investments accounted for 63% of all private equity investments in 2008 (45 buyouts out of total 196), a drop from 77% in 2007 (93 buyouts out of total 204). Buyouts together with growth and replacement capital represent the biggest portion of all investments in the region, as is the case for the Europe as a whole. However, growth investments, especially in the earlier phase of private equity market development in CEE, made up more significant role in the CEE region than in Europe as a whole. The reason is that firms in the high growing CEE countries were increasingly seeking development capital, moreover when taking into acount the short period of market conditions, regional firms were not mature for buyouts as the Western part of Europe knew (EVCA [2004]). But the situation is changing and as can be seen from the above mentioned statistics, firms in the region now represent a still expanding pool of buyout opportunities.

Currently, in the changing deal-making situation, investors in the CEE region seem to refocus on growth investments which experienced a tremendous growth shift, from 4% in 2007 to almost 29% in 2008. This corresponds with the activity in the growth segment in the whole Europe, where growth capital investment almost doubled in 2008 compared to the previous year (EVCA Yearbook [2009]).

Annual private equity investment value totalled EUR 2.5 billion in 2008, an 18% drop from 2007 (which was on the other hand almost 50% rise compared to 2006). In Europe as a whole, the fall was far bigger, investment decreased by 28% in 2008. Poland, Hungary, the Czech Republic, Ukraine and Romania accounted together for 86% of the total invested capital and 71% of total number of firms financed in the region in 2008 (EVCA [2009]).

The rise in deal value especially from 2006 to 2007 was caused mainly by number of larger transactions, e.g. the jump in deal value in Poland, where the country saw 20 deals valued at USD 257.7 million in 2006 and 49 deals valued at USD 2.2 billion in 2007, was attributed to acquisition of 96% of Medycyna Rodzinna (the sixth largest private healthcare provider in country) by Mid-Europa Partners[6]; similarly AIG's acquisition of Bulgaria's telecom company BTC accounted for high increase in deal value from USD 178.2 million (10 deals) in 2006 to USD 2.9 billion (14 deals) in 2007 (Euromoney).

For a literature review of determinants driving private equity activity, see Sedláková [2008, p. 30-32].

4.2 Exit channels

Trade sales continue to represent a key exit route in the region (43% of amount divested at cost) followed by secondary sales (37% of amount divested at cost) in 2008.

Exits via IPO accounted only for 0.1% of amount divested in 2008 compared to 4% in Europe as a whole. The Warsaw Stock Exchange (WSE) in

[6]Promptly after the acquisition of Medycyna Rodzina, Mid-Europa Partners merged it with another player in Polish healthcare market, Lux-Med, the second largest private healthcare provider in Poland, acquired in October 2007.

particular is an important exit channel for private equity backed companies in the region.

WSE is the biggest stock exchange in the region with 375 companies traded in August 2009 (August 18) valued at almost EUR 150 billion (compared to PSE market capitalisation of EUR 50 billion as of August 18, 2009). WSE hosted 94 IPOs in 2008 valued at PLN 9.5 billion (EUR 2.3 billion) and despite the financial crisis, the number of IPOs decreased only by 11 compared to 2007 (with 105 IPOs) (WSE). The WSE's market share of European IPOs by volume increased from 13% in 2007 to 27% in 2008 (the significant rise was caused partially due to co-hosting of the second largest IPO of the year with the triple listing of New World Resources raising EUR 1.39 billion in May 2008 and an IPO of Polish energy giant Enea which raised EUR 546 million, PricewaterhouseCoopers [2009]). According to the Federation of European Securities Exchanges WSE ranked first in the number of IPOs in Europe by the end of November 2008 ahead of London (72 IPOs), Euronext (21 IPOs) or OMX (18 IPOs) (MondoVisione). This ranking has changed for the whole year 2008, with London seeing 99 IPOs valued at EUR 8,884 million in 2008 (PricewaterhouseCoopers [2009]. For the first two quarters in 2009, the WSE keeps its second position behind London Stock Exchange in terms of IPO offering value (see Table 4.1). Enterprise Investors, Poland's largest private equity house, has completed 25 successful exits since 1993 on WSE (KPMG [2009]).

Out of all WSE IPOs in 2008, NewConnect attracted 61 new listings with a value of PLN 180 million (EUR 43 million). NewConnect is an alternative trading system operated by WSE since late August 2007. It was set up as a reponse to financing needs of young, high-growth companies with a potential to become leaders in the region. The companies have to be established not more than for 3-4 years with projected capitalisation up to PLN 20 million, looking for equity between several hundred thousand and several million PLN and operationg in innovative sectors (such as IT, media, telecom, biotech etc.) and at the same time with a vision and a likelihood of an IPO in

Stock Exchange	Number of IPOs	IPOs value (in EUR million)
Warsaw Stock Exchange	13	132
NYSE Euronext	9	1
Luxembourg	5	23
London Stock Exchange	6	260
Deutsche Börse	3	5
NASDAQ OMX	6	28
Borsa Italiana	2	16
Switzerland	2	-
Total	**46**	**465**

Table 4.1: IPO activity in Europe in 1Q+2Q 2009
Source: PricewaterhouseCoopers [2009a, 2009b]

the exchange market in near future (NewConnect). Formal obligations and information requirements are less stringent than for WSE Main List, which reduces significantly the costs. Photon Energy was the first Czech firm (and the first foreign firm at the same time) listed on NewConnect, raising PLN 2.16 million in 2008.

According to EVCA [2009], Romania was the most active region within CEE in terms of amount divested (one third of the CEE total), followed by Hungary and Poland.

Compared to previous years, exit conditions have worsened. A total of 53 companies were exited in 2008 compared to 78 in 2007 and 91 in 2006, which is in line with a development in Europe as a whole where number of companies divested dropped to 2,059 in 2008 from 2,726 in 2007 and 4,448 in 2006.

According to Survey results, trade sale was the most preferred exit strategy among private equity companies in the Central Europe until now, followed by IPO, secondary sales and buy-back. They expect the same preference order over next 2 years with an increase in IPO exits (see Figure 4.5).

	CEE		Europe	
Divestment type	**Total CEE**	**% of total**	**Total Europe**	**% of total**
Divestment by trade sale	125,652	43%	5,188,693	38.2%
Divestment by public offering	200	0.1%	727,104	5.4%
Divestment by write-off	2,079	0.7%	780,751	5.8%
Repayment of silent partnerships	0	0	135,330	1%
Repayment of principal loans	0	0	837,523	6.2%
Sale to another PE house	108,098	37.1%	3,654,961	27%
Sale to financial institution	16,450	5.6%	707,094	5.2%
Sale to management (MBO)	16,026	5.5%	623,714	4.6%
Divestment by other means	23,222	8%	900,991	6.6%
Total 2008	**291,727**		**13,556,163**	
Total 2007	**586,008**		**26,562,033**	

Table 4.2: Divestments in CEE vs. total Europe in 2008 (exit value at investment cost, in EUR x 1,000)

Source: PEREP_Analytics in EVCA [2009]

4.3 Emergence of LBO Lending in the Region

Before 2003, leverage lending was not common in the region. Private equity houses were focusing mainly either on expansion capital or on privatization deals in 1990s. In order to obtain bank loan, banks usually required assets as a collateral. As a result, if a private equity firm wanted to operate in the region, only such investments in asset-heavy industries with pledgeable assets were coming into consideration. This was quite restrictive for some countries within the region, such as the Czech and Slovak Republic, taking into account their relatively small market potential.

Moreover, the overall situation in the banking sector in the transition period was not favourable for LBO lending and there was a certain time period needed before LBO lending could emerge in the region. Privatization of banks was first important step and stabilization of existing loan portfolios and basic operations within banks followed. Only after these milestones were

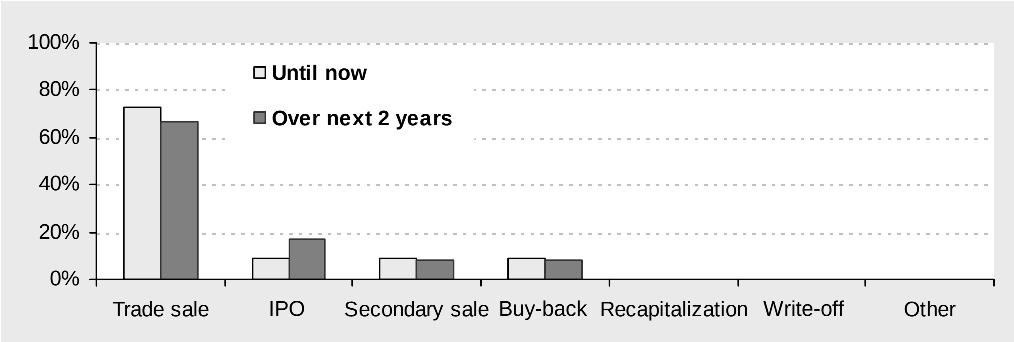

Figure 4.5: Preferred exit strategy among Central European private equity houses

Source: Survey results

achieved there could be a room for gradual development of LBO lending. Banks started to see higher competition in standard products offering and were extensively looking for ways to differentiate. They were also attracted by the outlook for higher margins. Karsai [2009] stresses that local banks had to change their lending approach from asset-based lending they were practicing before to cash flow analysis which was of a high importance for proper evaluation of LBO transactions.

An EU accession played a significant role in banks perception about the region as well. After the process, banks were more comfortable with risks associated with the region.

Though debt levels in private equity backed leveraged transactions in CEE have never reached the level of Western Europe, since 2003 when leverage in the region became available, leveraged deals have gained on popularity. Nowadays, leverage is a standard feature of transactions.

There are several reasons for smaller leverage levels in CEE compared to those observed in Western Europe. Local companies usually grew in range of 10-20% and such companies need rather equity than to be loaded with debt. Value is then created from company's organic growth possibilities as opposed to high leverage and financial engineering. Typical portion of debt in the region historically accounted for 40-60% of total transaction size (with around 3x EBITDA multiples for equity and 5x for debt) whereas in Western Europe debt represented often as much as 70% (with around 3x multiples for equity and as much as 7x for debt).

According to Karsai [2009], it was not very unique to see five or six banks in the region competing with Western Europe-like credit conditions in 2007, although the level of lending remained more conservative. It's a common practice in the region that deals up to around EUR 200 million could be financed by local banks whereas bigger deals with value exceeding this amount are usually financed and led by Western European banks, mainly London-based. They can not only provide bigger debt tickers but also more developed loan structures which local players can not compete with.

First significant LBO in the region was recorded in 2004 when the acquisition of Bulgarian Telecommunication Company (BTC) led by Advent International took place. The private equity firm purchased a 65% stake in the target company for EUR 280 million. This deal included the largest mezzanine tranche used in the region until 2006, a tranche of EUR 40 million (Wells [2006]). To avoid any misperceptions, it is important to stress that the portion of mezzanine used in the BTC deal was not common for the region. In CEE, mezzanine tranche usually accounted for EUR 10 million or even less (Karsai [2009]).

4.4 Importance of Relationship Lending

Existence of close relationship between companies and lending banks and its impact on loan terms associated with such financing model has been extensively discussed in recent literature, both theoretical and empirical. The aim of this section is to introduce views of market participants on relationship-driven transactions and to show results of survey conducted among EU banks and Central European private equity houses.

At different times, different means are required. In the pre-crisis era, banks in the CEE region were more looking on the target company when assessing the particular investment opportunity. After the screening process and evaluation of several possibilities, they stepped into the most promissing projects without paying special attention to who is standing behind the transaction. This situation has changed in the post-crisis time. When speaking about the Czech market, there were literally no banks willing to provide leverage for buyout deals in 2009. In 2010, banks (though very risk averse) started to lend again, however from significantly lower base than before (leverage multiples at around 3x EBITDA). More importantly, when assessing particular project, banks started to look more on which private equity firm is coming with the deal. Previous relationships with the private equity firm, its track record and overall reputation are important for banks before providing LBO loans at the moment. From a private equity firm perspective, it is common to contact 2-3 banks which managers know from previous lending transactions.

Banks usually offer more favourable terms on loans for first projects in order to attract the private equity firm and to establish the relationship. Afterwards, they tend to price the follow-on loans not better but also not worse than competition. And what is the benefit of working with such bank? According to market insiders, the lending process with such *relationship banks* is more flexible.

According to results of Large Banks and Private Equity Sponsored LBOs in the EU Survey [2006], a significant portion of European LBO deals executed were relationship-driven rather than transaction-driven. This kind of relationship-driven transactions is based usually on direct contacts between the bank and the private equity fund manager as well as on the past track records. Banks stated that national deals tended to be more relationship-driven compared to international deals which were often transaction driven.

Results of the Survey conducted among Central European private equity houses showed that the phenomenon of relationship lending between a private equity fund managers and exclusively one lending bank is not that

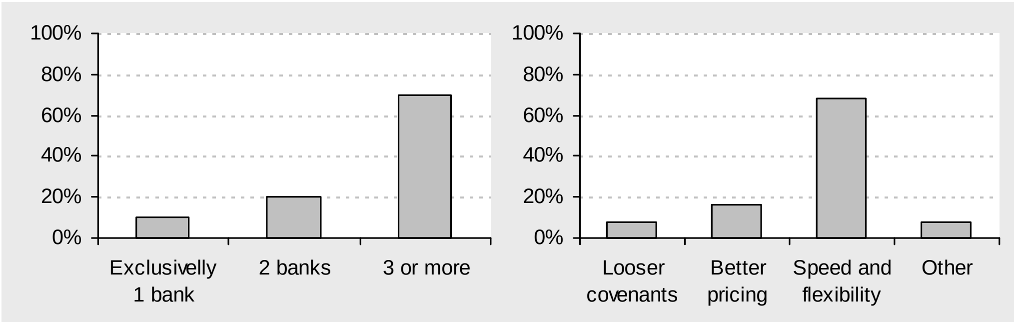

Figure 4.6: LHS: Preferred cooperation with exclusivelly one bank, with two banks or with 3 and more banks; RHS: Benefits of relationship lending

Source: Survey results

strong in the region. When working with a relationship-based bank, private equity firms identified speed and flexibility as the most valued benefits of such relationship. Results are provided below (see also Figure 4.6):

- 70% of all respondents usually cooperate with 3 or more banks – according to replies they usually get quotes from several banks and pick the one with best prices offered. Moreover, 60% usually work with the same banks and 40% change the financing bank over time

- The majority of survey respondents (68%) identified speed and flexibility as key factors stemming from relationship-based banking. 16% of all respondents get better pricing and 8% looser covenants. 8% named availability of debt finance as a benefit of relationship banking.

Since from the private equity firm perspective it's of high interest to study relationship between the sponsor and financing bank, the Author decided to conduct a detailed analysis focused on this topic. The analysis investigates the impact of long-lasting relationship between the bank and the sponsor on the interst paid over a reference rate. Chapter 5 provides theoretical insights, literature overview and results of the analysis.

4.5 Development of Loan Products

More sophisticated loan products which are available in last couple of years provided private equity investors with the flexibility to use more leverage and execute bigger transactions than ever before.

This section describes main drivers of financial innovation in LBO loans, how LBO loans are structured, how financial crisis influenced these structures and one special subsection is dedicated to mezzanine financing and its applicability in CEE LBO transactions.

4.5.1 Competitive Pressures and Innovation in LBO products

Financial innovation in European LBO products was mainly driven by increasing competition in the market. Risk-sharing through syndication or club deals has become a common practice with other methods evolving, such as repackaging and selling credit risk or derivatives trading. Especially origination of financial instruments (such as loan credit default swaps) served as a new tool for debt risk exposure management. Three traditional layers: senior debt, mezzanine and equity were accompanied by new instruments such as second lien, PIK notes (which allow to repay the debt by cash or by newly issued notes), floating rate notes and high-yield bonds which further extended the supply of structures used in LBO deals.

According to results of Large Banks and Private Equity Sponsored LBOs in the EU Survey [2006], European debt market was strongly pushed forward by the expansion of institutional investors such as CDO and CLO managers or hedge funds, with some of them representing 50% of debt structure in new deals executed in 2007 on European level. According to Loan Pricing Corporation, the frequency and volume of term B and C loans (which are mostly sponsored by institutional investors) increased rapidly and their share in loans grew to 80% in 2006, up from 44% in 1997. (Demiroglu & James [2007]).

Western European banks recorded strong competitive pressures rather in product innovation and the complexity of leverage instruments than price. Covenants and their flexibility were also considered to be relevant, while MAC[7] clause was named as less relevant to banks. In 2006, covenant-light structures (often called *cov-lite*) came into fashion. Though heavily demanded by borrowers, cov-lite structures represent possible threat to banks since they limit the ability of bank to monitor the borrower and undergo necessary steps early enough if the company has financial problems. Banks also stressed that stronger relationship with customers could often help to ease competitive pressures.

4.5.2 Deal Structures

Over last couple of years, there has been a trend of standardizing debt structures to allow for easier large scale lending. This turned out to be rather insufficient solution at the moment when flexibility of debt structures is of high importance. Market insiders stress the fact that debt should be designed in a way to meet business' specific needs as opposed to previous boom years when desires of lending institutions and sponsors gained often higher priority than target's actual needs.

Since 2003, when the majority of European LBO deals was financed by relatively simple structures (usually only by senior loan or senior loan together with mezzanine), LBO deals structures have become very complex. In early 2007, this complexity reached its peak and new financial products were employed in transactions (such as second lien and PIK notes) and tranche A was often replaced by tranche B or C. Nowadays in the post-crisis time, structures reflect those common back in 2003. Figure 4.7 illustrates basic evolvement of European deal structures over time.

[7] The term is abbreviated from *material adverse change* and the MAC clause is often a part of lending agreement. MAC clauses are included to protect lenders against material negative change in the condition of the business of the borrowing party (business of the target company in LBOs).

When following data provided by Standard & Poor's Leveraged Commentary & Data [2009], second lien seemed to almost dissapear in European LBO transactions in 2008 and 2009. Instead, senior debt together with mezzanine financing represented about 65% of total structres executed in 2008. In H1 2009, almost 80% of loan structure was financed by senior debt and the rest by mezzanine financing. Figures 4.8 and 4.9 provide basic overview of deal structure development and pricing respectively.

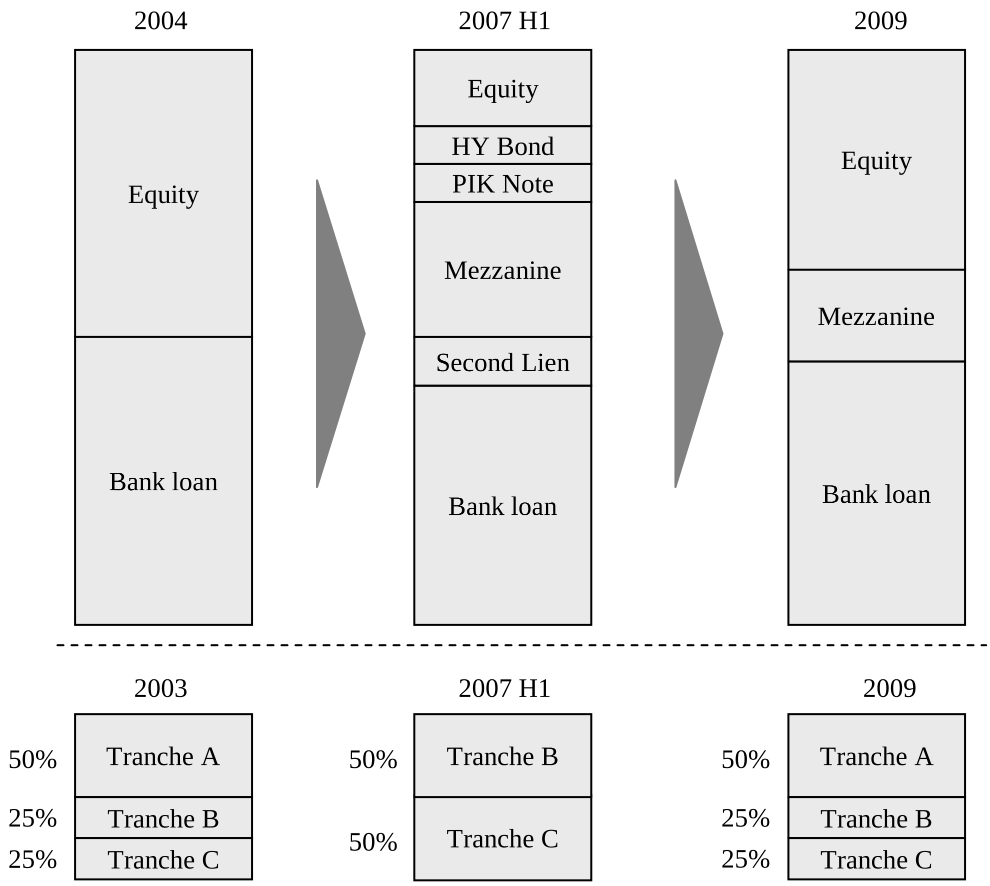

Figure 4.7: Evolvement of deal structures in Europe
Source: Author

Average leverage multiples for Sr debt/EBITDA and Jr debt/EBITDA (see Figure 4.12) were continuously increasing until 2007 when they reached the peak with 4.6x for Sr debt/EBITDA and 1.5x for Jr debt/EBITDA. Now

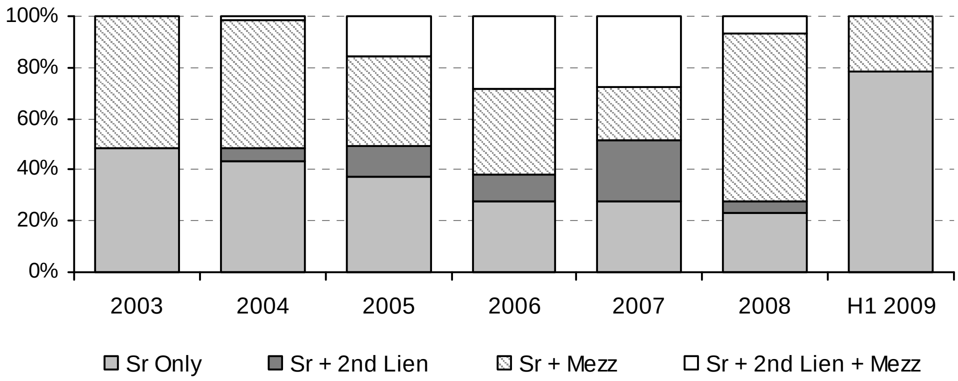

Figure 4.8: European total transaction structures 2003 - H1 2009
Source: Standard & Poor's Leveraged Commentary & Data [2009]

Year	2004		2007		2008		2009	
Categories	Multiple x EBITDA	% of Capital Structure	Multiple x EBITDA	% of Capital Structure	Multiple x EBITDA	% of Capital Structure	Multiple x EBITDA	% of Capital Structure
Senior Debt	4.0	50.2	5.5	57.9	3.8	46.9	3.0	45.0
Second Lien		3.1		10.5		-		-
Mezzanine		12.5		5.3		15.6		15.0
PIK Note		-		4.2		-		-
Total Debt	5.3	65.8	7.4	77.9	5.0	62.5	4.0	60.0
Equity		34.2		22.1		37.5		40.0
EV	8.0	100.0	9.5	100.0	8.0	100.0	6.7	100.0

Figure 4.9: Typical European deal structures 2004 - 2009
Source: Fitch in European Debt Report [2009, p. 18]

in the post-Lehman era, leveraged buyouts in Europe are in a different way than before. Debt/EBITDA multiples fell to pre-2004 period with multiples of 3.3x and 0.8x for Sr debt/EBITDA and Jr debt/EBITDA respectively. As being already mentioned, the fall in Jr debt multiples was caused mainly by disappearance of second lien in the deal structure.

Amount of equity used in European transactions was falling from 2002 to 2007 when equity represented 22.1% according to Fitch (European Debt Report [2009]) and less than 35% according to Standard & Poor's (Standard

& Poor's Leveraged Commentary & Data [2009]), see Figure 4.9. From 2008 onwards, sponsors had to put more equity in order to get deals done. Equity contribution in European leveraged buyouts rose to almost 45% in 2008 and reached 56% in the January - September 2009 period (see Figure 4.11).

Since raising debt financing from banks became rather cumbersome recently (taking into account longer time needed to obtain debt financing plus involvement of several banks in the transaction even for smaller deals), there has been an emerging trend of all-equity deals in the market. According to data provided by Private Equity Insight, 50% of buyouts in the UK in Q2 2009 were financed entirely with equity (compared to Q2 2007 with only 10% all-equity deals). The problem with all-equity deals is that such transactions are usually partly financed by vendor loan to bridge temporarily the gap between prompt financing need and actual amount of equity available to fully finance the deal. Deloitte estimated that the amount required to refinance such deals will increase to around USD 9 trillion by 2013 (European Debt Report [2009]).

Loan structures in CEE has never become so complex and sophisticated than loan structures in Western Europe. Smaller value of deals in the region do not allow for playing with different new structures and extensive structure packages as opposed to Western Europe. Historically, banks in the region were mostly competing in interest rates on loans than in structures.

In pre-2007, equity in CEE usually accounted for around 40% of the transaction value. The rest was financed entirely by debt (this case was more common in 2003-2006) or equity and debt were accompanied by an up to 20% tranche of mezzanine (this case was more common in 2007). Second lien has in general never become a standard feature in CEE deals. If second lien appeared in the transaction structure, it was rather an exception. Sr A tranche usually accounted for 80-100% of debt provided by banks in pre-2007 (the rest 0-20% was financed by Tranche B).

In 2010, banks require at least 50% of equity to be put into the deal. If this condition is satisfied, banks in the region are willing to provide debt financing for the rest of the deal value. The role of mezzanine seems to decrease in 2010. Mezzanine fills the gap between equity and debt with around 0-15% of deal value. Since mezzanine players started to demand very high returns (at around 20%), mezzanine tranche is now being replaced either by putting more equity into the deal or by employing the B (evtl. C) tranche. Banks usually set very agressive pricing for these tranches (at around 10%) but this kind of financing appears to be cheaper than mezzanine at the moment.

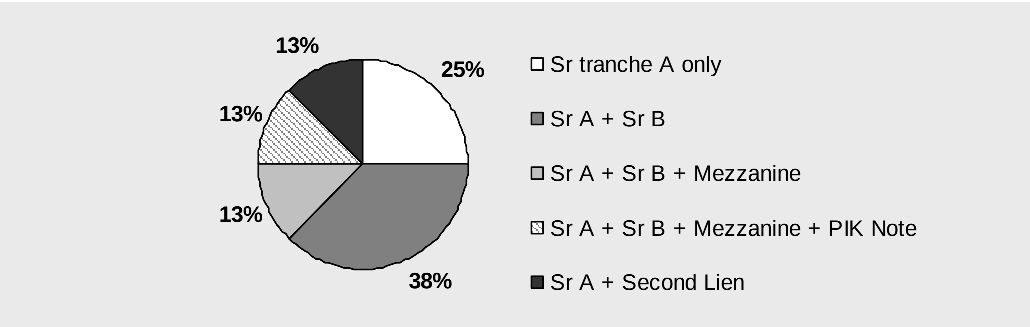

Figure 4.10: LBO deal structures used by Central European private equity houses in last three transactions

Source: Survey results

According to a Survey conducted by the Author, Sr A only and a combination of Sr A and Sr B tranche were the most commonly used in their last three LBO transactions whereas additional mezzanine layer, a combination of Sr A, Sr B and mezzanine or a combination of Sr A and Second Lien accounted each for 13% of structured deals (Figure 4.10).

4.5.3 The Role of Mezzanine in the CEE Region

Compared to Western Europe, just a couple of years ago mezzanine financing practically didn't exist in the CEE region. The first mezzanine fund dedicated to the region was set up by Mezzanine Management and held its final close in July 2003 (Accession Mezzanine Capital Fund, valued at EUR 150 million) (Private Equity Insight). Until then, only some banks were active

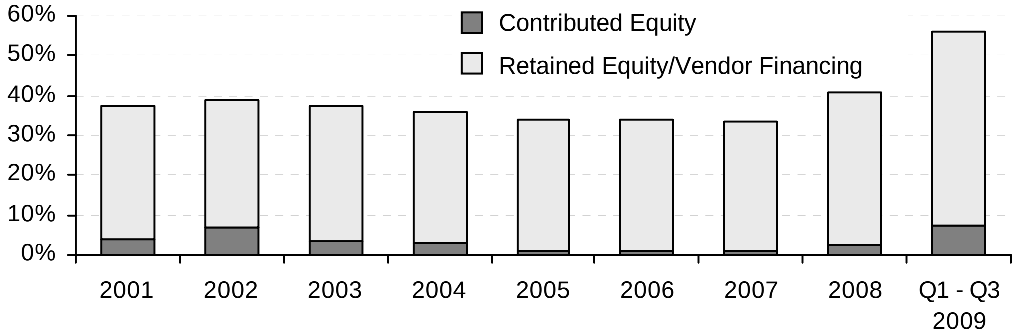

Figure 4.11: Average equity contribution to European LBOs as a % of total sources

Source: Standard & Poor's Leveraged Commentary & Data [2009]

in the mezzanine market offering forms of mezzanine financing, such as Erste Bank through its Prague-based M&A unit from 1997. However banks were focusing more on expansion deals and less on buyouts (Wells [2006]).

Since 2003, Mezzanine Management subsequently closed other two funds with a special focus on the CEE region: Accession Mezzanine Capital II (total amount raised: EUR 261 million, final close in April 2008) and Accession Mezzanine Capital III (still open, target amount: EUR 350 million, announced in January 2009) (Private Equity Insight).

It was a *one man show* for quite a long time and private equity houses were wishing to see more competition in the market. Austrian Darby Overseas entered the region among others and raised EUR 100 million for mezzanine business in the new EU member countries and emerging Europe in October 2005. In September 2007, Darby Converging Europe Mezzanine Fund focused on CEE held its final close with total funds raised of EUR 248 million (Private Equity Insight). See Table 4.4 for overview of mezzanine funds dedicated to the CEE region to date.

Table 4.3 provides an overview of most active mezzanine providers in the CEE region in 2007 and 2008.

There are couple of reasons why mezzanine was not very common in the

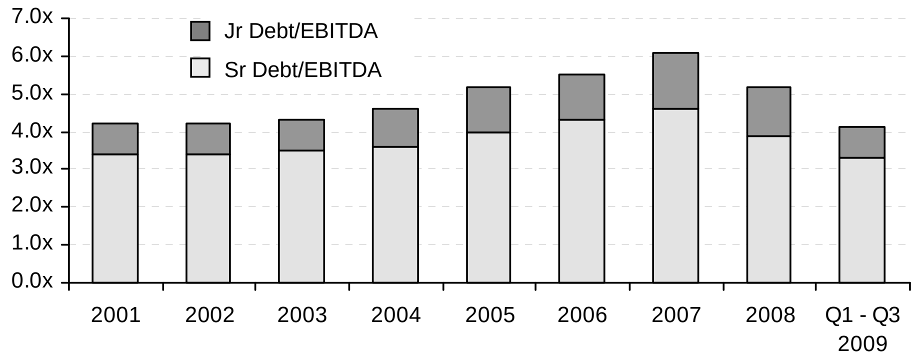

Figure 4.12: Average leverage (debt/EBITDA) for European LBOs
Source: Standard & Poor's Leveraged Commentary & Data [2009]

Mezzanine provider	Number of deals
2008	
Syntaxis Capital	3
Indigo Capital	1
2007	
KBC Private Equity NV	1
AXA Private Equity	1
Balkan Accession Fund	1

Table 4.3: Most active mezzanine providers in the CEE region in 2007 and 2008
Source: Author's calculations, data from Private Equity Insight database

CEE region. First of all, mezzanine was often seen as a relatively expensive source of financing with prices set very high. Moreover, at the same time when mezzanine started to be available in the region, commercial banks became more comfortable with riskier lending in CEE countries and became a competition to mezzanine providers as they offered financing without warrants. As discussed in the previous subsection, banks started to provide subordinated debt which is usually agressively priced, but still often cheaper than mezzanine.

Deal size played a significant role as well. Since the deals in the CEE region are far smaller than those in Western Europe, the need for mezzanine is not that high. When mezzanine tranche is used in Western Europe, it is usually large deal. Taking into consideration the size of regional deals and the fact that CEE LBO deals usually carry high amount of equity and senior debt multiples range from 2-5x, such structure does not leave much room for mezzanine to come into play.

Closed funds				
Fund name	**Fund manager**	**Country of origin**	**Final close**	**Fund size (in EUR m)**
Accession Mezzanine Capital II	Mezzanine Management Central Europe	Austria	April 2008	200
Darby Converging Europe Mezzanine Fund	Darby Overseas Investments Ltd	Austria	September 2007	248
Open funds				
Fund name	**Fund manager**	**Country of origin**	**Announced**	**Target size (in EUR m)**
Accession Mezzanine Capital III	Mezzanine Management Central Europe	Austria	January 2009	350
Baltic Mezzanine Fund*	Nordic Mezzanine Ltd	Finland	September 2006	50
GMP Gamma Mezzopreneurs Fund	gamma capital partners	Austria	January 2009	100
Syntaxis Mezzanine Fund II**	Syntaxis Capital	Austria	November 2008	250

Table 4.4: Mezzanine funds dedicated to CEE region to date
Source: Author's calculations, data from Private Equity Insight database
Note: (*) First close in June 2007, amount raised: EUR 20.5 million; (**) First close in December 2009, amount raised: EUR 137 million

Sean Glodek from Darby Overseas commented for Squire & Sanders 14th Annual C5 CEE Private Equity Forum (Squire & Sanders [2009]) on the current importance of mezzanine in the CEE region. He stated that Darby has currently 90% of such companies in their portfolio, where the mezzanine provider is the only debt provider. Moreover, those are not LBO transactions but rather corporations which are looking for alternative sources of capital to refinance their previous debt.

Mezzanine providers in the region are optimistic about their role in the market. They see significant deal flow especially in development capital and add-on acquisitions which allow private equity firms to leverage current steep discounted opportunities and hold the position until exit environment gets to *normal*.

4.6 Deal size and pricing

In general, Western European LBO transactions have been much bigger than those in CEE (see Figures 4.13 and 4.14).

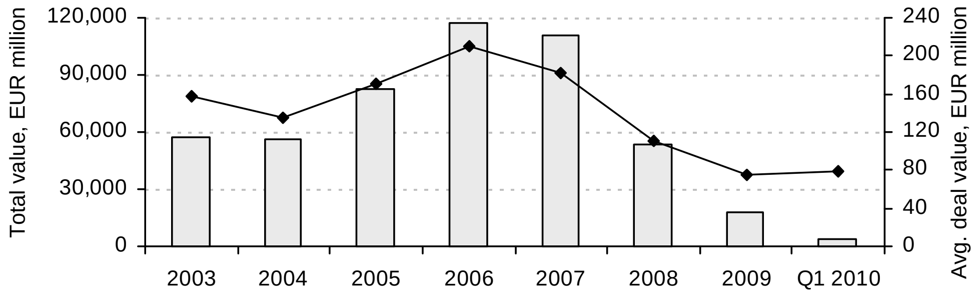

Figure 4.13: Value of European LBO transactions, 2003 - Q1 2010
Source: Author's calculations, data from Private Equity Insight

CEE deals exceeding EUR 500 million are rather an exception. According

Figure 4.14: Value of CEE LBO transactions, 2003 - Q1 2010
Source: Author's calculations, data from Private Equity Insight

to Private Equity Insight database, there were only three such deals in 2007. Since 2007, only one deal exceeding EUR 500 million was recorded in both 2008 and 2009. See Figure 4.15 for detailed overview of LBOs in CEE by deal value.

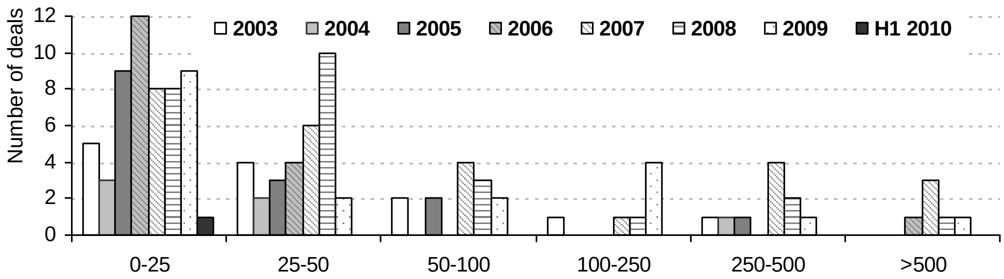

Figure 4.15: Number of CEE LBOs by deal value, 2003 - H1 2010
Source: Author's calculations, data from Private Equity Insight

As a result of overall tighter economic conditions, investors started to put additional equity in their portfolio companies and equity injections are quite frequently used to keep the businesses afloat. As the financing became unusually expensive, private equity backed firms that were exposed to some form of distress have to rely either on their equity investors or alternatively on options based in the lender agreements (such as PIK toggle note option).

European Debt Report [2008] offers a couple of examples of European equity cures undertaken by private equity houses: KKR and Doughty Hanson invested an additional EUR 140 million in ATU, EQT invested a further EUR 70 million in Sanitec, while Premira, Candover and Cinven injected Gala Coral with GBP 125 million.

A number of buyout funds have to deal with their portfolio companies not able to service the debt and maintain operating performance. Such funds have to subsequently write down the value of their portfolio. Standard & Poor's estimated a decrease in the portfolio value to represent as much as 25-30% in 2008 (Craig [2009b]). The same rating firm recorded 21 covenant waivers on European leveraged loans in 2008 from only 5 in 2007 (and the same number in 2006). Default rates increased from 1.4% to 1.55% by June

2008 and were expected to reach as much as 15% in 2009.

Another emerging strategy seems to be so called *loan-to-own* investing. The idea behind this concept is based on acquiring debt in financially unhealthy company loaded with debt, forcing restructuring process and by doing so exchanging debt for equity in the company, usually a majority stake. Such strategy can lead to private equity-like returns once the company is sold. But even before trade sale occurs, there is a significant upside for the investor - when restructuring the company, debt is still at par however the debt position acquired by the investor was sold at steep discount. However, such strategy is possible only if lenders, investors and management of the company find a solution desired by all participating parties. For a *loan-to-own* investor, this is very much dependent on who owns the debt in the target company. As discussed before, majority of deals has been syndicated in recent years which means that instead of 1-2 lenders, there are many parties involved - banks, CLO investors, hedge funds, etc. Especially banks are not very keen on writing down the debt, but prefer issuing new debt to darn the most critical financial problems. Indeed, accorting to European Debt Report [2009], the market saw only small number of balance sheet restructurings in 2009. What will most probably happen in the future? The businesses will have to deal with de-leveraging problems at a later stage of the company development and instead of expanding its operations, they will have to find sources to service the debt.

According to Thomson Reuters, the amount of leveraged loans provided for European private equity deals fell in Q1 2009 to USD 1.4 billion (EUR 1.1 billion), which is the lowest level since the Q2 1999 when leveraged loans for private equity transactions totalled USD 457.6 million. This is a 99% fall compared to Q1 2007 when USD 106.6 billion was provided (Hodkinson [2009]).

Especially large buyouts are now off the table. Dealflow is characterized by small-to-midmarket transactions with EUR 150-250 million debt involved. There were only 2 transactions valued above EUR 2 billion in the first six month in 2008 compared to 10 for the same period in 2007 (European Debt Report [2008]).

Despite the fall in high end buyouts, small-to-medium sized transactions in the CEE region are still being executed such as acquisition of Polish soft drink manufacturer Kofola-Hoop in November 2008 by Enterprise Investors for USD 176 million or an acquisition of Romanian Frigotehnica in December 2008 by Accession Management Company for USD 33 million. Also some large deals occured in 2008, e.g. Euromedic, a Hungarian medical testing company was acquired by a consortium of Ares Life Sciences and Merrill Lynch Global Private Equity for USD 1.5 billion in June 2008.

The largest LBO deal in Q2 2009 was the acquisition of UPC Slovenia by local private equity house Mid Europa Partners, closed in July 2009 (Craig [2009a]). The private equity firm acquired 100% of the target company from international cable operator Liberty Global in a transaction valued at EUR 120 million. Five banks - ING, UniCredit, BNP Paribas, WestLB and Natixis provided a EUR 63 million

In September 2009, S&P reported that EBITDA in 2008 was more than 10% lower than forecast for 45% of surveyed European speculative-grade companies which have been through an LBO (Brown [2009]). 20% of these companies defaulted, breached covenants or asked for looser covenants or amendments.

Three years ago in 2006, in the time of favourable market conditions, increasing competition among banks in Europe and an influence of institutional investors led to more favourable loan terms starting with increasing tolerance of loan covenant breaches and ending with rising usage of *covenant-light* loan structures (these so-called *cov-lite* structures do not contain financial maintenance covenants used by lenders to protect themselves[8]; such cov-lite structures thus increase potential risks associated with deteriorating value

[8]Instead of financial maintenance covenants, incurrence covenants are included. These covenants don't carry the obligation to be met on an ongoing basis but rather in some special situations such as issuance of debt or making an acquisition (Demiroglu & James [2008]).

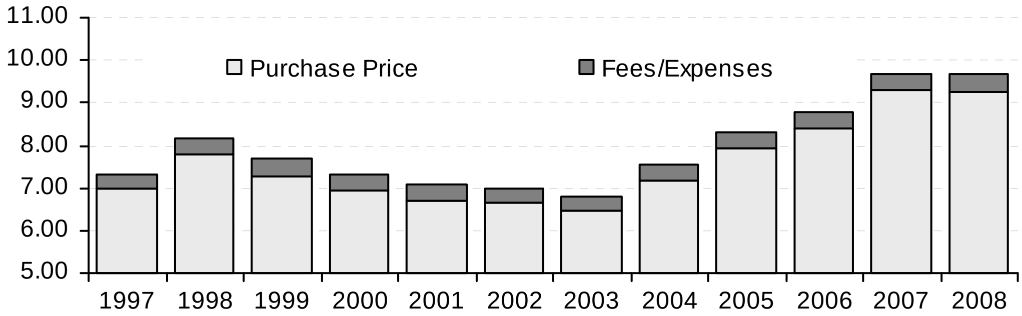

Figure 4.16: Average European LBO price as a multiple of EBITDA, 1997 - 2008

Source: Standard & Poor's Leveraged Commentary & Data [2009]

of borrower's assets or with other special situation which might cause serious problems in repayment of debt). According to Standard & Poor's, the volume of LBO cov-lite loans increased from USD 0 in 2000 to over USD 93 billion in the first half of 2007.

Not surprisingly, the post-crunch pricing turned out to be less favourable for borrowers. According to European Debt Report [2009], while tranche A was priced at Euribor +200, B at +250 and C at +275 in the pre-crunch time, it was 275/325/375 in 2009 accompanied with higher spreads and fees. If it was common to have 50% A and 25% each for B and C in 2003, it is not that far from this situation nowadays (see Figure 4.7 for illustration of structures development). It simply means that banks are not any more comfortable with providing larger B and C term loans with bullet repayment. Instead, large tranche A or equal proportion of the three senior tranches is more common. When compared to the US, senior tranche A was historically always higher in Europe than in the US where the A tranche accounted for only 0.8% of total bank debt in 2006 (ECB [2007]).

On an European level, as can be seen in the Figure 4.17, spreads of senior secured leveraged loans were continuously falling until summer 2007, when a sudden fall in liquidity availability forced out pricing for term loans A, B and C to new records in late 2008.

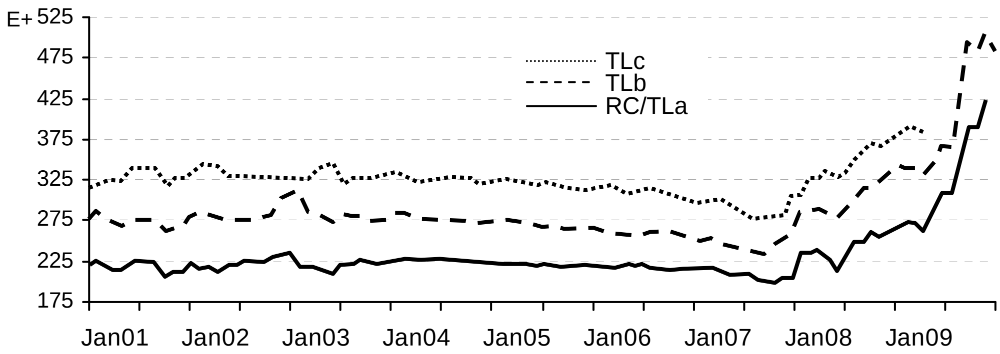

Figure 4.17: Spreads in the primary market
Source: European Debt Report [2009]

David Vials, head of UniCredit Group's Financial Sponsor Solutions CEE Team described for Squire & Sanders CEE Forum (Squire & Sanders [2009]) the post-crisis deal terms and structure developments in the CEE region as follows: equity in deals increased on average to about 50%, overall multiples decreased to 3x or 4x and pricing increased from pre-crisis 300 bps to around 500 bps at the end of 2009. Moreover, the *underwrite and distribute* model has shifted to club deals and relationship between banks and private equity firms gained even more on importance.

According to Ivan Meloun, Director of CSOB's Acquisition and Leveraged Finance department, as of August 2009 the Czech LBO market saw mild recovery trends. With the drop in leverages not being that significant and pricing below Western Europe, the financing is still attractive and banks are still willing to provide the senior leverage above 3.0x as before the crisis. Moreover, he stated that the big deals (over EUR 100 million) have returned to the region and the bank itself was working on three EUR 100 million deals in senior loan size in 2009 (Abott [2009]).

According to Survey results, 75% of respondents expect the availability of debt finance to get better in 2010. 12.5% expect the availability of debt finance to get worse and the same proportion expect it to stay the same. For 2011, 88% of respondents expect better availability of debt finance (see

Figure 4.18).

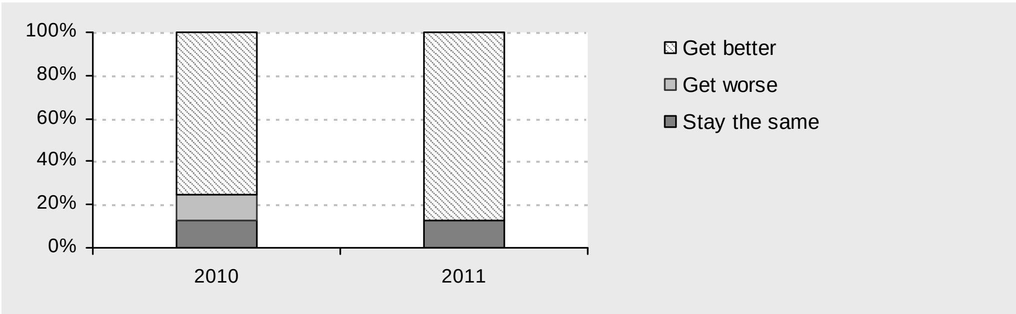

Figure 4.18: Expectations about the availability of debt finance in 2010/2011 compared to 2009

Source: Survey results

4.7 Post-crisis transaction execution

Banks are exposed to credit risks from several activities ranging from underwriting, arranging and syndicating loan packages, bridge loan financing and providing debt tranches.

As the liquidity in the market has become a sought-after commodity, syndication risk is getting higher and most deals are clubbed with regional as well as international banks involved. These transactions usually involve pre-selling and require longer time to finish. Club-based deals with banks taking little or no underwriting risk are the most common in the market. Deals with sole underwriting bank are rather exception, one example is the buyout of frozen food manufacturer FoodVest by Lion Capital in July 2008 (for EUR 1.4 billion) financed by JP Morgan (Reuters).

According to Private Equity News portal, market insiders named 10 to 15 banks accross Europe which were willing to provide M&A financing at the end of 2008 (in Craig [2009b]). This group involved HSBC, Lloyds Banking Group, Societe Generale, BNP Paribas, ING, Deutsche Bank, Dresdner Bank, Nomura, Mizuho Barclays and Royal Bank of Scotland, plus some of the US banks which might also consider investing in the region - JP Morgan, Morgan Stanley, Citigroup and Goldman Sachs among those named.

According to league tables in Private Equity Insight database, there were 8 banks in Europe which were lending for LBO transactions in 2009: HSBC (with 17 deals), Lloyds TSB Bank (16 deals), Societe Generale (13 deals), CIC (13 deals), LCL (12 deals), Nordea (11 deals), Credit Agricole Corporate & Investment Bank (10 deals) and Royal Bank of Scotland (10 deals). BNP Paribas and UniCredit follow with 9 and 7 deals respectively.

However, creating a club of banks to finance a particular transaction remains still challenging. Though banks are willing to invest in interesting projects, they are offen open only for tickers up to EUR 20-25 million (per bank) which means putting together 4-5 banks for financing EUR 100 million transaction. This requires longer time for negotiations and overall transaction execution.

As for the CEE region, according to market insiders, there are still banks which are open for LBO lending, however they are more cautious. According to Private Equity Insight database, there were 5 banks which provided debt financing for LBOs in CEE in 2009: UniCredit, WestLB, ING, Credit Agricole Corpoate & Investmenet Bank and LBBW Landesbank Baden-Würtemberg.

Banks in CEE are, as in all the other parts of the world, more focused on due dilligence and pay more attention to assessing risks associated with lending. Higher fees and margins are required in order to privide financing. Citing Johan Bastin of Darby Private Equity, *"in 2007, six became the new five and now four is becoming the new six"* (Squire & Sanders [2009, p.8]. Banks are now requiring 40-50% equity to do deals, which brings the investors to transactions valued no more than EUR 300 million. Investors who want to make bigger deals can alternatively try the bond market. Structures as plain vanilla came back to fashion together with covenants and higher pricing - 200-250 basis points above the pre-crunch state. Supriya Saxena of UniCredit Markets & Investment Banking stresses that *"many banks have retreated to their home markets, and relationship and ancillary business has become* *increasingly important in the overall investment decision"* (Squire Sanders [2009, p.6].

Large transactions requiring significant amount of debt were always more or less beyond the capacity of most local banks, thus accessing debt for such deals became difficult due to lack of leverage which would have to come from some of the Western European or North American bank. However, these foreign banks leading some bigger buy-outs in the region use to approach local banks for their knowledge and advice.

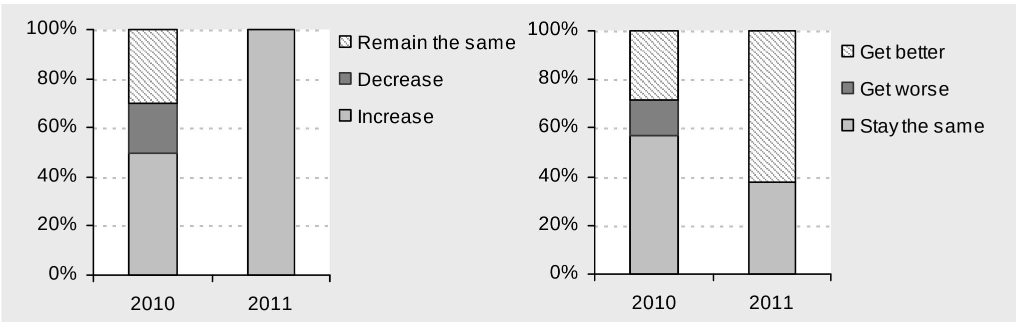

Figure 4.19: LHS: Expectations about deal multiples in 2010/2011 compared to 2009; RHS: Expectations about credit terms in 2010/2011 compared to 2009

Source: Survey results

Regarding the credit terms and deal multiples expectations among Survey respondents, key findings follow below (see also Figure 4.19):

- 50% of respondents expect deal multiples to increase in 2010 (compared to 2009). In year 2011, all respondents expect deal multiples to increase (compared to 2009).

- The majority of respondents (85%) expects credit terms to get better in 2011 compared to 2009. In 2010, the majority expects credit terms to stay the same.

4.8 Redefinition of strategies

Since leverage became scarce, many private equity houses are forced to redirect their strategy. Highly leveraged mega-buyouts are appearently dead for some time and those funds which raised several billion global funds are now looking at emerging markets. Investment bankers and private equity houses are opening new offices in some of the major emerging countries with the phrase *Mumbai, Dubai, Shanghai or bye-bye* explaining their positioning in the current financial world.

High-end market players in the region such as Mid-Europa Partners, Advent International or Enterprise Investors, and bigger pan-European funds who want to invest in CEE will have to look more at the lower to mid-market segment. Growth capital investments, as compared to leveraged buyouts, are predicted to be more common because there will be only few bigger buyout deals and several players in that segment of market will be bidding for them (see also Figure 4.20 for evidence of higher growth capital investments in 2008 compared to 2007). This means that private equity houses might want to redirect their focus on taking smaller stakes in target companies with little or no debt included to support the deal.

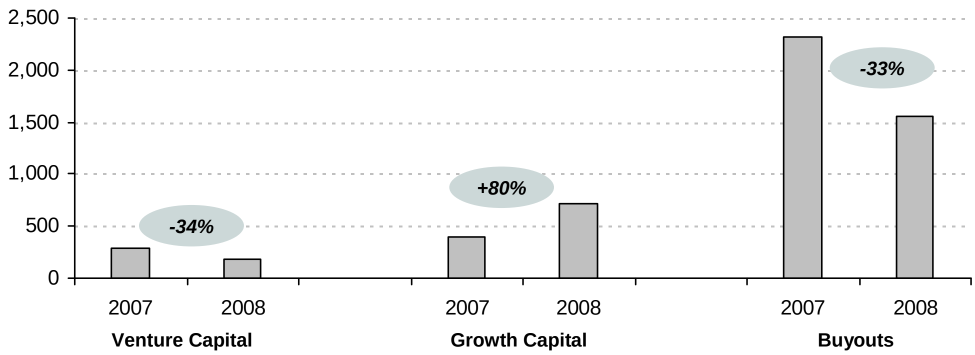

Figure 4.20: Changes in PE strategies in the CEE region
Source: EVCA [2009], EVCA Yearbook [2009], Author's calculations

Many believe that it was only a matter of time when unsustainable returns would come back to *normal*. The time has arrived and private equity industry is predicted to reshape in a way which focuses more on due dilligence and long-term investment approach.

Figure 4.21 provides summary of investment preferences of Central European private equity houses obtained in the Survey conducted by the Author.

	Very attractive	Attractive	Not very attractive	Not at all attractive
Small buyout	11%	56%	33%	
Medium buyout	25%	63%	12%	
Special situations	14%	29%	57%	
Growth/development capital	33%	56%	11%	
Large buyouts	12%	63%	25%	
Mezzanine		57%	29%	12%
Venture Capital		29%	42%	29%
Secondary sales		71%	29%	

Figure 4.21: Attractiveness of opportunities in 2010
Source: Survey results

4.9 Rise in Secondaries

Strong growth in activity in secondary market appears to be a new trend in the LBO market. ECB [2007] recorded higher liquidity of LBO investments supported by the emergence and further development of secondary market for LBO deals over the past couple of years. Many institutional investors and banks use secondary sales as viable exit channel and a way to decrease their exposure to private equity investments and increase their liquidity levels.

The rise in secondaries in the CEE region (which accounted for 37.1% in 2008, an increase from 23.6% of amount divested at cost in 2007 and only 12.7% in 2006 in CEE; EVCA [2009, 2008]) could be explained by deteriorating exit conditions. This development is fully in line with the rise in secondary sales in Europe as a whole (16.6% of amount divested at cost in

2006, risen to 30.4% in 2007 and totalled a fraction of 26.3% in 2008; EVCA Yearbook [2009, 2008]).

Secondary market offers very attractive pricing in today's financial environment and buying the private equity stakes at discounts (rather than investing in funds themselves) may be an appealing choice. According to Standard & Poor's Leveraged and Commentary Data [2009], European Leveraged Loan Indices reached level as low as 600 in March 2009 (see Figure 4.22).

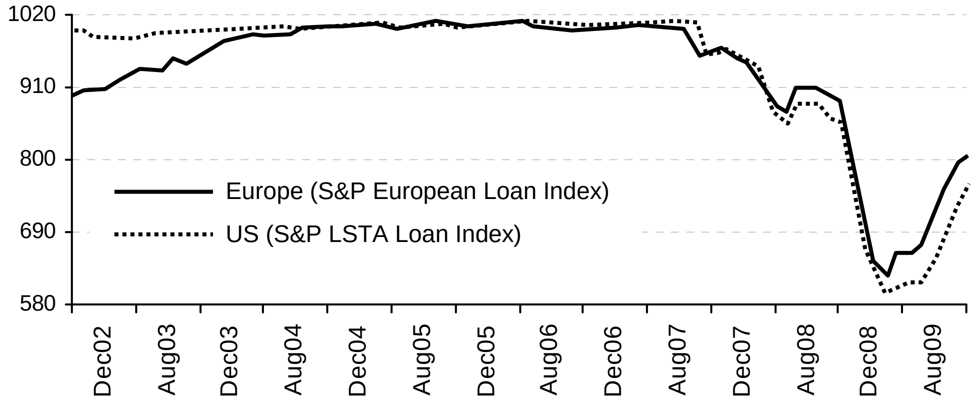

Figure 4.22: Leveraged Loan Indices
Source: Standard & Poor's Leveraged Commentary and Data in European Debt Report [2009, p.5]

Several factors can be identified as drivers for a huge activity increase in secondaries.

- As the public equity is losing in value, total value of an investor's portfolio (the denominator) is decreasing. Then the portion of investments in other asset classes (such as illiquid private equity investments) is too high (so-called *denominator effect*) and many investors are starting to sell their private equity stakes at discounts to meet the asset allocation policies. This is a case of some institutional investors such as pension funds and insurance companies which are subject to maximum allocation benchmarks into different investment classes. Landmark Partners in their latest whitepaper "The Denominator Dilemma" warned that this approach might be suboptimal (Reuters).

- Other investors, e.g. banks, might be worried about liquidity issues and are trying to free-up cash via selling their non-core assets such as private equity stakes. Some funds might rationalize and sell some of their companies in order to finance the rest of their portfolio.

- NB Alternatives Advisers [2009] pointed out that many LPs are starting to view secondary market as a *portfolio management tool* for rebalancing their sector allocations and reaching desired diversification.

Partners Group [2009] estimated that liquidity driven secondary sales accounted for around one third of all fund interests offered on the global secondary market in 2008.

The rise in secondaries is expected to continue in Europe as a whole as well as in CEE, however CEE seems to be underserved by secondary capital in the near-term. This creates an opportunity for those who have the capital and want to invest in the region.

Indeed, there was a lot happening in the secondary market in CEE in 2009. In August 2009, a Polish retailer Zabka (part of Penta Investments' portfolio) acquired retail operations of Palma-Tumys from Slavia Capital for an undisclosed amount; in October 2009, EQT Partners acquired Bulgarian cable TV provider Eurocom from Warburg Pincus; Enterprise Investors acquired Czech AVG Technologies in a secondary deal for an undisclosed amount in the same month; in September 2009, Soravia Group acquired Bulgarian Devin Group in a secondary transaction (EMPEA [2009, p.6]).

With plethora of interesting secondary opportunities in the region, it might be difficult to raise primary fund in the market in 2010.

The positive impact of secondaries on the target firm remains still questionable. Some investors believe that when a company is going through hands of several private equity houses, there is rather a higher tendency to increase the debt levels than a potential and incentive for generating higher growth.

4.10 Regulation of the Industry

After the financial crisis hit all the segments of the economy, not excluding the financial system in Europe, a wave of regulation efforts in the European Union has strenghtened with an aim to revive the financial markets.

In 2008, Paul Nyrup Rasmussen, a head of the Party of European Socialists proposed a regulation of private equity industry which would lead among others to introduction of capital requirements and non-deductibility of interest for tax purposes. He was followed by Klaus-Heiner Lehne, a member of the European Democratic Party, who called for regulation of private equity and hedge funds.

The European Commission released its proposal on regulating Alternative Investment Fund Managers (AIFM) in April 2009 with an aim to provide an integrated regulatory framework for EU hedge funds, private equity funds, commodity funds, real estate funds and infrastructure funds, etc.

The draft released by the EC in April 2009 faced a strong criticism from the private equity industry. The industry managed to bargain some partial changes to the original draft. The regulation could catch only GPs managing more than EUR 500 million compared to the original plan with EUR 250 million. The EVCA Brussels Task Force in its Response to the proposed Directive called for further increase of this benchmark at EUR 1 billion. The EVCA team argues that without this additional change, the regulation would cause a disadvantage to other forms of investment and funds in other jurisdiction. Funds with assets under management not exceeding EUR 1 billion usually specialize in financing of small to medium sized firms at local level, that is why they should remain subject to national regulation as opposed to an international one. The EC requires disclosure of general investment strategy (with annual reports including EU-audited accounts, detailed incomes and expenditures), unified valuation of fund assets and units, limits for leverage or capital requirements among others.

This regulatory framework draft received a sharp cold answer from industry insiders. Private equity professionals believe that self regulation is the best possible way for the industry. They understand the need for widely shared professional standards but they prefer flexible code of conduct defined by the industry itself before the "one-fits-all" regulation as proposed by the EC. EVCA with other industry representatives explain that legal regulation would reduce flexibility of private equity, its potential for creating value, moreover regulation in its shape how it was introduced by the EC, is *"inappropriate, irrelevant and disproportiate"* (European Private Equity & Venture Capital Industry [2009]).

Self-regulating activities in Europe started with British Private Equity and Venture Capital Association which upheld the so-called *Walker Guidelines* in 2008[9], followed by Germany and Denmark which produced their own guidelines. France issued already a statement of principles and Sweden finalized first proposals (Craig [2009b]).

Recently, director of Sweden Institute for Financial Research Per Strömberg released a paper which contains research evidence from different academic sources on economic and social impacts of private equity on the European economic model (Strömberg [2009]). According to this research, there is a strong positive relationship between private equity investment activity and economic growth, a positive relationship between private equity investments and innovation and positive impact of private equity on operating performance of companies[10].

As of May 2010, there are still turbulent discussions on the EU level about possible regulation of private equity industry and about specific regulation measures required by European institutions. Market insiders claim that LBO market might see some restrictions in the form of some kind of leverage limits, higher pressure for disclosure of private equity firm's specific information and reporting in the near future.

[9]Sir David Walker is former chairman of Morgan Stanley International who called for self-regulation of UK private equity industry with better communication and transparency with stakeholders in 2008.

[10]See Strömberg [2009] for further research evidence.

4.11 Conclusion - CEE in the Light of Financial Crisis: Down but not out

Before the crisis hit the region, private equity industry was evolving in a promissing way. Though not reaching the level of Western Europe, venture capital was becoming an important source for financing start-ups and early-stage innovative companies, banks started to offer more sophisticated loan products to finance private equity transactions. Moreover, more mature deals were executed often with significant portion of leverage included. Now, the leverage is off the table for some time not only in the US and in traditional Western Europe, but also in CEE.

The LBO post-crisis market in the CEE region is characterized by several trends:

- Raising new funds remains to be extremly difficult.
- Debt is still a scarce *commodity*, banks are risk averse; however, there is still senior debt available for good transactions.
- Large deals are off the table, but small to mid-market deals are being executed.
- Deals require longer to complete and terms of the deals are rather conservative.
- The trend of global private equity houses opening their offices in CEE is over (which goes hand in hand with lack of mega buyouts in the post-crisis time) and couple of global private equity companies exited region. This represent an opportunity for local players specializing in the mid-market.
- Among CEE countries, Poland remains the most attractive market.
- As in other parts in Europe, there is an ongoing discussion about sustainability of current market model (partly pushed by recent regulatory

pressures).

Know-how of regional GPs and their ability to manage funds in unfavourable market conditions has become an important criterion for investors. Local presence, the ability to understand local market and thus faster reactions to unforseenable situations are being emphasized by number of investors in the region. Moreover, in order to attract LPs' interest, fund managers to offer clear investment strategy, strong team and proven track record. These are said to be key aspects considered by investors. GPs are usually required to commit more than 1% to the new fund to show their commitment and conviction in the success of the fund.

According to Deloitte Central European Private Equity Confidence Survey (Deloitte [2009]), confidence among private equity investors investing in the region was continuously increasing since September 2005 and hit the highest value in April 2007 since 2003 when the first survey was conducted. The confidence level reached the bottom in October 2008 - debt availability was expected to cut further, fund managers showed clear shift from identifying new acquisitions to portfolio management and the whole market was veiled with a lack of optimism and cautiousness. However, the newest survey showed a bit more optimism - concerns about the economic climate still exists, but fund managers expect to split their time between managing the portfolio and focusing on new investments and predict an increase in returns in near future.

According to data provider Dealogic, the value of deals in CEE in the first quarter of 2009 fell to its lowest level in almost 7 years, with USD 31 million investment in only 9 deals. This fall represented a 99.3% decrease compared to the same quarter in 2008 when there was USD 4.5 billion invested across the region (Lewis [2009]).

When the financial crisis started, investors became selective about their investments and started differentiating among particular countries in the region. Differentiating between winners and losers seems to be currently a new approach to private equity investing in the region. The Czech Republic, the Slovak Republic, Poland and Slovenia belong to those named as the winners with good opportunities for private equity investing, whereas the Baltic states, Bulgaria, Hungary, Romania, Russia and Ukraine with their higher debt and unstable currencies are often called the losers (see Figure 4.23 for Survey results regarding country preferences).

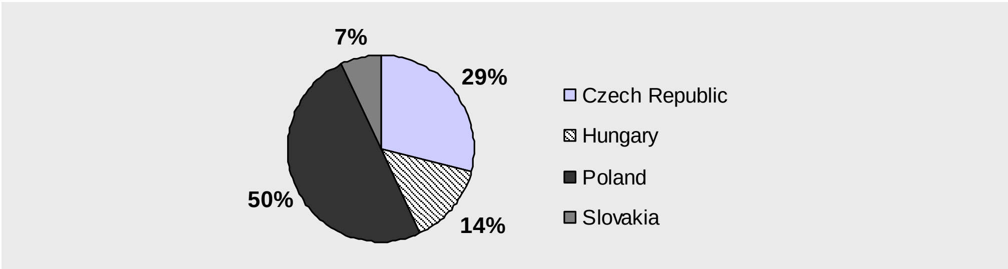

Figure 4.23: Country investment preferences among Central European private equity firms in the horizon of next 5 years

Source: Survey

Hungary with its external debt levels reaching 97% of GDP at the end of 2007 and balance sheet mismatches quickly discouraged international investors (IMF).

Though the CEE region is experiencing a slowdown, it is expected to grow at around 2.8% in 2010, compared to the Euro area as a whole with 1% and advanced economies[11] with 2.3% in 2010 (IMF). For an overview of growth projections, see Table 4.5.

Many market insiders believe that not only the bad and the worse is coming with the crisis, but actually the private equity's current cruch might also have a possitive impact on the industry. They predict that the market will be relieved by more realistic - decreased valuations and fueled by better access to talented management professionals. Some private equity houses can take a bigger advantage of this situation than the others. Those who find themselves in the higher stage in the fund lifecycle with all the fund invested,

[11] Definition of advanced economies in IMF statistics includes the US, Euro area, Japan, UK, Canada and others

Country	2007	2008	2009	2010f
Advanced economies	2.7%	0.5%	-3.2%	2.3%
Emerging and developing economies	8.3%	6.1%	2.4%	6.3%
CEE	5.4%	3.0%	-3.7%	2.8%
World output	**5.1%**	**3.0%**	**-0.6%**	**4.2%**

Table 4.5: Growth projections
Source: IMF, May 13, 2010

they will most probably focus on monitoring the portfolio companies and try to keep them healthy. Those who recently raised new funds may be able to profit from the situation and pick up attractive targets at reasonable prices. According to Michael Tojner of Global Equity Partners Betiligungs-Management AG (in Squire Sanders [2009, p.4]), *"there is at least USD 3 billion to USD 4 billion in dry powder awaiting investment opportunities in CEE that will surface as valuation levels align with expectations."* According to Deloitte, private equity firms have in excess of EUR 4.1 billion to invest in the CEE region (FinancierWorldwide).

Deals motivated by financial engineering are said to be a dead model. Instead, buy-and-build strategy is expected to be the one which might cause the change and add value to businesses.

In a Survey conducted among Central European private equity firms, firms were asked to describe the effect of the financial crisis on the industry on the LBO market in the region. The summary follows:

- Debt became more scarce and expensive.
- Local banks can finance only up to EUR 25 million.
- Return to reasonable leverage levels; leverage available for small to medium size deals, not so much for large buyouts.

See Figure 4.24 for Survey results regarding the impact of the financial crisis on the private equity industry in the region and regarding future trends expected in the market.

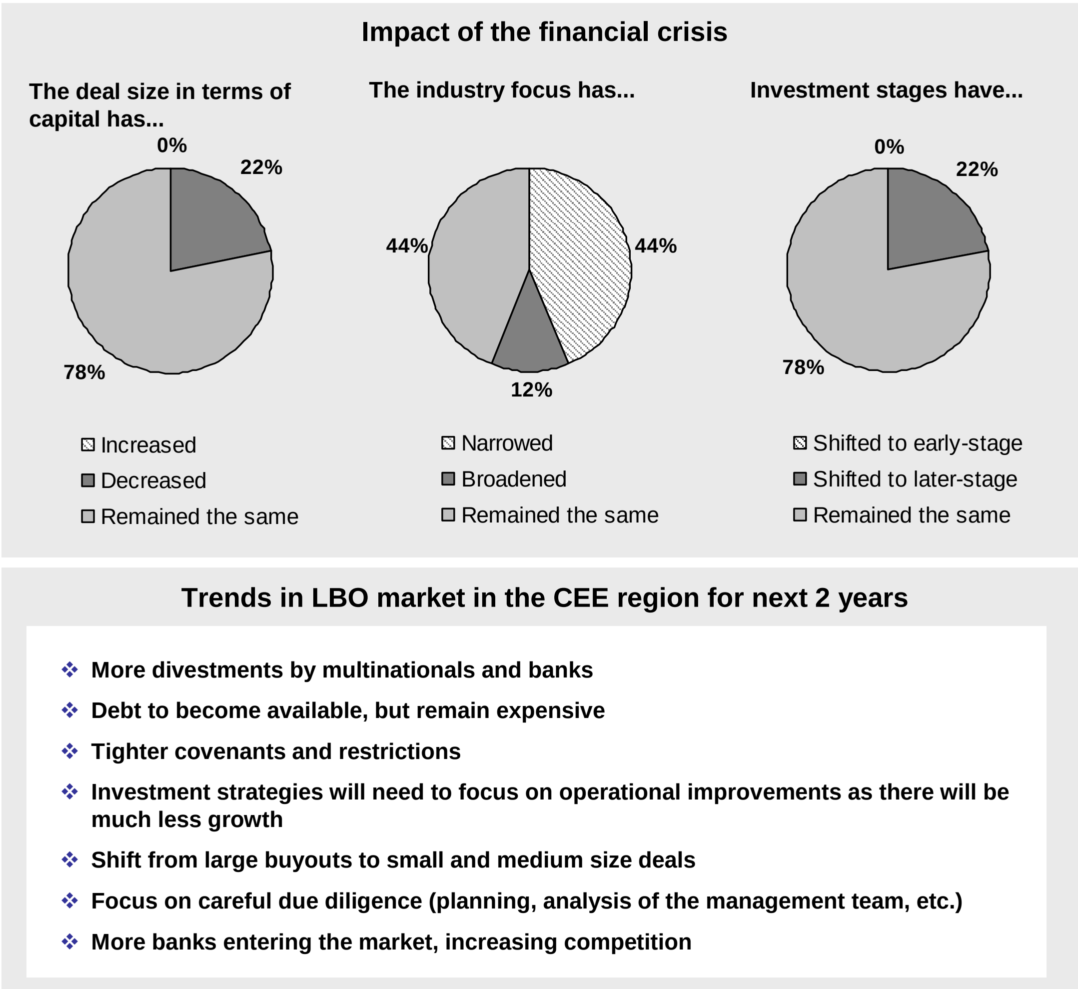

Figure 4.24: Impact of the financial crisis and trends in LBO market in CEE for next 2 years

Source: Survey results

Chapter 5

Relationship lending and its impact on syndicated LBO loan terms

5.1 Introduction

In recent years, a lot of attention has been paid by researchers to relationship lending. However, the Author must conclude that the term "relationship lending" is not clearly defined in the existing literature.

Following Boot [2000] and Berger [1999], relationship lending is defined here as such relationship between borrower and lender where:

- The financial intermediary obtains borrower specific information which is not publicly available.
- Obtaining such information is possible through repetitive cooperation and this information remains confidential.

The special nature of relationship between bank and the borrower in the long run allows banks to acquire this specific information about borrower's quality and to use it in designing debt contract. Assymetric information theory suggests that borrowers with special long-lasting relationships with financial intermediaries can benefit from better loan terms. However, empirical results in this field differ substantially. Number of recent papers confirm that there is a statistically significant evidence about better loan terms as as result of special relationship with financing bank (Ivashina & Kovner [2008], Bharath, Dahiya, Saunders & Srinivasan [2004], Hellman, Lindsey & Puri [2007], Berger & Udell [1995]). Other studies (Harhoff & Körting [1998], Elsas & Krahnen [1998], Sharpe [1990], Rajan [1992], Degryse & Van Cayseele [2000]) did not prove existence of such relationship between loan terms and tighter relationship with financing bank.

Relationship lending literature focuses on analysing mutual influences between banks and borrowers. The Author choose different approach in this analysis. Since the sponsor of the LBO[1] enters the transaction as a strategic partner which influences the target company - it controls target company's equity, management and future roadmap of the company; the Author assumes that prior cooperation between the LBO sponsor and the bank can impact terms of the LBO loan.

The objective of this chapter is to provide an analysis on how LBO sponsor's relationship with a lending bank impacts loan terms associated with the loan provided to finance a particular LBO transaction. More specifically, the impact on loan spread paid over reference rate (LIBOR and EURIBOR) is investigated. The Author hypothesizes that repeated interactions between bank and private equity firm (sponsor of equity) decreases costs arising from information assymetries and thus positively affects the loan terms (i.e. this should result in lower spread paid over reference rate).

Two main sources were used to collect a uniqe data set in order to perform the analysis: the Reuters LPC Dealscan database and the Thomson One database. In a period ranging from 1995 to 2005, 716 LBO syndicated loans with sponsors were identified in 40 European countries. For every deal, two

[1] *Sponsor of the LBO*, *private equity firm* and *sponsor of the transaction* all describe the same participant, the private equity firm which invests its equity in the particular LBO transaction.

variables measuring the strength of relationship between the bank and the sponsor were calculated: the amount of loan underwritten by the same bank as a percentage of all loans sponsored by a private equity firm over last 5 years and the number of loans sponsored by a private equity firm and underwritten by the same bank over last 5 years.

Syndicated loans represented 96% of all European LBO loans in the 1995 - 2005 time period. Using data on syndicated loans, the Author analyzes the relationship between the lead bank (administrative agent) and sponsor of the transaction (private equity firm) to determine impact of such relationship on loan spread. Loan syndication is a process where the lead bank conducts due dilligence on particular target, collects information neccessary to assess potential risks associated with the transaction and after entering the process, it sells parts of the loan to other participants. Lead bank is therefore the owner of target specific information. Moreover, the lead bank is responsible for monitoring borrower's financial health after the syndication process.

To Author's best knowledge, this is a first study examining European data with the purpose of analysing the impact of close relationship between the LBO sponsor and the lead bank on loan terms. The purpose of this chapter is to bridge the gap in the empirical literature concerning this particular area of research.

The chapter is organized as follows. The Author begins with literature overview in Subsection 5.2 and describes the hypothesis, data and sample selection in Subsection 5.3. Section 5.4 provides results and discussion, followed by Subsection 5.5 which concludes the chapter.

5.2 Literature Overview

The Author contributes to the literature in two ways - relationship lending/assymetric information problems in lending and leveraged buyouts and role of participants in the transaction. This topic is rather scarce in the recent literature and the number of papers analyzing European data with respect to relationship lending in LBO transactions is very limited.

A recent paper from Bharath, Dahiya, Saunders & Srinivasan [2004] focuses on analyzing benefits of relationship lending from the perspective of lenders. The central question of their papar was "what is the rationale behind establishing a tight relationship with the borrower from the lender's perspective". They hypothezed that banks step into such deals with a perspective of winning future loan business easier than other players. Data used in this analysis range from 1986 to 2001. Their results show a 10-16 basis points lower interest rates on loans to relationship borrowers and up to 14% higher fees on investment banking services. Moreover, they found out that existence of repetitive lending interactions between financial intermediary and borrower increase the probability of winning future underwriting business from the same borrower.

Drucker & Puri [2007] examined the secondary market for loan sales. Despite theoretical concerns that loan sales can harm borrowers and weaken lending relationships, based on the USA data on secondary loan sales authors demonstrated more durable lending relationships when loans were sold. One possible explanation can be that by selling loans to other market participants (and thus lowering its exposure to individual borrowers), bank can increase its flexibility when originating future loans for a borrower. Moreover, banks typically sell only a part of the loan instead of entire amount which preserves current lending relationship. Their results showed that loans sold in the secondary market carry more restrictive covenants (i.e. more strict covenants with lower slack[2] or higher number of covenants), as opposed to loans which were held by the bank and were not sold.

Memmel, Schmieder & Stein [2006] analyzed determinants of relationship lending in Germany and their impact on the firm's borrowing costs. They used borrowers micro data from balance sheets from 1996 to 2002. They

[2]Covenant slack is a difference between the restrition set by the covenant criteria and the actual accounting value; e.g. if a company has debt/assets ratio of 0.3 and the covenant allows maximum of 0.35, covenant slack is 0.5 here.

found out that the number of lending relationships decreases with firm's size and R&D intensity. Moreover, they showed that costs associated with loans are an increasing function of number of lending relationships and that advantages from a single lending relationship decrease in time.

Hellman, Lindsey & Puri [2007] investigated an intertemporal cross-selling hypothesis about future lending based on prior strategic bank investment to a borrower at venture capital stage. Using data from 1980 to 2000 they found out that building a relationship at an early stage from banks perspective increases the likelihood of providing a loan in the future. Moreover, the authors showed that companies benefit from such relationship with lender via favourable loan pricing. This is consistent with findings of Berger & Udell [1995]. Using a data set on small firm finance, they examined price and non-price terms of commercial bank lines of credit provided by banks with long-lasting relationship with borrowers and found out that borrowers with longer banking relationships tend to pay lower interest rates and are less likely to pledge collateral. Based on small firms data collected in a survey, Petersen & Rajan [1994] found out that lending from multiple lenders increases price of loan and reduces the availability of credit.

On the other hand, analyses based on German borrower data did not prove the hypothesis that longer relationship with lending partner has a favourable impact on loan interest rates (Harhoff & Körting [1998], Elsas & Krahnen [1998]).

Recent study by Geršl & Jakubík [2008] investigated Czech firms' tendency to build close relationships with lending institutions. Using borrower charasteristics from internal database of Czech National Bank, their results showed that a majority of non-financial corporations in the Czech Republic borrow from a single lender.

The Author contributes to the literature on leveraged buyouts and role of participants in the transaction as well. Commercial banks represent traditional lenders for leveraged transactions. Kaplan & Stein [1993] showed that banks provided the majority of debt financing for buyouts during 1980s, mainly short-term and covenant-heavy loans and revolvers.

Axelson, Jenkinson, Strömberg & Weisbach [2009] analyzed how the financing for leveraged buyouts is related to debt market conditions. They found out that prices paid in large buyouts are strongly affected by the economy-wide cost of borrowing.

Demiroglu & James [2007] examined the reputation of private equity groups in LBO financing. They found out that buyouts of reputable private equity groups pay narrower bank loan spreads, have fewer and less restrictive financial loan covenants and longer loan maturities, use less "traditional" bank debt, borrow more and at a lower cost from institutional loan markets.

A recent paper from Strömberg [2009] analyzes global LBO activity, exit behaviour and holding periods using data from 1970 to 2007. He estimated the total value of firms acquired in this period to be USD 3.6 trillion. Resulting from his research, LBO transactions undertaken by more experienced sponsors are more likely to go public and the probability of going bancrupt or undergoing a financial restructuring is lower.

In this article, we follow the approach of Ivashina & Kovner [2008] who examined the impact of leveraged buyout firms' bank relationship on the terms of their syndicated loans using US data from 1993 to 2005.

5.3 The hypothesis, data and methodology

Definition: A *lead bank* is defined here as an administrative agent in the particular transaction.
Definition: A *sponsor* is defined here as a private equity firm which contributes to the deal with its equity.
Definition: A *loan spread* is defined here as the total annual costs (incl. fees) measured in basis points over a reference rate.

Following Ivashina and Kovner [2008], the Author formulates the hypothesis as follows:

Hypothesis: A tighter relationship between the lead bank and a sponsor of an LBO transaction should result in a lower loan spread.

In order to test the formulated hypothesis, the Author constructed a unique data set using information from 2 sources: The Reuters LPC Dealscan database (Dealscan) and The Thomson One database.

Dealscan contains an extensive number of leveraged loan transactions with a detailed deal characteristics (loan origination date, sponsors, banks participating in the transaction, number of facilities, type of facilities, maturity and amount for each facility, etc.). For a limited number of deals, covenant information and ratings are available.

The subset of syndicated LBO transactions from 1995 to the end of 2005 was selected for Europe as a whole. The initial aim of the Author was to run the analysis solely for Central and Eastern European data, however the database includes only 33 deals completed in the CEE region in the preset time period out of which 0 were available with financial covenant details. Since the analysis with only 33 data points available might suffer from biases and other distortions, the Author decided to broaden the range to other countries and cover the whole European space. The data from 2006 onwards were omitted from the analysis in order to avoid distortion of results since cov-lite structures became more common in 2006. Because the information about financial covenants is very limited prior 1994, the Author focuses on transactions starting in 1995. The Author considers the 10 years period to be sufficient for the purpose of the analysis.

Complete set of selection criteria was chosen as follows: only European loans were taken into consideration, time period from January 1st 1995 to December 31st 2005, LBO was chosen as specific purpose of transaction and only completed deals with sponsors were selected.

The original data sample contained 716 observations, out of which 689 were syndicated and 16 deals were with disclosed financial covenants details.

This indicates that syndication plays an important role in the LBO market. Globaly, syndicated loan market accounted for more than USD 4.5 trillion in 2007, an increase of 13% over 2006. The largest market is the United States, followed by the United Kingdom (with USD 2.1 trillion and USD 376.3 billion in syndicated lending respectively) (DTCC [2008]). There are 151 different LBO sponsors and 309 banks in the data set.

According to the survey conducted among European banks (ECB [2007]), for around 80% of EU top deals, banks were a part of syndicate from the beginning (either at the request of the fund manager or of another syndicate member). In 20% of the top transactions, reported bank was the sole lender or joined the syndicate at a later stage.

The basic unit of observation in Dealscan is a loan facility or tranche. LBO loans comprise generally of several tranches which differ in seniority and other terms. To construct the final data set, the Author used the following algorithm: only syndicated loans were taken into consideration, all transactions with information missing on loan spread, tranche maturity, sponsors or amount were omitted from the analysis; for each pair of sponsor and target company[3] only the first transaction was included; for loans with multiple facilities, the largest facility that starts at the loan initiation was chosen (Ivashina [2005]).[4] Using this data sample, independent variables were calculated and if one of relationship independent variables was 0, the particular deal was omitted from the regression. Final set of data contains 510 LBO transactions.

Spread is the dependent variable in this analysis and this variable represents costs of borrowing. The corresponding variable in Dealscan is called *All-in Drawn* and it's defined as the total annual costs (incl. fees) measured in basis points over a reference rate (LIBOR or EURIBOR) for each dollar used under the loan commitment (Dealscan in Ivashina [2005, p. 11)].

To measure strength of relationship lending, two independent variables

[3] Target company is defined here as a target of an LBO transaction.

[4] Examples of different facilities include term loans, revolver lines, lines of credit, etc.

were constructed:

- $RB(amount)_i^j$ is defined here for sponsor i as total dollar amount of loans underwritten by the same lead bank j over past 5 years divided by total dollar amount of loans sponsored by sponsor i over past 5 years underwritten by arbitrary lead bank. Measuring the relationship in the 5 years period is consistent with Bharath, Dahiya, Saunders and Srinivasan [2007] and Ivashina & Kovner [2007].

- $RB(number)_j^i$ is defined here for sponsor i as total number of loans underwritten by the same lead bank j over past 5 years divided by total number of loans sponsored by sponsor i over past 5 years underwritten by arbitrary lead bank.

A *lead bank* is defined here as an administrative agent. However, the Dealscan database does not always identify the administrative agent. In such cases Bookrunner, Mandated arranger, Lead arranger, Lead bank, Lead manager, Agent or Arranger is defined as the *lead bank*. Deals with multiple banks where it was not possible to decide on the lead bank were omitted from the analysis.

To control for sponsor quality, the Author included *Fund size* information gained from the Thomson One database. Since larger sponsors tend to manage several funds simultaneously, the Author used the selection criteria as follows: if there was a fund raised by the sponsor in year x and the next fund was raised in year y, all investments between x and y are attributed to the first fund; if there are several funds raised in the same year, the one dedicated to buyouts is chosen; for international sponsors with multiple buyout funds raised in the same year the one dedicated to Europe was chosen.

Figure 5.1 provides an overview of other independent variables used in the regression.

Tables 5.2 and 5.3 provide the summary statistics for the data set - means, medians, 25 and 75 percentiles and correlation matrix.

For selected regressions, the Author controls for year and credit rating.

Independent variable	Description
RB(amount)	A total dollar amount of loans underwritten by the same lead bank over past 5 years divided by total dollar amount of loans sponsored by sponsor over past 5 years underwritten by arbitrary lead bank
RB(number)	A total number of loans underwritten by the same lead bank over past 5 years divided by total number of loans sponsored by sponsor over past 5 years underwritten by arbitrary lead bank.
Loan amount	Logarithm of total deal amount
Maturity	Tranche maturity measured in months
Without rating	A dummy variable equal to 1 if the company was not rated
Unsecured	A dummy variable equal to 1 if the loan was not secured
Revolver	A dummy variable equal to 1 if the tranche examined was a revolver line
Lenders (number)	Number of lenders in the syndicate
Fund size	Logarithm of fund size amount associated with the deal
Old bank	A dummy variable which assigns value of 1 to a transaction where there was prior relationship between sponsor and the bank

Table 5.1: Overview of independent variables

	Mean	25%	Median	75%	St. Dev.
Loan amount (USD million)	411.54	119.37	218.46	493.93	618.84
Spread (basis points)	238.79	210.63	225.00	225.00	112.61
Maturity (months)	80.46	83.00	84.00	84.00	16.77
Lenders (number)	8.45	3.00	6.00	12.00	7.42
RB(amount) (%)	0.25	0.00	0.10	0.45	0.32
RB(number)	0.10	0.00	0.00	0.09	0.22
Old bank	0.19	0.00	0.00	0.00	0.39
Fund size (USD million)	1,572.75	500.00	1,002.00	2,100.00	1,450.94
Revolver	0.06	0.00	0.00	0.00	0.24
Without rating	0.91	1.00	1.00	1.00	0.29
Unsecured	0.87	1.00	1.00	1.00	0.33

Table 5.2: Summary statistics - Mean, Median, 25% and 75% percentile
Source: Author's calculations

	# of deals	Loan amount (USD million)	Spread (basis points)	Maturity (months)	Lenders (number)	Without rating
1995	0	-	-	-	-	-
1996	1	262.39	225.00	84.00	16.00	1.00
1997	9	297.19	191.67	84.67	7.00	1.00
1998	27	314.92	180.46	81.78	9.52	1.00
1999	45	257.86	204.72	83.44	10.67	0.84
2000	50	265.32	212.35	79.32	11.40	0.90
2001	44	463.12	230.34	80.20	9.34	0.84
2002	55	430.87	237.08	83.04	9.35	0.84
2003	77	351.60	256.33	80.29	8.16	0.97
2004	90	469.75	244.16	82.66	8.36	0.91
2005	113	535.94	269.80	76.30	5.54	0.93

	# of deals	RB(amount) (%)	RBI(number)	Old bank	Fund size (USD million)	Revolver	Unsecured
1995	0	-	-	-	-	-	-
1996	1	-	-	0.00	720.00	0.00	1.00
1997	9	0.00	0.00	0.00	1,199.25	0.33	0.89
1998	27	0.01	0.02	0.04	1,513.06	0.19	0.81
1999	45	0.14	0.10	0.09	1,373.39	0.09	0.87
2000	50	0.11	0.03	0.10	1,604.52	0.08	0.90
2001	44	0.21	0.06	0.20	1,604.19	0.02	0.98
2002	55	0.28	0.07	0.15	1,838.32	0.04	0.96
2003	77	0.21	0.08	0.17	1,309.42	0.04	0.92
2004	90	0.34	0.12	0.22	1,549.59	0.06	0.89
2005	113	0.35	0.17	0.32	1,792.72	0.04	0.75

Table 5.3: Summary statistics - Annual means

Source: Author's calculations

		1	2	3	4	5	6	7	8	9	10	11	12
1	Amount	1.000											
2	Maturity	0.0561	1.000										
3	Without rating	-0.3259	-0.0885	1.000									
4	Unsecured	-0.1283	0.0337	0.1126	1.000								
5	Revolver	-0.0382	-0.0521	0.0638	0.0212	1.000							
6	Lenders	0.4510	0.1544	-0.1818	0.0667	-0.0006	1.000						
7	RB(amount)	-0.0002	-0.1249	-0.1596	-0.1215	-0.0332	-0.0746	1.000					
8	Old bank	-0.0853	-0.1054	-0.0660	0.0356	-0.0718	-0.1664	0.4195	1.000				
9	RB(number)	-0.1173	-0.1562	-0.1308	-0.0333	-0.0315	-0.1985	0.6372	0.7347	1.000			
10	Loan spread	0.1326	0.2220	-0.1642	-0.0755	-0.1000	-0.0563	0.0740	-0.0171	0.0410	1.000		
11	Fund size	0.2920	0.0520	-0.1323	-0.0389	0.0538	0.2084	0.0190	0.0210	-0.0267	0.1399	1.000	

Table 5.4: Correlation matrix

Source: Author's calculations

To control for credit rating, S&P rating categories were used and dummy variables were assigned to each category of credit rating (the sample contained credit ratings A, A-, AA+, AA-, B, B+, B-, BB, BB+, BB-, BBB+ and CCC+).

The Author estimates the model as follows:

$$Spread = \beta_0 + \beta_1 RB + \beta_2 Amount + \beta_3 Maturity + \beta_4 WithoutRating +$$

$$+\beta_5 Unsecured + \beta_6 Revolver + \beta_7 Lenders(number) +$$

$$+\sum \beta_k Year + \sum \beta_l CreditRating + \epsilon$$

RB is one of independent variables (*RB(amount), and RB(number)*) measuring strength of relationship between lending bank and sponsor in the transaction.

To estimate the proposed relationship, the Author used a regression with robust standard errors.

5.4 Results of the cross-sectional analysis and discussion

In this subsection, the Author provides results of the cross-sectional OLS regression with Huber-White robust standard errors analysing impact of stronger relationship between the bank and the sponsor of LBO on terms of the loan.

Figure 5.5 gives the resulting coefficients with respective robust standard errors. *, ** and *** stand for significance levels of 10%, 5% and 1% respectively.

The results of the regression did not prove the hypothesis about favourable impact of relationship lending on loan terms. However, the results are consistent with a so-called *hold-up problem* arising from relationship lending (Boot [2000]). The hold-up problem describes a situation when the bank collects

	(1) Coeff.	(2) Coeff.	(3) Coeff.	(4) Coeff.	(5) Coeff.
Loan amount	0.05 *** (0.02)	0.07 *** (0.02)	0.03 * (0.02)	0.07 *** (0.02)	0.04 ** (0.02)
Maturity	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
Without rating	-0.23 (0.30)	-0.22 (0.29)	-0.61 ** (0.29)	-0.20 (0.29)	-0.60 ** (0.05)
Unsecured	0.01 (0.05)	0.06 (0.07)	-0.03 (0.05)	0.06 * (0.07)	-0.03 (0.05)
Revolver	-0.01 (0.05)	-0.08 * (0.05)	-0.10 ** (0.05)	-0.08 *** (0.05)	-0.10 ** (0.05)
Lenders(number)	-0.01 (0.00)	-0.01 (0.00)	-0.01 *** (0.00)	-0.01 *** (0.00)	-0.01 *** (0.01)
Old bank	-0.03 ** (0.03)	-0.03 (0.04)	-0.02 (0.02)	-0.10 * (0.05)	-0.06 ** (0.03)
RB(amount)		0.07 * (0.04)	0.07 ** (0.03)		
RB(number)				0.15 (0.11)	0.16 ** (0.08)
Fund size			0.02 * (0.01)		0.02 ** (0.01)
Controls					
Year	Yes	Yes	Yes	Yes	Yes
Credit rating	Yes	Yes	Yes	Yes	Yes
Observations	510	356	287	356	287
R^2	0.16	0.21	0.28	0.22	0.28

Table 5.5: Loan spread - Regression results

Source: Author's calculations

valuable information about a borrower through repetitive lending interaction and this knowledge gives the bank an information monopoly. This information monopoly allows the bank to charge higher interest rates in following loan contracts (Sharpe [1990], Rajan [1992]). Using data on European loans, Degryse & Van Cayseele [2000] showed that the loan terms worsen with longer relationship between the bank and borrower. They examined data on small European firms and found out that the longer relationship between the lending bank and the borrower, the higher interest rates were associated with loans. Greenbaum, Kanatas and Venezia [1989] found out the same positive dependence between the length of relationship and cost of borrowing.

A possible explanation for different results obtained for European data (this study) and results for the USA data (Ivashina & Kovner [2008]) is that the hold-up phenomenon is more present in Europe than in the USA.

According to results obtained from the survey conducted among private equity firms, it's a flexibility and speed rather than better loan terms which sponsors are looking for when stepping into repeated business with their relationship-based lending bank. This could support the result from the empirical analysis that borrowers are still willing to borrow money from the bank even if the loan terms are worse but the probability of obtaining the credit and speed of the overall transation is higher.

Borrowers may look for alternative ways how to obtain loans with more favourable terms. They might be looking for establishing several relations with different banks to reduce the hold-up problem. Ongena and Smith [2000] showed that relationship with multiple banks reduces the interest rates charged on loans, however on the other hand decreases the availability of credit.

5.5 Conclusion

Relationship lending and its possible value ad for lenders and borrowers is gaining a lot of attention in recent years. The aim of this chapter was to conduct an empirical analysis about the possible favourable impact of long-lasting relationship between the lender and sponsor of the LBO transaction on loan interest rates.

The majority of literature available focuses on analyzing relations between the bank and the target company itself. The Author argues however, that sponsor of an LBO transaction, the private equity firm, and its repeated interaction with the lending bank can influence resulting terms of the contract. To prove the proposed hypothesis, the Author collected uniqe data set on European syndicated LBO transactions ranging from 1995 to 2005.

The Author used All-in-Drawn Spread (spread paid over a reference rate) as a dependent variable and several independent variables measuring strength of relationship between the bank and the sponsor as well as loan specific variables and controls for sponsor quality.

Consistently with Ivashina & Kovner [2008], the Author hypothesized that the information obtained via repeated interations between the financing bank and the private equity firm will have positive impact on loan terms and will lead to decrease in interest rates. However, the empirical results proved the opposite and supported the theoretical concept of a hold-up problem where the bank gains an information monopoly over time and charges higher interest rates on future loans. This empirical evidence points at potentialy stronger presence of hold-up problem in Europe than in the USA.

Chapter 6

Conclusion

Leverage represent nowadays a standard feature of global buyouts. The history of leveraged buyouts in the US and in Western Europe is far longer than in the CEE region. Since banks were struggling with the privatization process in 1990s, LBO lending in the region could emerge only after the situation has stabilized and banks started to search for new lending areas with higher margins. Moreover, investors started to look at the region as a viable candidate for generating high returns - Poland, Czech Republic, Slovakia, Hungary and Baltic countries accessed EU already in 2004, Bulgaria and Romania in 2007. The accession excellerated a process of legislative and regulatory harmonization, administrative harmonization as well as harmonization of economic policies. Many countries in the region were growing faster than old EU-15 countries, consumption was rising and investors were in general speaking about investing at risk known from developed countries with growth comparable to emerging countries.

The aim of this thesis was to provide a comprehensive overview of LBO market in the CEE region and to analyze the impact of stronger relationship between a private equity firm and lending bank on syndicated LBO loan terms. In the first part (Chapter 4), the Author focused on proper introduction to situation in the European market which led to description and more in-depth analysis of LBOs in CEE. Special attention was paid to development of LBOs in the post-2007 era.

Loan structures used in LBOs in the CEE region have never reached the level of complexity common in Western Europe. In Western Europe in the pre-crunch time it was not an exception to see number of new financial instruments used together with traditional equity, senior debt and mezzanine. Deals in the CEE region were always structured in more conservative way. In pre-2007, equity represented around 40% of deal value, senior loan around 40% and the rest was usually financed by mezzanine. Second lien and PIK notes have never gained such popularity as in Western Europe. In the post-2007 time, investors were required to put at least 50% equity to get deal done. The rest was financed either entirely with senior debt or with combination of senior debt and mezzanine. Leverage multiples decreased to a level of 3-3.5x EBITDA and deals take longer to finish. However, there are still banks in the region which are willing to provide leverage for good investements.

In the second part (Chapter 5), the Author used two different databases and collected an unique data set containing information on European syndicated loan structures in the 1995-2005 period. The goal of this Chapter was to address the potential favourable impact of establishing long lasting relationship between a private equity firm and bank on interest rates associated with LBO loans. The Author hypothesized that repeated interactions between bank and GPs decrease information assymetry and should result in lower spread paid over reference rate on loans provided to finance particular LBO transactions. Results of the cross-sectional analysis showed an opposite. This is consistent with theoretical concept of a hold-up phenomenon. Hold-up phenomenon explains the situation when a bank acquires lender specific information via prior lending interactions and charges higher fees on future loans (Sharpe [1990], Rajan [1992]).

This Thesis fills the gap in the literature in two ways. First, to Author's best knowledge it is the first study describing CEE LBO market in detail - development of loan structures, deal size and volumes, current trends in the market in relation to post-crisis changes. Second, as a first of its kind, Chapter 5 analyzes European syndicated loan data and investigates the influence of tighter relationship between lending bank and private equity firm on interest ratest associated with an LBO loan.

Appendix A

Survey - Characteristics of participants and selected results

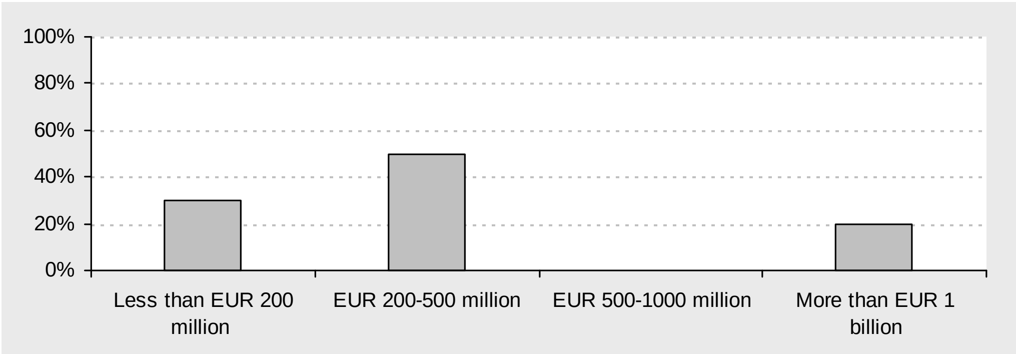

Figure A.1: Capital under management

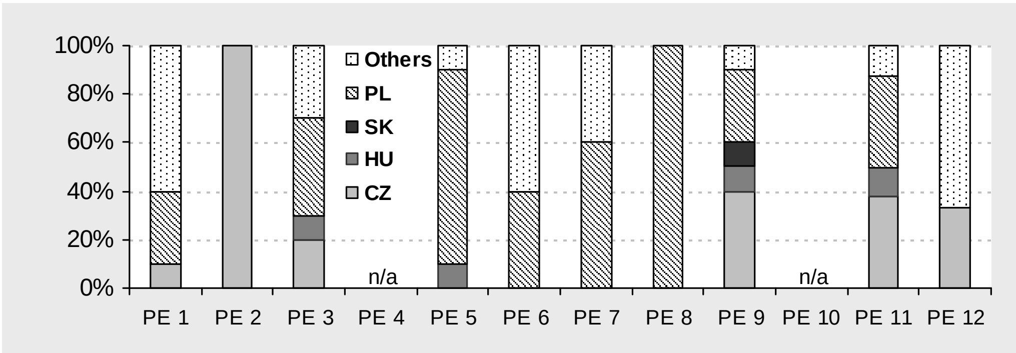

Figure A.2: Country structure in the portfolio

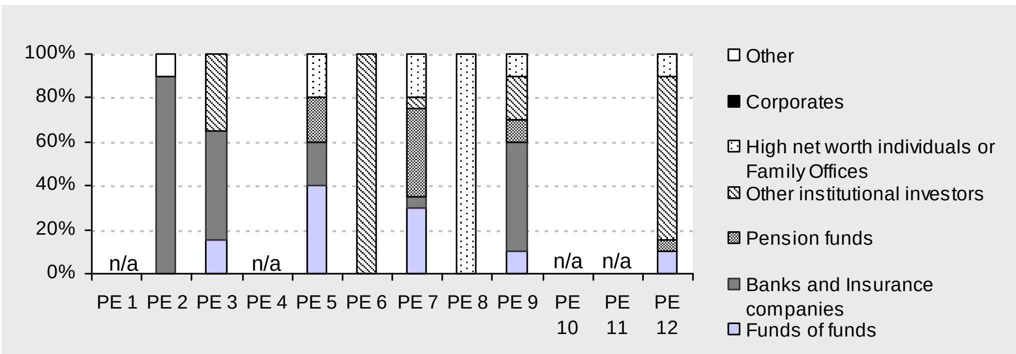

Figure A.3: Proportion of investors commitments in the last fund dedicated to the CEE region

Appendix B

Overview of Buyout Funds dedicated to the CEE region

Closed funds				
Fund name	**Fund manager**	**Country of origin**	**Final close**	**Fund size (in EUR m)**
Abris Capital Partners	Abris Capital Partners	Poland	November 2008	300.00
Advent Central & Eastern Europe IV LP	Advent International	United Kingdom	April 2008	1000.00
Argus Capital II	Argus Capital Group	United Kingdom	February 2007	263.00
East Capital Financials Fund	East Capital	Sweden	June 2007	350.00
Emerging Europe Growth Fund II (EEGF II)	Horizon Capital	Ukraine	November 2008	159.22
Gamma III	gamma capital partners	Austria	October 2008	75.00
Innova/5	Innova Capital	Poland	-	185.17
Mid Europa Fund III LP	Mid Europa Partners	United Kingdom	November 2007	1500.00
Nova Polonia Natexis II	Krokus Private Equity	Poland	September 2007	75.00
Polish Enterprise Fund VI	Enterprise Investors	Poland	September 2006	-
UFG Private Equity Fund I	UFG Private Equity	Russia	June 2006	201.26
AIG New Europe Fund	PineBridge Investments (formerly AIG Investments)	Poland	June 1999	272.29
Bancroft II	Bancroft Private Equity LLP	United Kingdom	-	-
DBG Eastern Europe II LP	Arx Equity Partners	Czech Republic	-	80.00
Polish Enterprise Fund	Enterprise Investors	Poland	February 2007	96.64
Polish Enterprise Fund V LP	Enterprise Investors	Poland	January 2004	238.34
Poteza Adriatic Fund B.V.	Cielo Azul	Netherlands	June 2004	67.00
Riverside Central Europe	Riverside Company	Belgium	-	42.39

Table B.1: Closed buyout funds dedicated to CEE to date
Source: Author's calculations, data from Private Equity Insight

Open funds				
Fund name	**Fund manager**	**Country of origin**	**Announced**	**Target size (in EUR m)**
ADM Capital CEECAT Recovery Fund	ADM Capital	United Kingdom	August 2009	250.00
Arx CEE III	Arx Equity Partners	Czech Republic	May 2008	125.00
Aurora II	Aurora Private Equity Asset Management	Russia	-	59.64
Balkan Accession Fund	Axxess Capital 3	Romania	October 2006	100.00
BaltCap Private Equity Fund	Baltcap Management Ltd	Estonia	-	100.00
CEE Special Situations	CRG Capital	Austria	-	200.00
CRG Capital CEE Special Situations Fund	CRG Partners	Austria	October 2009	150.00
Emerging Europe Accession Fund	Axxess Capital 3	Romania	June 2009	200.00
Europe Virgin Fund	Dragon Capital	Ukraine	May 2009	55.16
Genesis Private Equity Fund II	Genesis Capital	Czech Republic	May 2008	60.00
GILD Long Haul II	GILD Bankers	Estonia	December 2008	50.00
Interros Holding/One Equity Partners	One Equity Partners	Russia	October 2009	502.06
P&S East Growth II	P&S East Growth Luxembourg	Luxembourg	March 2009	100.00
PPF Partners 2 LP	PPF Partners	Czech Republic	June 2009	2300.00
Resource Eastern European Equity Partners I	Resource Partners Sp. z o.o.	Poland	-	200.00
Taiga Inversiones Eólicas II	Taiga Mistral	Spain	January 2009	50.00
Taiga Mistral	Taiga Mistral	Spain	November 2008	50.00
UFG Private Equity Fund II	UFG Private Equity	Russia	-	102.89

Table B.2: Open buyout funds dedicated to CEE to date

Source: Author's calculations, data from Private Equity Insight

Appendix C

CEE - League tables

2009		
Debt provider	**# of deals**	**Value of deals (in EUR m)**
UniCredit	2	825.00
Bank Austria Creditanstalt	2	95.00
ING Group NV	1	800.00
Bank Zachodni	1	46.00
Bank of Ireland	1	800.00
DnB Nor	1	-
2008		
Debt provider	**# of deals**	**Value of deals (in EUR m)**
UniCredit	1	200.00
West LB	1	200.00
ING Group NV	1	200.00
Credit Agricole Corporate & Investment Bank (Formerly known as Calyon)	1	200.00
LBBW Landesbank Baden-Württemberg	1	-
2007		
Debt provider	**# of deals**	**Value of deals (in EUR m)**
UniCredit	1	404.32
Nordea	1	404.32
DnB Nor	1	404.32
Bank Zachodni	1	64
Parex Bank	1	404.32
Lehman Brothers	1	1,500.00
Royal Bank of Scotland	1	1,661.00
Commerzbank	1	-
HSBC Bank	1	-
Fortis Bank	1	-
ING Group NV	1	-
Citigroup	1	-
Bank Pekao	1	-

Table C.1: Top debt providers in CEE, 2007 - 2009

Source: Author's calculations, data from Private Equity Insight

2010		
Equity provider	**# of deals**	**Value of deals (in EUR m)**
Abris Capital Partners	2	63.50
TFI Investors	1	4.00
Advent International	1	-
Innova Capital	1	-
Enterprise Investors	1	-
GED Capital	1	-
Baltcap Management Ltd	1	-
Penta Investments	1	-
Almaz Capital	1	-
2009		
Equity provider	**# of deals**	**Value of deals (in EUR m)**
Advent International	2	118.00
Enterprise Investors	2	69.60
GED Capital	2	24.00
Mid Europa Partners	2	220.00
EQT Partners	2	409.91
Arx Equity Partners	2	38.00
CVC Capital Partners Ltd	1	1529.91
VTB Capital	1	-
Oresa Ventures	1	-
Royalton Partners	1	-
PPF Investments	1	-
Penta Investments	1	-
TA Associates	1	-
AnaCap Financial Partners	1	-
TPG	1	-
CapMan Group	1	-

Table C.2: Top equity providers in CEE, 2009 - 2010

Source: Author's calculations, data from Private Equity Insight

2008		
Equity provider	**# of deals**	**Value of deals (in EUR m)**
Bessemer Venture Partners	2	500.00
Oak Investment Partners	2	500.00
Columbia Capital Partners	2	500.00
M/C Venture Partners	2	500.00
Innova Capital	2	500.00
Penta Investments	2	50.00
HarbourVest Partners Limited	2	500.00
Onexim	2	441.39
Reconstruction Capital II Limited	1	82.50
Jet Investment	1	5.50
Crossroads Capital Investments	1	127.41
Ares Life Sciences fund	1	800.00
Romanian Investment Fund	1	82.50
Enterprise Investors	1	46.00
East Capital	1	28.00
Lion Capital (formerly Hicks Muse)	1	386.65
MCI Management	1	8.59
Aurora Russia	1	6.36
Merrill Lynch	1	800.00
TPG	1	1022.23

Table C.3: Top equity providers in CEE, 2008

Source: Author's calculations, data from Private Equity Insight

2007		
Equity provider	**# of deals**	**Value of deals (in EUR m)**
Penta Investments	3	943.18
Krokus Private Equity	2	46.50
PPF Investments	2	45.00
Enterprise Investors	2	104.00
Mid Europa Partners	2	40.00
GED Capital	1	9.00
Vienna Capital Partners	1	1500.00
Permira Advisers LLP	1	1500.00
Blackstone Group	1	404.32
Penta Capital Partners	1	104.00
PineBridge Investments (formerly AIG Investments)	1	1661.00
Advent International	1	35.00
Royalton Partners	1	-
Argan Capital	1	-
Lion Capital (formerly Hicks Muse)	1	-
AnaCap Financial Partners	1	-
KBC Private Equity NV	1	-
Providence Equity Partners	1	-
Bridgepoint Capital Limited	1	-
Oresa Ventures	1	-

Table C.4: Top equity providers in CEE, 2007

Source: Author's calculations, data from Private Equity Insight

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