The Central European private debt market

Draft for Private Debt Investor

Private debt in Central Europe

By Ben Edwards

Writing about the private debt industry in Central Europe is a little like recommending a restaurant that is a hidden gem: one immediately regrets it because it might attract too much attention and become tougher to get a decent table.

However, as paid-up members of the European private debt industry, we will sweep any hesitation aside for the greater good, and compare and contrast the Central European market with those in Western Europe. We will highlight some of the reasons we think it is attractive (but still thankfully overlooked), and set-out our views as to why the region will provide attractive returns for private debt investors in the years to come.

Origins and composition of the market today

Consistent with other geographic precedents, the development of the private debt markets mirrored, with a lag, the trajectory of their respective private equity markets. In Central Europe, private equity after the fall of the Berlin Wall was focused on privatisations, where the key driver of success was buying things cheap (and sometimes not that transparently). Later in the 1990s, the private equity market fell in love with 'roll-out' investments, based on concepts already successful in the West, but which ultimately proved harder to implement successfully in Central Europe, either because they were ahead of their time, or unsuited to local tastes.

As both of these waves either did not require debt (privatisations) or were not leverage-able (roll-outs), the private debt market really only took off in the following development phase of the private equity industry: leveraged buyouts, starting in the early 2000s. Those private equity funds that had survived the first two waves and had raised successor funds, now focused on low-hanging fruit—cost-cutting, synergies, operational improvements, professionalization of management—and the banks loved it. A gusher of credit and inward investment into the region in the run-up to accession to the European Union in 2004, fuelled bumper returns for funded portfolios. It also marked the beginning of an asset-price bubble for those that were just starting to put capital to work, many of them Western private equity firms looking to get in on the game.

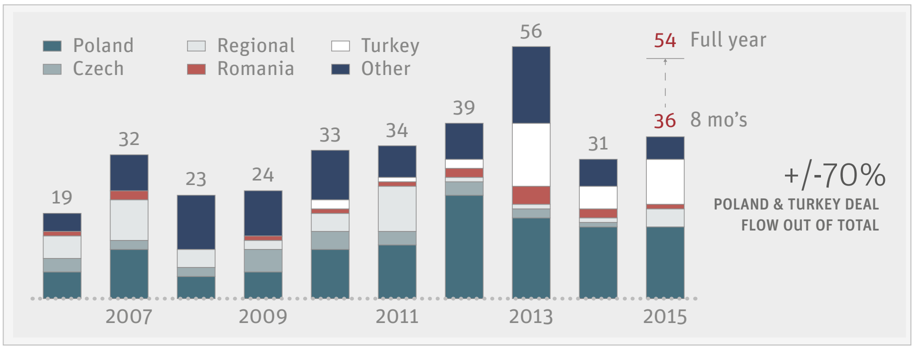
That there was a bubble is clear. With long-term convergence-based growth accepted as gospel, leverage levels in the middle of the decade approached and even exceeded those in Western Europe, and debt was generally cheaper, certainly on a risk-adjusted basis. When the bubble burst post-Lehman and economies went into recession, many funds fared poorly, and many Western European private equity funds packed-up and left. So too did some Western European mezzanine firms that had leaped into the fray. The banks retrenched as well, shutting-off credit, not just for new deals but for existing relationships, initiating downward spirals due to scarce working capital, exacerbating losses in existing portfolios, and effectively stopping the buyout market in its tracks.

Lots of painful lessons were learned, and the remaining private equity funds and debt providers, though battered and somewhat bruised, made changes that mean the industry is in a much healthier state today. The abundance of equity dry-powder and credit also meant that the necessary deal infrastructure was put in place to facilitate those prospective investments. Having established a presence on the ground for twenty-plus years, all the main accounting and legal firms are today staffed by locals, not expats. Importantly, the work they do is comparable to that done by their Western European colleagues, and all loan documentation is fundamentally Loan Market Association (LMA)-compliant.

So how do things look now that the dust has settled?

In our experience from covering a number of countries across the central European region, from the Czech Republic and the Baltics all the way south to Turkey (though excluding Russia and Ukraine), Poland is by far the most active market in terms of deal-flow, due to its size, macroeconomic potential and political stability. In terms of deal completions, it accounts for two-thirds of our most recent fund's portfolio.

Figure 1 | Deal activity, 2006 to the present, by geography[1]



Visible trends in Figure 1 include the relative decline in regional transactions, which where typically larger buyouts of companies active in more than one of our focus geographies. Additionally, deal activity in Turkey has risen from zero to circa 20 percent of volumes, second only to Poland with circa 50 percent of volumes. Activity levels in 2015 are high, and annualised will approach the levels seen in 2013, supporting our view that alternative capital for smaller businesses for growth is scarce in the region.

Syntaxis has always provided capital in both sponsored and sponsorless deals and, since 2012, the number of sponsorless opportunities has been 2.4x the number of those that were led by an equity fund (404 sponsorless, or circa 70 percent, versus 165 sponsored). This tendency is in part due to the dramatically lower level of sponsored transactions in the region, but for us it is primarily because it is where we see much better value and much lower risk (discussed further below). Related to the overall shift towards sponsorless transactions, average mezzanine tranches have also fallen in the region, from an average of just over €35 million in the period 2006-08 to an average of just over €11 million in the last three years.

In terms of industry players, there are few, but include less than a handful of dedicated mezzanine funds, each with a different geographic focus (for instance the Baltics and Turkey, or South Central Europe) and investment strategy (either 'structured' equity, or just plain equity).

Relative risk and return

Despite the pre-Lehman excesses, leverage in Central Europe has on average remained below that of Western Europe. Since the beginning of 2010, total leverage in Central Europe has averaged 4.4x versus 4.6x in Western Europe[2]. More meaningfully, at least for us as we do not participate in larger syndicated deals, and have always absolutely controlled the layer in each of our financings, senior leverage in Central Europe has averaged 2.1x versus 3.6x in Western Europe over the same period. In our particular area of focus, senior leverage in sponsorless transactions has been just 1.2x since around 2010,

1 By number of deal opportunities. Source: Syntaxis DeaLog.
2 For leveraged finance metrics in Central Europe, the source is Syntaxis's proprietary database "DeaLog", as of the August 2015, while for Western Europe it is the S&P/Capital IQ European Leveraged Lending Review, June 2015.

a third of the level in Western Europe, which for a subordinated lender is a substantial financial risk mitigant. In contrast to leverage levels, pricing on leveraged loans in Central Europe is similar to that in Western Europe, with term loan A and revolver spreads ranging from 350bps to nearly 500bps at their height, and term loans B/C from 370bps to 540bps. However, recent trends point to further pricing pressure in Western Europe, where spreads as at the end of June have on average fallen by nearly a quarter from their three-year highs, while in Central Europe spreads have remained static.

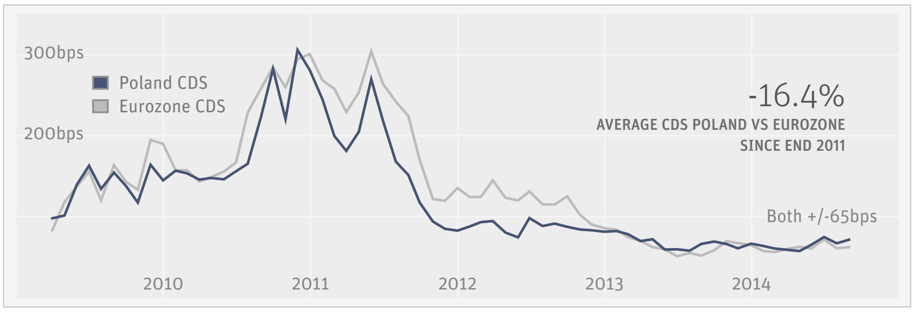
Comparable data for mezzanine is less robust, but we aim to price the contractual return element of our investments to achieve between 1.4x-1.5x money, excluding front-end fees, which equates to cash pay plus payment-in-kind (PIK) spreads over Euribor of circa 11 percent. Ignoring some of the subordinated issuance financing of the larger pre-Lehman buyouts in Central Europe, the industry has always included equity upside via warrant equivalents. Typically, the Central European market prices instruments to achieve all-in returns of 1.8x-2.0x money, or high-teens IRRs. At these pricing levels, equity upside can amount to between one-third and one-half of total non-principal flows, providing investors with returns closely correlated with those of the owners of the portfolio companies, but with meaningful downside protection due to lower senior leverage levels and substantial creditor protections. Developments such as covenant-lite and loan portability have not yet found favour amongst leverage finance providers in Central Europe.

Prospects

Discussing the outlook for anything involves projected supply and demand, and in Central European private debt that dynamic points to a continuing attractive environment for investment and credit.

Looking at demand first, real GDP growth across the primary countries of Central Europe is projected over the next three years to be 1.8x that of the Eurozone, or CAGRs of 2.8 percent and 1.6 percent for Central and Western Europe, respectively. In the case of Poland, our key geography, projected annual compound growth is 3.5 percent, or 2.3x that of the Eurozone. The country is rated investment grade, and the economy firing on all cylinders. As is illustrated in Figure 2, the credit market's take on sovereign risk is that it is effectively the same as the Eurozone (not just on a simple average basis, but on a GDP-weighted basis, reflecting the importance of Germany, France et al.).

Figure 2 | CDS Poland vs. Eurozone[3]



However, because of increased regulatory costs, loan losses and general deleveraging, credit to the private sector has not kept pace with the overall growth of the Central European economies. Our focus country of Poland provides a good example of this lack of finance, as shown in Figure 3.

3 The Eurozone index is the S&P/ISDA Eurozone Developed Nation Sovereign CDS index. Source: Bloomberg.

Figure 3 | **Growth vs. credit availability**[4]

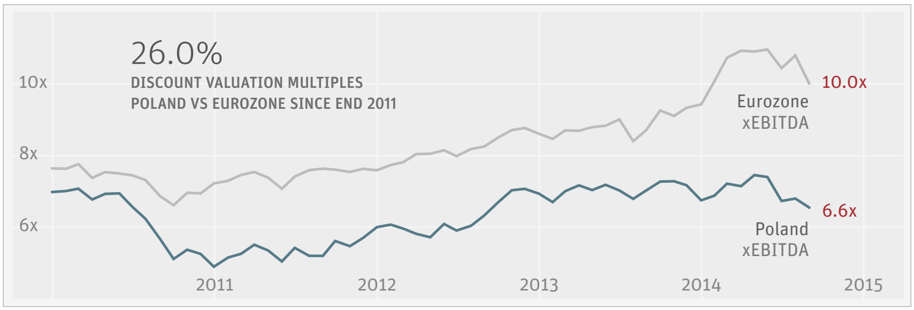
Additionally, because of the reduced profitability of banks in our region, which has fallen by nearly three quarters, from a 2002-07 average ROE of 14.7 percent to an average of just 3.7 percent since 2008, banks are now much more selective, opting to provide what credit there is to larger companies and national champions. In addition, using credit default swap-levels for those same banks as an approximation, cost of funds for borrowers has risen sevenfold (from an average of 24bps from 2002-07, to 167.2bps) from 2008 to the present. Smaller mid- to lower mid-market Central European companies have suffered as a result. Even if banks turn the taps back on in the future, there is still significant scope for further credit penetration, with domestic credit to the private sector in Central Europe just over half that in the Eurozone (51.9 percent versus 93.1 percent at the end of 2014).

With limited competition from banks and other independent regional private debt providers, we believe that financing conditions in Central Europe will remain benign.

What about the borrowers?

The credit crunch and subsequent Eurozone crisis has in many ways separated the wheat from the chaff, imposing a form of natural selection across the private sector. Innovative companies with robust business models have been able to demonstrate their comparative advantages, have made it to the next stage of their development, and have done so during a period where growth financing was hard to come by. Not only that, on average company valuations typically remain below those in Western Europe, as seen in Figure 4.

Figure 4 | **Relative value**[5]



A good example of such a company is Polflam, a Polish business that provides fire-resistant glazing solutions to the non-residential construction industry.

4 Foreign claims are consolidated, on an ultimate risk basis. Source: Bloomberg for real GDP data, Bank of International Settlements for cross-border credit, Syntaxis analysis.
5 For Poland the LTM EBITDA multiples for WIG index companies, for the Eurozone, the LTM EBITDA multiples for the MSCI free-float weighted index of European developed nation stock markets. Source: Bloomberg.

Polflam has developed a highly innovative and proprietary technology that injects gels between float glass, enabling it to resist heat and flames for very specific periods of time and to various specific standards. It is not a glass manufacturer. The fire-resistant glazing market is a €400 million niche within the European float glass market and, though growing fast for safety and aesthetic reasons, still accounts for just 11 percent of the overall market. It is perhaps easy to overlook.

However, due to increasingly stringent building-safety standards, the industry is also highly regulated, presenting a formidable barrier to new entrants. Until the arrival of Polflam five years ago, just three large players (Saint-Gobain, Pilkington and AGC Glass) enjoyed an oligopolistic position, selling products manufactured using technologies from the 1970s and 1980s. Since the company's entry, it has become the market leader in Poland, with a market share of some 30 percent. It has grown its top-line in excess of 25 percent annually since 2011, and has generated EBITDA margins in excess of 40 percent over the same period.

The opportunity for us to invest arose because in 2014, the founder, who owned 60 percent of the equity, wished to partially cash out. He wanted to retain a stake to capture some of the projected growth of the business, was bank debt-averse, and aimed to sell to a strategic investor in the next three to five years. As such, he chose to hold a limited auction to sell a stake to a private equity fund, and because of our franchise and long-established presence on the ground, we were able to muscle-in. Non-binding bids were received from a number of firms, valuing the company at just over €30 million, a meaningful discount to comparables but still allowing for a pay-out to the existing owners of circa €27 million. With a recap combining our non-amortising loan with warrants (we are senior-secured, the only debt in the business, at 3.0x LTM EBITDA at close), and a small equity co-invest, we were able to demonstrate the value of holding on, of taking less out of the company today, and of having a much greater share in the upside when selling directly to a strategic investor in that same time-frame.

Where are we one year later? As part of the plan, the company accelerated the process of accreditation in other European Union markets, has signed up three large customers and, jointly through our involvement on the company's board, initiated discussions with a further five. Full-year forecasts for this year show revenues and EBITDA up in excess of 35 percent, margins expanding to above 45 percent, and a 2015 EBITDA forecast that matches our original forecast for 2017, our assumed exit year. Total leverage is projected to be 2.0x by year-end due to better than planned cash flow, and there have already been unsolicited offers to buy the Company.

Conclusion

Do we think that all our investments across Central Europe will perform as well as Polflam? Of course not, but we do think that there are a very large number of smaller, innovative companies across the region, that can be invested into at highly attractive valuations. Combining that with the relatively limited availability of cost-effective credit, and the conditions are in place for superior returns in the private debt markets in the years ahead, at least in the space we target. However, our market, not just in Poland but across Central Europe, is relatively small, with an average annual volume of just under €600 million, or just one fifth of that of the on/off second-lien market in Western Europe (€26.9 billion since 2005, or €2.7 billion annually). For Syntaxis, being both relatively small and very local, there is a formidable competitive advantage in origination and execution, and there simply isn't the scale for larger funds to enter and put significant money to work.

Coming back to the hidden gem idiom, we definitely think that Central Europe is full of them, and we aim to continue mining this seam profitably in the years ahead, just as our team members have for the last fifteen.