EXIT STRATEGIES FOR PRIVATE EQUITY PORTFOLIO COMPANIES IN THE MARKETS OF CENTRAL AND EASTERN EUROPE. THE CASE OF POLAND

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Abstract

The purpose of this paper is to focus on the investigation of private equity exit strategies in the markets of Central and Eastern Europe (CEE), between the years 2008 and 2012. Exits are central to the venture capital (VC) and private equity (PE) process because financial returns are primarily derived from capital gains upon sale, and not dividends on equity. Even though exit strategies are placed as the last part of the PE process, they are so crucial that they are already planned prior to the initial investment. This article reviews the pre-existing literature and examines the potential factors that might affect PE exit outcomes in terms of initial public offerings (IPOs), trade sales, secondary sales, buybacks and write-offs. Findings indicate that Poland is similar to the other CEE countries with respect to exit route strategies for private equity managers. Divestments have been performed mainly through trade sales of companies to strategic investors and not through IPOs despite the fact that Poland hosts one of the most active European stock exchanges. In the years 2008 through 2012, exit activity was concentrated in a few countries, with the Czech Republic, Hungary and Poland accounting for 81% of the total exit value at investment cost in the CEE region.

Key words: venture capital, private equity, divestments

JEL Code: G24, G32

Introduction

Venture Capital (VC) and Private Equity (PE) constitute an asset class where institutional investors provide capital to enterprises not quoted on the stock market. Private equity is distinguished by active management in order to make a profit by enhancing the fundamental value of the private companies in which it invests in the course of an improved strategy and capital structure (Duda & Wolak-Tuzimek, 2008). The terms venture capital and private equity differ primarily with respect to the stage of development of the entrepreneurial firm in

which they invest. Venture capital refers to investments in earlier-stage firms. Private equity funds are pools of capital managed in general, as closed-end, fixed-life funds making equity capital investments into later-stage enterprises as well as buyouts and turnaround investments. The term private equity encompasses all private investment stages including venture capital. Due to the structure of the private equity industry, in which closed-end funds are often used, the VC/PE investments have to be liquidated after some time to return the proceeds to the investors. Gompers and Lerner (2001) state that venture capital exits are the most important aspect of the industry's survival and growth, due to the fact that venture firms invest in companies that do not pay dividends to equity holders, which hence allows them to realize their returns. Planning an exit route is an integral part of the initial decision to invest, with exits usually occurring between three to seven years after the initial investment. Private equity managers have several exit channels at their disposal when attempting to realize the value created over the holding period of an investment and cope with the limited time frame of the fund. It is therefore particularly important to consider factors that drive different exit outcomes. This article reviews the literature and examines potential factors thatmight affect PE exit outcomes in terms of initial public offerings (IPOs), acquisitions (also referred to as a trade sales), secondary sales, buybacks and write-offs.

Emerging markets, such as those in Central and Eastern Europe (CEE), where the PE industries are to a large extent, underdeveloped, have attracted a lot of attention and interest from international investors. The purpose of this article is to examine the private equity (PE) exit strategies in the markets of Central and Eastern Europe (CEE), between the years 2008 and 2012. This study tries to filter out particularities of the emerging markets of CEE as compared to the more established Western European markets. This study also examines the exit behaviour of Poland private equity (PE) firms from their portfolio companies. Studying the behaviour of Poland PE exit strategies is important for two reasons. First, Poland represents the most developed private equity and venture capital market in Central and Eastern Europe, evidenced by three major activities: fundraising, investing and exiting. Second, a significant portion of the material presented has practical relevance in the international context of PE funds that have pursued expansion outside their home locations, specifically, in Europe. The statistical data used in the article has been based on publications of the Polish Private Equity Association and reports of the European Private Equity and Venture Capital Association.

1 Literature Review

Numerous researchers have studied the exit decisions of venture capitalists (Cumming & MacIntosh, 2003; Black & Gilson, 1998; Kaplan & Schoar, 2005; Gompers & Lerner, 2003). Private equity firms have five primary types of exit strategies at their disposal when attempting to realize the value created over the holding period of an investment: Initial Public Offerings (IPOs), acquisitions (sometimes referred to as a trade sales), secondary sales, buybacks and write-offs (liquidations). As noted by Cumming and Johan (2014), the exit process includes the following primary issues:

a/ choice of mode of exit, and allocation of decision rights among the venture capital fund and entrepreneur

b/ choice of time of exit

c/choice of full versus partial exits

d/anticipating the exit value.

Previous literature suggests that the choice of exit channel by PE depends mainly on both company-level factors and market-related factors (Achleitner et al., 2012) and has generated a compelling list of company-level factors that affect exit decisions of venture capitalists. For example, Cumming and MacIntosh (2003) stress that the choice of exit channel is driven mainly by the perceived "quality" of the exiting companies and that a public exit is most likely for companies of the highest quality. They argue that the exit choices depend on the degree of information asymmetry between seller and buyer of venture capital investments. Cumming (2008) found that several entrepreneurial firm characteristics, such as the size of a firm's assets, which for IPOs must meet minimum listing requirements and the primary industry in which it operates, can also affect the choice of an IPO rather than an acquisition. The choice of the exit vehicle is strongly connected to profitability of the VC- backed company.

Cummming and Johan (2014) note that there are two fundamental exit routes for successful entrepreneurial firms backed by VCs; IPOs and acquisitions (in which the PE fund and entrepreneur sell to a larger firm). Determining whether to go public or not involves a number of factors. As Cumming (2008) notes in examining individual VC contracts and their effect on the exit channel, strong control rights of the VC firm, for example the right to replace a CEO, favor acquisitions. According to Gompers and Lerner (1999), firms in high-tech industries have higher market/book ratios and greater growth options and therefore may be more likely to go public.

Cumming and MacIntosh (2003) and Cumming and Johan (2008) articulated a variety of other factors affecting exit outcomes, including: the ability of new owners to monitor and discipline managers and add value to the venture, the growth of the entrepreneurial firm and the demand for funds, firm size, the ongoing costs of operating as a public versus a private firm including the reporting requirements and public profile of a firm that goes public, the liquidity of the investment to the buyer, transaction synergies and the state of the IPO markets. There is a growing literature that suggests that the quality of a country's legal system facilitates exit via IPO (Cumming et al., 2006, Groh & Liechtenstein, 2009). According to Cumming et al. (2006), the quality of a country's legal system is an even stronger driver of VC returns than the state of development of a country's stock market.

Exit patterns vary depending on market conditions in the exit year, the characteristics of the PE investor, the stage of financing and the industry and country of a portfolio company. Private equity firms are likely to exit their backed companies using different routes for different countries. For instance, exits through the IPO in some countries might be more time consuming than in other countries, due to legal regulations. Wang and Sim (2001) found that the potential of the company, in terms of sales dollars, is positively related to the likelihood of an IPO-exit in emerging markets. There is also evidence that cross-border involvement by VC firms can influence exit behaviour. Wright et al. (2005) notes that the presence of foreign VC firms reduces the informational problems related to the arrangement of exits through IPOs and trade sales in European markets, thus increasing the likelihood of such exits. Klonowski (2007) and Farag et al. (2004) found that the venture capital process in the CEE region is more complex than in Western countries, due to evolving accounting rules, taxation regimes and poor legal infrastructure. As Klonowski (2007) explains, local venture capitalists continue to rely on offshore legal structures in deal structuring to manage the imperfections of the local legal infrastructure.

2 Investment and divestment activity in CEE region

Investments and divestments are generally aggregated by EVCA via two methods – industry statistics and market statistics. Market statistics are an aggregation of figures according to the country in which the investee company is based, regardless of the location of the private equity fund. We use the market statistics approach in our research.

Comparison of PE investments activity to gross domestic product (GDP) reveals the growth level of a country market. According to EVCA data, in 2012, the ratio of private equity investment value to GDP in the CEE region was 0.082%. The CEE level in 2012 remained at

approximately one-third of the European level. Investment activity in the CEE region represented 2.8% of the total investment value in Europe (EVCA 2013). In the years 2008 through 2012, €8.5 bn of private equity was invested in 920 companies located in the CEE region. Private equity investment activity was concentrated in a few countries in the region, with the Czech Republic, Hungary and Poland accounting for 51,8% of investment by number of companies between 2008 and 2012 and 71,1% of investment by value. In terms of the number of companies that were financed in the years 2008 through 2012, Poland led the region with 273 companies (EVCA Yearbook 2013). Several factors have contributed to the growth of the international private equity market in the CEE region: the internationalization of capital sources, growth of GDP, need for risk diversification, deal opportunities and increasing opportunities for exiting investments due to a well-developed stock market that permits exit through an IPO (Sołoma, 2013).

Tab. 1: Divestment by CEE country, 2008-2012 (in € million)

Country	2008		2009		2010		2011		2012	
	€	N*	€	N	€	N	€	N	€	N
Bulgaria	1	1	6	3	5	2	7	4	57	3
Baltics**	27	9	1	2	8	6	40	6	9	9
Czech Republic	115	4	52	6	121	10	637	10	736	7
Hungary	76	10	6	5	8	9	687	11	3	2
Poland	69	18	31	9	77	16	180	24	53	21
Romania	52	5	12	4	23	5	31	3	120	3
Ukraine	5	2	9	3	88	3	2	1	20	3
Other***	5	4	15	5	14	1	33	9	72	13
Total CEE	350	53	132	37	344	52	1617	68	1070	61

* Number of companies
** Baltics: Estonia, Latvia, Lithuania
*** Bosnia &Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia, Slovenia and Slovakia
Source: Own research based on EVCA YEARBOOK 2013.

In the years 2008 through 2012, exit activity was concentrated in a few countries (Table 1). The Czech Republic accounted for 47.3% of the amount divested in the CEE region, followed by Hungary (22,2%) and Poland (11,7%). Those three countries collectively recorded 81% of the total exit value at investment cost in the CEE region (Table 1). In terms of the number of exited companies, Poland led the region with 88 companies. According to EVCA data, trade sale accounted for 85% of the total exit value by amount in the CEE region in 2012. This is consistent with prior periods in CEE in that trade sale remains by far the most common exit route. Sales to strategic partners are typically the most common form of exit (in CEE

markets), yet a number of issues are raised about this option in different contexts. Trade sale exits may be just as profitable as IPOs, and possibly more profitable depending on the particular transaction. As Cumming and Johan (2008) explain, in an acquisition exit, the acquiring firm does have the time, inclination and ability to carry out the due diligence to ascertain the merits of the purchase, which is in contrast to the IPO. The trade sale is agreed in private and makes both the buyer and the seller less vulnerable to the external pressures of a stock market flotation. However, in an acquisition exit, the founding entrepreneur often leaves the merged organization, which is frequently viewed as a negative and emotional event for the entrepreneur (Cumming & Johan, 2008).

3 Exit vehicles employed by PE managers in Poland

Exit is the ultimate objective of all private equity investors to realize the return on their investment after a certain amount of time (between three to seven years after the initial investment in the case of Poland). In 2008, sale to another private equity house was the most common exit method. Poland showed four sales to another private equity house with €27m of exit value (Table 2).

Tab. 2: Exits in Poland, 2008-2012 (exit value at investment cost; in € milion)

Exit route	2008		2009		2010		2011		2012	
	€	N*	€	N*	€	N*	€	N*	€	N*
Divestment by trade sale	16.6	3	6.3	3	7.3	4	124.9	7	22.8	5
IPO:	0.2	1	14.3	4	0.6	2	36.7	5	0.5	1
a/ Divestment on flotation (IPO)	0.2	1	0	0	0	0	22.7	3	0	0
b/ Sale of quoted equity	0	0	14.3	4	0.6	2	14.0	2	0.5	1
Divestment by write-off	2.1	2	0	0	36.4	1	0	0	7.1	1
Repayment of silent partnerships	14.4	1	0	0	0	1	0	0	0	1
Repayment of principal loans	0	0	0	0	0	0	0.4	1	0	0
Sale to another private equity house	27.0	4	0.6	2	13.2	3	4.1	3	0	0
Sale to financial institution	0.1	1	9.9	2	0.1	1	10.8	6	3.6	3
Sale to management (MBO)	3.6	5	0	0	19.6	4	3.5	2	6.1	2
Divestment by other means	5.1	2	0.3	2	0	0	0	0	12.7	8
Total	69.1	18	31.4	9	77.2	16	180.4	24	52.8	21

* Number of companies
Source: Own research based on EVCA YEARBOOK 2013.

In 2009, IPO was the most prominent exit method, accounting for 45.4% of total exit value by amount divested at cost in Poland (Table 3). This compares favourably with Europe as a whole, where exits via IPOs accounted for only 10,9% of the total exit value.

In 2010, as a result of the recent financial crisis, write-offs came first with 47% of the total, followed by sales to management (25,4%) and then by sales to another private equity house (17,1%). This was not comparable to the average for Europe as a whole where sales to another private equity house came first with 38,1% of the total exit value. Ranking exit routes by number of companies in 2010 shows a somewhat different outcome to the preceding analysis for exit value in Poland. Measuring the relative importance of exit methods by number of companies exited (i.e. not by amount), trade sales (4) and sales to management (4) came first, followed by sales to another private equity house with three companies (Table 2).

Between the years 2011and 2012, trade sale were the most common exit method by amount divested at cost in Poland (Table 3). This was in line with figures for Europe as a whole, which also show trade sale to be the main exit route in the same period (37% of the total in 2011 and 38% of the total in 2012). In 2011, seven companies were exited via IPO, accounting for 20.3% of the total exit value by amount in Poland. With respect to exiting via the IPO market in 2012, only one company was exited, accounting for 1% of the total exit value. This was despite the fact that the Warsaw Stock Exchange registered the largest number of IPOs among all European exchanges in each year between 2009 and 2012. However, liquidity on the Warsaw Stock Exchange, as measured by the ratio of turnover to capitalization of instruments, is low in Poland when compared to other large stock exchanges. The reason for the low liquidity of shares on the Warsaw Stock Exchange is the relatively large number of companies with small capital and low free float, whose shares are traded on the market (Soloma, 2013). Groh and Liechtenstein (2009) found that low corporate taxes (on average) are the strongest incentive for investors in the CEE. However, the size and liquidity of the CEE Capital Markets is the biggest investment obstacle. The low level of exits via public market in 2012 in Poland can also be explained by timing issues. The time to exit from an investment is influenced by the size of investments, the number of venture capital firms syndicating in financing rounds, the stage of financings and the industry and country of a portfolio company. Market conditions and regulations also play an important role in PE exit outcomes. Not only do stock markets in CEE vary in terms of their stage of development, but

there may be different attitudes with respect to the sale of majority versus minority stakes, and different regulations regarding sales to foreigners, etc. For example, Zinecker (2011) argues that the development of the PE market in the Czech Republic is adversely affected by the following factors: inflexibility of corporate law (fixed capital level requirements, non-existence of share classes, etc.), tax obstructions and non-transparency of the existing structures.

Tab. 3: Exits in Poland vs. total Europe, 2008- 2012 (% of total exit value at investment cost)

Exit route	2008		2009		2010		2011		2012	
	Europe	Poland	Europe	Poland	Europe	Poland	Europe	Poland	Europe	Poland
Divestment by trade sale	37,6	24.0	28,5	19.9	22,8	9.5	37,3	69.2	38.1	43.0
IPO:	5,1	0.3	10,9	45.4	11,0	0.8	11,6	20.3	14.7	1.0
a/ Divestment on flotation (IPO)	0,4	0.3	0,2	0.0	5,3	0.0	1,6	12.6	1.4	0.0
b/ Sale of quoted equity	4,7	0.0	10,7	45.4	5,7	0.8	9,9	7.8	13.3	1.0
Divestment by write-off	6,1	3.0	35,2	0.0	21,6	47.0	12,8	0.0	8.7	13.5
Repayment of silent partnerships	1,1	20.9	0,8	0.0	0,6	0.0	1,0	0.0	1.1	0.0
Repayment of principal loans	6,2	0.0	3,3	0.0	3,4	0.0	3,7	0.2	4.8	0.0
Sale to another private equity house	29,4	39.0	9,3	1.9	31,8	17.1	25,9	2.3	24.5	0.0
Sale to financial institution	5,1	0.1	4,2	31.7	2,3	0.2	4,7	6.0	3.4	6.9
Sale to management (MBO)	5,0	5.2	5,4	0.0	4,4	25.4	2,2	2.0	2.2	11.6
Divestment by other means	4,3	7.4	2,5	1.1	2,0	0.0	0,8	0.0	2.5	24.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100	100.0

Source: Own research based on EVCA YEARBOOK 2013.

Conclusion

- Globalization and integration of international capital markets have greatly expanded the choices available to firms seeking equity capital. The last and perhaps the most critical step of the investment process of venture capital and private equity is the exit route. There is recognition in the literature that the choice of exit channel by private equity depends mainly on both company-level factors and market-related factors. Exit patterns vary

depending on stock market conditions in the exit year, the characteristics of the PE investor, the stage of financing, the profitability of the VC- backed company and the industry and country of a portfolio company. There are differences in the relative importance of factors across developed and emerging markets. Private equity firms are likely to exit their backed companies through different routes for different countries. Also, the availability of exit alternatives determines the attractiveness of an investment opportunity.

- Research results indicate that in Poland as well in the CEE region, the most common exit route for private equity managers is trade sale. Divesting via IPO is more difficult and less likely to be successful in countries with illiquid capital markets. In the years 2008 through 2012, exit activity was concentrated in a few countries, with the Czech Republic, Hungary and Poland accounting for 81% of total exit value at investment cost in the CEE region. In terms of the number of exited companies, Poland led the region with 88 companies.
- Research findings indicate that Poland is similar to the other CEE countries with respect to exit route for private equity managers. Divestments have been performed mainly through trade sales of the companies to strategic investors and not through IPO despite the fact that Poland hosts one of the most active European stock exchanges.

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