Dealing with the downturn

Natalja Sidorenko of Luiga Mody Hääl Borenius, Tallinn, Lauris Liepa of Liepa Skopina/Borenius, Riga and Tomas Rymeikis of Foigt & partners/Regija Borenius, Vilnius discuss private equity trends amid the economic downturn hitting the Baltic states

Over the past ten years the Baltic states have seen a continuous growth in its economy, being ones of the fastest developing countries in the EU. The GDP growth rates of the Baltic states exceeded the indices of the other EU countries. In 2006 the GDP growth in Latvia reached 12.2% and in Estonia 10.4%, as compared to the 3.1% average within the EU. Those numbers combined with stable political situation, a trait lacking in neighbouring Russia and Ukraine, and favourable tax treatment, rendered the Baltic states an attractive investment target. The accession to the EU brought about the decrease in the debt pricing, which also contributed to the growth of the economy. The deals have flourished in all possible sectors, including IT, agriculture, real estate, transportation and logistics. The real estate market was marked by a particular success, accompanied by a dramatic expansion of the mortgage market.

However, the Baltic states were not unaffected by the global financial crisis. The Estonian GDP started sliding, from the slight decline in growth down to 3.6% in 2008 and reaching -16.6% in the second quarter of 2009. However, it was Lithuania to set a record with critical 22.4% of decrease for the same period. The other major economic indices do not leave too much space for optimism. The volume of loans overdue by more than 60 days in Estonia increased in July, making up 6.2% of the portfolio. The loan portfolio quality deterioration was, according to the Bank of Estonia, mostly due to the corporate sector, the households have been more successful in serving the loans. Sadly, it can hardly be claimed that the Baltic states have been innocent bystanders and victims to the external factors. The major banks take their blame for the current situation by confessing that at a certain point the regular competition for the deposits compliant with the regular prudency requirements has transformed into the marathon for the lending.

Latvia became one of the first countries in Europe to face a halt in investment activity in all areas of business and recession of the economy. In July 2007, after prolonged public debate, a programme was introduced by the government aimed to prevent speculative investments in the real estate market. Higher taxes were imposed for investments in the third consecutive real estate purchase by the same person. Stricter requirements were introduced for banks that lent money to property investors. The initiative had wider implications, slowing down the real estate market and stopping the rise of the property prices. The limitation also affected M&A market, real estate related businesses (construction and services) and investment environment.

The distress of the Baltic economies has understandably had a negative impact on the private equity and venture capital market. The main reason for the slowdown has been the extremely unenthusiastic financing by the banks trying to compensate for the previous lending feast. The volume of the portfolio of loans and leasing issued to enterprises and households in Estonia declined by 3.5% within one year. The margins charged by the banks have skyrocketed due to the increased risks, although the increase of the margin has been neutralised on account of the recent fall of the Euro Interbank Offered Rate (EURIBOR). On the one hand, the restricted access to the usual source of financing (a bank loan) motivates the companies to search for alternative routes to the capital, thus increasing the demand for the private equity and venture capital involvement. On the other hand, the private equity players find themselves struggling to meet the requirements under the loan agreements entered into for financing the previous acquisitions, let alone incurring

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any new liabilities. The investment funds admit that the need for renegotiating the loan terms has become an extremely pressing matter as the target companies may not generate the expected cash flows for serving the loans, let alone meeting the financial ratios. However, the banks are generally not in a hurry to default the loans. Firstly, the proceeds of the collateral assets in the conditions of the general lack of demand are not sufficient to cover the owed amounts and, secondly, the rushed sale is likely to contribute to a further increase in the offer, thus increasing the price fall. Major banks operating in the Baltic countries have already commenced setting up funds for distressed asset management, due to expected worsening of the general economic conditions, raise of unemployment and decrease of the average family income. This is rather likely to be a successful area for cooperation of the banks and private equity investment managers. Most of the interviewed investment company executives have also admitted that the trend for the remaining part of the 2009 will be management of the distressed assets. They also stated that the market demands to step aside from the traditional model of the passive financial investor and to engage more actively in the management of the portfolio companies.

Better off are the venture capitalists traditionally investing on account of equity capital. The value of their portfolio may well have dropped during the last year but at least they are not facing the risk of the loan acceleration. One of the common recognitions by all the industry representatives was that the venture capital business will be the first to signal the revival of the business and return of the active transaction market.

Another issue preventing the recovery of the private equity market is the difficulties the market participants meet to establish the value of the companies. In the circumstances of the unstable market the investors can hardly rely on the cash flows from the previous periods as a projection of future turnover. Lack of confidence in the future market development trends seems to render the price negotiations harder than usual. This factor forces the leading private equity/venture capital investors, with funds available to spend, to remain largely in standby mode waiting for entry multiples and seller expectation to curtail.

Despite the rather negative correction in the last quarter of the year, 2008 was an active year for the venture capital and private equity industry. The first part

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of the year was particularly marked by the number of transactions, although some market participants have demonstrated an outstanding success record for the whole period. SEB Enskilda has brokered major transactions, including advising Invalda group in selling 100% of Finasta Bank to Snoras Bank (all parties of the transaction are Lithuanian entities); representing Carlsberg Group in acquisition of 25% stake in Saku Brewery (Estonia) for €25 million; and advising SAS as sellers of 47% of the shares in AirBaltic for the disclosed deal price €20 million. It is worth noting that this transaction was closed in February 2009, amidst the totally frozen transaction market. Vadims Jerosenko, Chief Executive Officer of the corporate finance company Laika Stars and Member of Riga Port Authority, has emphasised the benefit of acquiring business in times of market slowdown. He notes that customers now begin to appreciate companies with a real business value, based on their industrial capacity. Both of SME's investment funds, supported by the Latvian state and European Structural Fund investment via Latvian Guarantee Agency, acting as a fund of funds, continued their investments last year, ZGI Fund and the Second Eko Investors Fund invested approximately €7 million and €20 million each respectively in a variety of businesses, including transportation, publishing and medical services.

One of the most notable pan-Baltic transactions in 2008 was the acquisition by BaltCap of the Interinfo group of companies in Estonia, Latvia and Lithuania. Interinfo is the leading operator of the Yellow Pages directories in the Baltic states and provides printed, internet and directory assistance services. The annual turnover of the Interinfo operating companies in Estonia, Latvia and Lithuania in 2007 constituted €15.5 million. BaltCap is one of the leading private equity and venture capital investors in the Baltic states. In 2008 BaltCap also acquired a 75% stake in Estonia's largest, private medical diagnostic company Quattromed HTI Laborid.

The tendency of a growing number of transactions reversed in the second part of 2008 in particular when financial markets stalled after the news that Lehman Brothers will not be subjected to the government bailout in mid September. Lehman Brothers had a year before entered into real estate investment projects in Latvia. By the end of the year the list of unconsummated investments was much more impressive than a list of

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completed deals. One of the most notorious failure has been the cancellation of the acquisition of several food-producing subsidiaries of AS Kalev, including the chocolate and candy producer Kalev Chocolate Factory, as well as dairies AS Tere and AS Meieri Transport by Alta Capital Partners. With the intended €56 million for the food producing companies only (the value of AS Tere and AS Meieri Transport has not been disclosed), this transaction was expected to become one of the biggest acquisitions in the Baltic Sates in 2008.

At the end of 2008 the industry started looking for the potentially trendy consolidation of businesses. Despite the clear understanding that this might be the perfect time for consolidation of businesses, as admits Viesturs Tamuzs, founder and chairman of Eko Investors, in Latvia this still remains a theoretical concept. There are no industries or even enterprises, that would try to benefit from consolidation, stated the experienced venture capitalist. He used a rather stark description of the current affairs (May 2009): "Entrepreneurs here seem to be ready to die standing alone, rather than to attempt to survive, gaining from synergies." Perhaps the trend may change, but out of despair, rather than a reasoned business assessment. As to the business of Eko Investors, this is one of the best examples of an innovative approach and flexibility in the dramatically changing market conditions. Eko Investors has expanded their investments into Uzbekistan, one of the former middle-Asian republics of the Soviet Union. The first signs of consolidation can be seen however on the Lithuanian and Estonian markets, such as an acquisition by the Lithuanian Agrowill Group, the largest agricultural investment and development group in the Baltic states, of the Estonian milk production company Põlva Agro in July 2008, for €14 million.

Another successful investor, Catella Property Group, has been continuing acquisitions of real estate all over the Baltic states, admits Pauls Platais, partner of the leading Swedish origin property advisor in the region. For Catella, price correction has catalysed successful investment projects. During 2008 Catella Corporate Finance completed several real estate transactions for approximately €80 million worth of logistics and office properties in Estonia and Latvia.

The state of Estonia has also engaged in venture capital investments for the purpose of the creating innovative entrepreneurship. In 2007 a public early-stage risk capital organisation was established under the name of the Estonian Development Fund (EDF). The EDF is a public legal person operating on a commercial basis engaging in equity and quasi-equity investments into small and medium enterprises in a seed and start-up stage together with private investors. The EDF operates on the basis of the Estonian Development Fund Act and is a member of the European Private Equity and Venture Capital Association and the Finnish Venture Capital Association. The EDF has been established directly by the Estonian Parliament. Its personnel are, however, selected by public tenders and are required to have an extensive experience in international private equity. For the two years of being active the EDF has examined more than 160 projects. Its portfolio consists of five companies and KR 235.9 million that amounts to €2.3 million. Another three investments are at the stage of negotiations and expected to close in the third quarter of 2009.

In Estonia the private equity and venture capital players, with the participation of EDF, resolved in March 2009 to unite their forces and to establish the Estonian Venture Capital Association (EstVCA) with the objective to promote the private equity and venture capital industry. EstVCA is expected to welcome as members PR/VC funds, asset management companies, law offices, business angels associations and financial advisors.

The Latvian Venture Capital Association has existed for more than five years; in 2003 it became an associated member of European Private Equity & Venture Capital Association. Astra Neimane of Baltcap was elected in March 2009 as the new chairperson of association. The association demonstrated the ability to represent

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Natalja Sidorenko's scope of expertise includes advising on public securities offerings, the provision of investment services and activities of investment firms, investment funds and other issues related to securities market activities. Natalja has also participated in numerous leveraged finance transactions and offered advice on mergers, acquisitions and the division of companies.

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the consolidated industry in May 2009 when it convinced the government and parliamentary commission to permit increase of the investment by pension funds into each private equity fund from 10% to 30%.

Most of the interviewed industry leaders admitted that it is almost impossible to provide any responsible forecast for the remaining year and beyond. The main reason for such cautious approach is the apparent dependence of the Baltic states on foreign resources. The striking example of the mortgage market emphasises powerful presence of foreign investments: more than 60% of the mortgage loans in Latvia are issued by banks with Nordic origin (Finland and Sweden). No major changes in the investment and transaction markets can be expected until the revival of capital markets in the Nordic region.

Another reason for uncertainty may be the longstanding debate on the strength of national currencies of the Baltic states. One of the Latvian industry leaders even admitted that there will be no rebound of the business activity until certain steps are taken in the direction of currency devaluation, in order to enable Latvian industries to enter into export markets on more competitive conditions. Due to intense interdependence of the Baltic states' economies, it is extremely likely that the devaluation of the national currency of one of the Baltic states will lead to a domino effect and leave the others with no choice but to follow the example in order to remain competitive on the international level. The devaluation will also cause the increase of the local currency value of the foreign borrowings. Since most of the loans in the Baltic states are issued in euros, the devaluation may produce widespread defaults. When preparing this overview the government and the central bank of all three Baltic states have resisted calls for devaluation of the national currency.

Another measure sought by the Baltic states in order to increase the level of competitiveness on the international market is the adoption of euro. The Estonian government is struggling to fulfil the Maastricht criteria to access the eurozone. It is believed that adopting euro might be the only way to attract new investments and to help the recovery of the economy. The inflation rate that used to be the main obstacle to the accession to the euro has recently subsided due to the financial crisis but Estonia is now facing a fight with another Maastricht criterion- the state budget deficit in 2009 is likely to exceed 3%. According to the recent forecast by the Bank of Estonia, staying within these limits requires improvement of the fiscal position by 2.5-3 billion kroons (approx 0.16-0.19 billion euros). In order to increase the incoming cash-flows, the Estonian Parliament has already Among others raised the value added tax from 18% to 20%, and the Government is also discussing selling certain state-owned companies and cutting expenditures. However, not everybody is supportive of this objective. The venture capitalists claim that the focus of the government on the euro accession is comparable to the flight over the Atlantic Ocean while observing only the altimeter and totally ignoring the data provided by the other meters.

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The investment companies believe that the existing private equity model will have to transform in order to survive the market conditions. According to a Deloitte's Central Europe Private Equity Confidence Survey in December 2008, "the current private equity model may have to adopt, or rather step back, to the models used in early 2000s- buying at comparative low multiples, focusing on improving operations, bringing in expertise, realising synergies and selling again, rather than relying on a leveraged-based models." However it is noted, that "emerging markets are expected to continue to be one of the key focus points for many private equity funds." With regard to the activities areas likely to be attractive targets for the investors, the representatives of investment companies stated that the main M&A transactions should be expected in the sectors, which are resistant to economic turmoil, such as energy, gas, pharmacy and telecommunications. However it is more likely that the transactions, on which the investment companies are working at the moment, will be closed only after the end of 2009.

The private equity and venture capital market of the Baltic states is obviously not immune to the impact of the financial crisis. Its future is clearly dependent on the macroeconomic trends and political decisions both on the local and to a major extent on the international level. However, the venture capitalists claim that despite the unstable conditions, this is the age of opportunities not to be ignored.