

PRIVATE EQUITY INVESTMENTS IN HUNGARY AND THE FINANCIAL CRISIS

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–Abstract–

The Hungarian private equity market reacted quite sensitively to the 2008-2009 financial crisis. Although not in an equal degree and in the same year, but all of the market's fundraising, investment and exit segment suffered a decline. However, the distrustful economic environment also affected negatively the traditional financial sources, making it more complicated to obtain bank loans. As a result of this moderate credit supply, private equity and venture capital investments became relatively more valuable. This was further strengthened by the appearance and launch of the so-called hybrid funds in 2010.

Although the paper focuses on the investment segment of the Hungarian private equity market, as an introduction we also describe briefly Hungary's macro environment in the recent years. The rest of the paper analyse private equity investments from different aspects.

Key words: private equity, investments, financial crisis

JEL Classification: G24

1. INTRODUCTION

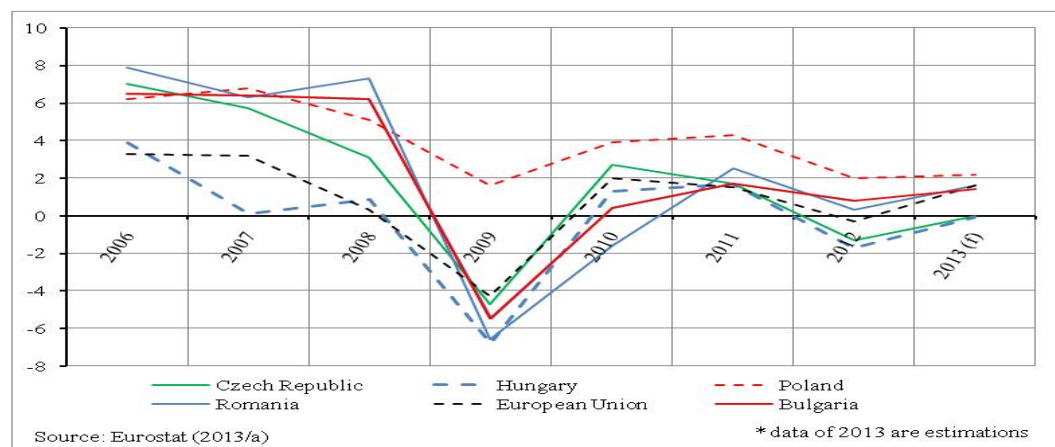
Private equity investments play an important role in the economy since their provision of equity capital and other essential services (e. g. networks, additional financial sources, advices, etc.) to enterprises in different lifecycles. The paper focuses on the Hungarian private equity market and provides a brief overview about its investment segment during the years of the recent crisis. The paper starts with a short analysis of the investment environment in Hungary and its relative position to other several Central Eastern European (CEE) countries. The second part concentrates on the private equity market, presenting the investment segment's characteristics between 2007 and 2011. Private equity investments as a percentage of GDP, the value and number of transactions by the different corporate stages and other relevant changes in the venture capital and buyout segment are also included in the second part. Finally, the third part concludes.

2. THE INVESTMENT ENVIRONMENT IN HUNGARY

2.1. Macroeconomic environment in the recent years

When the 2007 financial crisis turned into a global economic recession, the Central Eastern European countries suffered a serious decline in their GDP values. Due to their relatively small size but essential independence from their foreign export partners, most of the CEE countries couldn't avoid recession, when the economic performance of Western European countries started to shrink in 2008.

Figure-1: Annual real GDP growth rate in several CEE countries and in the European Union (2006-2013*, %)



The effects of the downturn can be seen in *Figure-1*, which shows that GDP growth rates decreased under zero in 2009, and the countries of the region, except Poland plummeted by -4,3% and -6,8%. Although signs of recovery were showed in 2010, the region couldn't present considerable economic performance in the recent two years. 2013 can bring a moderate growth but according to professionals, the real recovery won't come until the Eurozone shows some progress in solving their own debt and growth problems (FT, 2012/a).

Hungary's situation among the region is quite interesting, because it couldn't achieve substantial economic growth before the crisis. The country had lost its competitiveness and from 2006, GDP started to decrease and the economy was stagnated in 2007. Hungary entered the crisis with an already weak economy but the situation was even worse in 2009. As a sign of insufficient domestic demand, the retail sector fell sharply and unemployment rose up to 10%. Foreign investors refused to finance Hungarian Forint denominated assets, which resulted in tumbling stock prices, dried out government bond market and a 25 billion euro bailout package from the World Bank, EU and IMF (HVG, 2010).

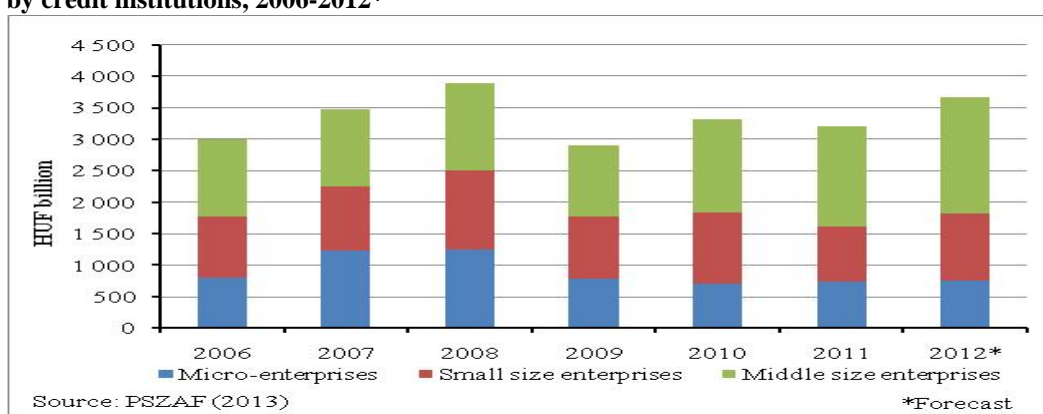
A moderate improvement in the economy occurred in 2010, when the annual GDP rose by 1,3% due to the country's processing industry, which provided products for external markets. From the expenditure side, Hungary's export activity could contribute positively to GDP growth, but domestic demand remained depressed. Unemployment climbed up to 12% and the ratio of government debt/GDP reached 80% (HVG, 2011). Hungary's credit rating decreased drastically, in 2011 Moody's and Standard & Poor's downgraded the foreign and domestic debt to junk category (AKK, 2013). Due to the serious uncertainty in the economic environment, the Forint weakened sharply against the euro and government bond yields increased above 10%. The economy remained weak in 2011, the growth of

GDP was 1,7% still mainly driven by the export (HVG, Origo, 2012).

2.2. Hungary's banking industry in the years of recession

Not surprisingly, among the different sectors, Hungary's banking industry suffered the most during the years of the crisis. As the country's economic conditions deteriorated, the parent banks in Western Europe scaled back their cross-border activity, which led to insufficient credit supply and struggling interbank lending market in Hungary (FT,2012/a-b). The weakening of the local currency and the high level of foreign indebtedness all directed to worsening credit portfolios among the local banks. Moreover, government introduced the bank tax in 2010 reducing the profit margins sharply in the total industry (HVG, 2011). As a consequence of the unfavourable environment, credit institutions retained their lending toward the housing and corporate sector. According to *Figure-2*, the annual supply of credit to Small and Medium sized Enterprises (SMEs) decreased significantly in 2009, especially in the case of micro credits. The total amount showed some recovery in 2012, but it is expected that the microcredit segment remains at a low level. Considering the total banking industry, experts say that within the CEE region, Hungary has a quite unfavourable position and this could deter the foreign-based parent banks from executing investments in the country in the near future (FT/a-b, 2012).

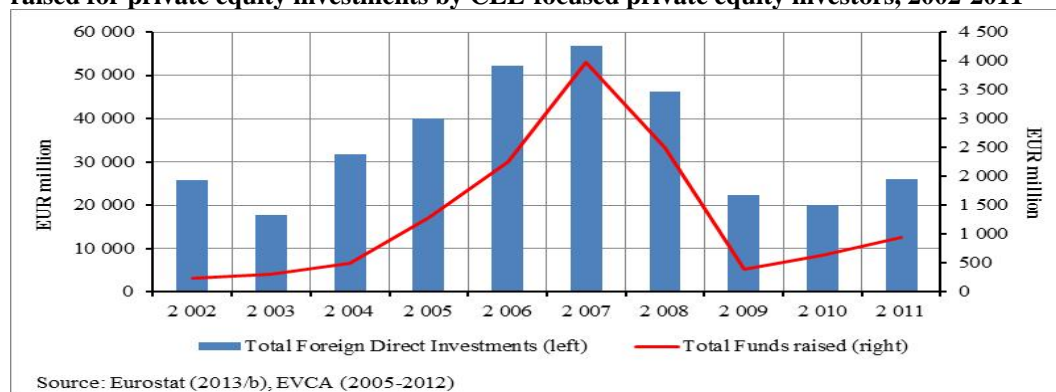
Figure-2: Annual amount of gross credits to Small and Medium sized Enterprises provided by credit institutions, 2006-2012*



2.3. What about private equity?

In Hungary, during the years of recession, the general macroeconomic environment was quite unfavourable for private equity investments. Looking at the total industry, the status of the economic climate is really important, especially in the case of capital allocations for investments. Generally, due to the Hungarian economy's relatively small size, it is unable to provide the sufficient capital supply for private equity transactions, therefore the country is strongly depend on the inflow of foreign capital. *Figure-3* shows a regional approach indicating that after 2007, the increasing trend of Foreign Direct Investments was broken and the annual inflows started to shrink drastically hitting a low in 2010, around 20 billion euro. In parallel, private equity investors fundraising activity showed a similar path between 2008 and 2010. As the region's overall investment risk elevated during the crises, institutional investors lowered significantly their capital exposure to the CEE region and committed less capital (400-634 million euros in 2009-2010 respectively) for CEE-focused private equity funds.

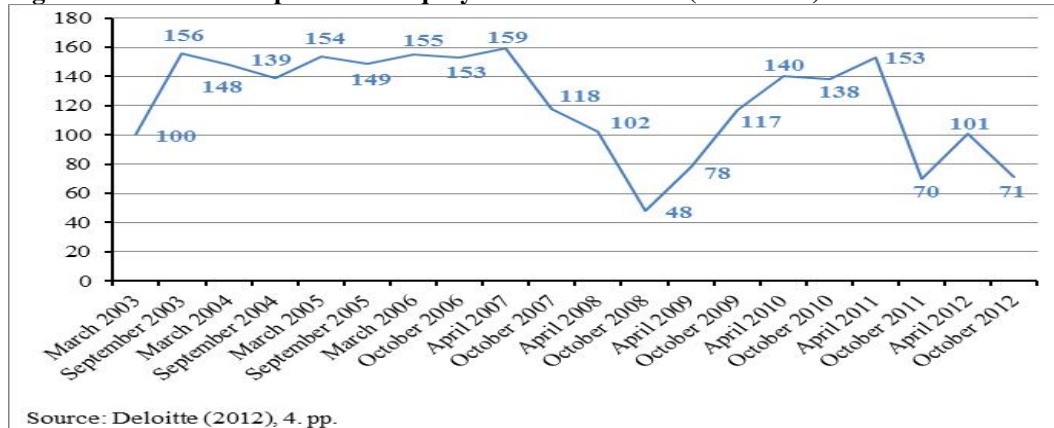
Figure-3: annual inflow of Foreign Direct Investments to the CEE region compared to funds raised for private equity investments by CEE-focused private equity investors, 2002-2011



Deloitte's Central Europe Private Equity confidence survey demonstrates the changes in investors' appetite for executing private equity investments in the Central European region. Regularly, the survey measures an index twice in a year reflecting investors' anticipations about different topics (e. g.: economic climate, average size of transactions, market activity, etc.). *Figure-4* presents the value of the index between 2003 and 2012. Not surprisingly, in late 2008 the index reached its lowest level at 48 points making a nearly 70% drop from its peak at 159 in April 2007. Although the figure shows a rapid recovery in 2010, the index couldn't stabilize at the upper segment because of the intensifying uncertainties especially in the Eurozone region. In 2012 the low levels of the index shows that private equity investors still not see the total Central European region as attractive

to execute investments as before the financial crisis.

Figure-4: Central Europe Private Equity Confidence Index (2003-2012)



3. PRIVATE EQUITY INVESTMENTS IN HUNGARY AND THE CRISIS

Considering private equity investments as a percentage of GDP *Table-1* shows that the Hungarian private equity market had a quite remarkable relative size to the total Gross Domestic Product, compared to other CEE countries. Between 2002 and 2011 there were only two years (2009, 2010) when the investments/GDP figure couldn't reach the entire region's average. Except from those years, among its neighbouring countries, Hungary almost every year had a first or second position in the investments/GDP ranking. Data refers to a relatively well developed private equity industry in Hungary, although this favourable position was somewhat deteriorated due to the worsening investment climate. In 2009 and 2010, investments dropped back seriously and investors (especially in the case of privately owned private equity firms) withdrew from executing new projects. Only Poland could maintain constantly a total deal value of more than 200 million euro in the years of recession (2008-2010) and also in 2011.

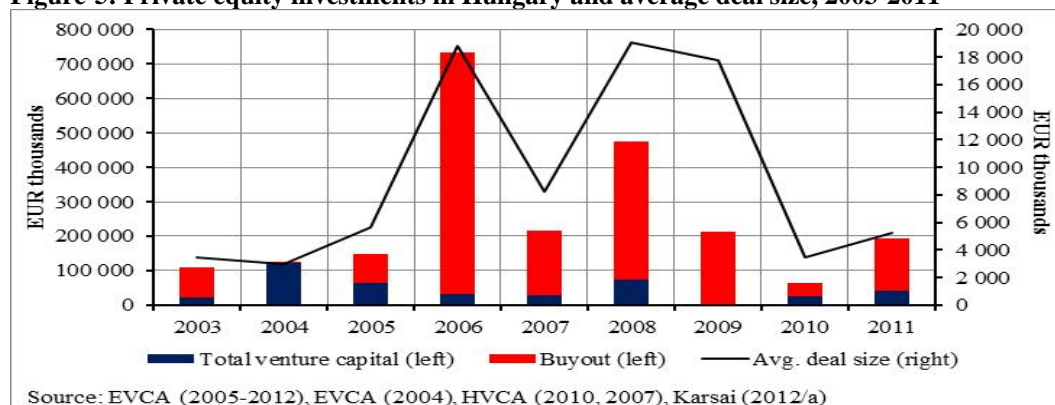
Table-1: Private equity investments as a percentage of GDP in several Central Eastern European countries, in the region and in the EU, 2002-2011 (%)

Country/years	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Bulgaria	0,016	0,101	1,110	0,000	0,143	1,950	0,265	0,530	0,229	0,018
Czech Republic	0,037	0,052	0,019	0,112	0,315	0,143	0,294	1,010	0,124	0,089
Hungary	0,110	0,154	0,150	0,167	0,883	0,208	0,422	0,223	0,067	0,194
Poland	0,069	0,098	0,069	0,045	0,118	0,141	0,167	0,089	0,186	0,185
Romania	0,037	0,159	0,055	0,088	0,115	0,239	0,205	0,187	0,098	0,050
Total CEE	0,054	0,088	0,096	0,073	0,221	0,190	0,201	0,241	0,115	0,105
Total Europe	0,277	0,284	0,321	0,388	0,552	0,570	0,394	0,186	0,320	0,326

Source: EVCA (2005-2012), EVCA (2004)

Although the annual value of private equity investments fluctuated considerably in the second part of the recent decade, it is obvious, that the crisis did not affect the structure of transactions. *Figure-5* shows that the major proportion of investments was related to buyout deals, which accounted for more than 80% of total transaction value from 2006 to 2009. The year of 2010 brought a quite depressed time for the market as the overall transaction value plummeted to 65 million euro and the average deal size also hit a low at 3.4 million euro. The signs of the crisis weren't really seen in 2008 but as investors' risk aversion emerged in 2009 and 2010, the activity of the entire private equity market decreased dramatically. The average deal size remained at a high level in 2009 but this was due to the significant decrease in the number of transactions and the execution of several buyout deals with higher investment amount.

Figure-5: Private equity investments in Hungary and average deal size, 2003-2011



From the number of deals approach, *Table-2* indicates that the recession didn't have the same effect on both sides of the private equity industry. Moreover, the buyout segment showed the same or slightly more transactions in 2009 and 2010, compared to the years before 2007. Therefore, investors did not fully

retreat from the buyout segment, but the valuation of deals became quite depressed, especially in 2010. On the other hand, venture capital investments dropped back seriously both in terms of value and number, verifying the fact that investors delayed to execute new deals in this segment of the market. According to *Table-2*, the total number of venture capital transactions more than halved by 2009 making a nearly 70% shrink in the case of expansion stage transactions. With its total amount of 11 million euro, the entire venture capital segment almost disappeared from the market in 2009, and it remained depressed in 2010 as well (25 million euro).

Table-2: Number of private equity investments in Hungary by stage, 2003-2011 (pieces)

Stage / Years	2003	2004	2005	2006	2007	2008	2009	2010	2011
Seed, start-up and early stage	9	13	6	16	6	4	4	11	29
Expansion	19	27	19	20	11	16	5	4	3
<i>Total venture capital</i>	28	40	25	36	17	20	9	15	32
Buyout	4	1	1	3	9	5	3	4	5
Total private equity	32	41	26	39	26	25	12	19	37

Source: HVCA (2010, 2007), Karsai (2012/a)

Fortunately, thanks to the recently launched 8 JEREMIE hybrid funds, venture capital investments showed a moderate recovery in 2011 as the size of the segment increased to 40.5 million euro, and the number of deals reached 32 pieces, including 3 transactions in the expansion stage and 29 in the seed, start-up and early stage. Without the JEREMIE initiative, it would have been expected that the overall venture segment would have shown the same picture as in 2009.

Comparing several CEE countries in respect of the annual volume and number of private equity investments executed in the recent past, *Table-3* shows that the region's private equity industry did not enter the crisis in 2008. Experts also argued that although the total private equity investment value in the European Union dropped by 27% in 2008, investment level climbed at a record level in the CEE region (Karsai, 2009). Hungary also presented an impressive position with its 476 million euro invested capital. But for most of the countries, the years of 2009 and 2010 were all about shrinking albeit not equally. The Hungarian market suffered a serious decline compared to its peers, as the annual amount of investments declined from 476 million to 214 million (-55%) and then to 65 million euro (-70%) in 2009 and 2010 respectively. According to experts, these negative changes were mainly driven by Hungary's weak economic status, the implemented uncustomary government measures and the retreat by global

private equity players, who shifted their focus to more attractive regions (Karsai, 2012/b).

Table-3: Value and number of private equity investments in CEE countries, 2007-2011

	2007		2008		2009		2010		2011	
	mEUR	pc(s)	mEUR	pc(s)	mEUR	pc(s)	mEUR	pc(s)	mEUR	pc(s)
Poland	441	55	633	71	267	25	657	45	681	57
Czech Republic	182	20	435	19	1386	22	193	15	139	17
Romania	318	22	289	33	221	24	119	17	66	14
Bulgaria	563	8	90	13	185	9	82	8	7	4
Hungary	215	19	476	14	214	11	65	17	195	37

Source: EVCA (2005-2012)

Although in every year, total investment value is remarkably dominated by one or two huge-sized buyout transactions, following the crisis the buyout segment showed a downward trend in terms of deal volume (see also *Figure-5*). For example in 2008, Ares Life Sciences and Merrill Lynch Global Private Equity acquired Euromedic, a Hungary-based medical services provider from Warburg Pincus with a deal value of about 800 million euro, including debt also (Karsai, 2008). In 2009, Mid Europa Partners brought ownership in the Hungary based leading fixed line operator, Invitel Zrt. for 253 million euro, which was followed by additional rounds of investments in 2010. Also in 2010, Enterprise Investors acquired a majority stake in the online insurance company Netrisk.hu for 23 million euro, making more than the half of the total value of buyout transactions in that year (HVCA, 2011). All in all, the average deal size in the buyout segment decreased significantly in 2009 and 2010 and investors turned their attention to portfolio management instead of executing new projects. Investors became more strict while making their due diligence process and the insufficient supply of credits also made it harder to structure the originally bigger-sized leverage buyout transactions. As in the case of venture capital investments, 2011 brought a moderate recovery in the buyout segment as well, as two transactions were made in the 15-150 million euro category and the average deal size increased to 31 million euro from 13 million euro (Karsai, 2012/a).

4. CONCLUSIONS

When the financial crisis started to emerge to a global economic recession, Hungary had an already weak economic status. In the case of investments, the private equity market reacted lately to the crisis as the total investment value

began to shrink only from 2009. Nevertheless, the worst year was 2010, when both venture capital and buyout segments decreased seriously in terms of value and number also. The average deal size declined dramatically, global investors retreated from the Hungarian market and the country lost its relatively attractive status as a potential investment position in the Central Eastern European region. The new EU initiative, the so-called JEREMIE program helped the industry to show up some recovery in 2011, as investors started to execute projects in the early stage corporate segment using capital from the recently raised hybrid funds. Although Hungary's depressed banking industry had also enhanced the use of equity financing for undercapitalized enterprises, due to the economy's slow recovery and the uncertainties in government policy, the Hungarian private equity market will need more time to show record amounts of invested capital again.

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