

RESTRUCTURING

Restructuring and investment in Central and Eastern Europe

BY MUAZZIN MEHRBAN



As the global downturn continues to hurt Western economies, their appetite for investment in the Central and Eastern European (CEE) region has begun to wane. Companies within the region are now struggling to raise capital, and those previously struggling are now fighting to stave off insolvency. Also, CEE's continuously evolving regulatory environment has meant efforts to refinance manage risk have faltered, and have not enabled firms to plan for their future. On the other hand, the region's troubles have presented strong, cash healthy firms with opportunities to make distressed investments at bargain prices. Private equity firms could also take advantage of these lowered prices, allowing them to expand into a region that was considered very attractive before the global downturn. There is still life in CEE, but deal making has become a much slower, less certain process. Therefore, buyers need to be sure that they are purchasing at the right time.

Current trends

The CEE market has deteriorated significantly over the past six months, despite reassurances from its leaders that it would be insulated from the brunt of the financial crisis. The global recession is having an increasingly negative effect on the region, particularly in the oil and gas sector, where crumbling demand has caused a drop in export sales. Its largest economies,

Russia and Ukraine, are experiencing growing unemployment and severe budget deficits.

Investors in CEE are also having problems accessing capital. The region's banks, predominantly foreign owned, have frozen financing, especially for new companies with limited collateral. Anton Klyachin, a senior partner at Salomons, points out that companies have had to become more flexible as a result. "Some projects which were calculated in anticipation of rather cheap debt have now become unprofitable and thus out of existence. On the other hand, lack of bank financing forces companies to seek alternatives, including private equity and venture capital money. Companies are now more willing to accept rather low valuations and stricter terms of the investors." In addition, savings are too low to counterbalance company debts, while local banks have had to turn to overseas parents to bolster balance sheets – many of whom are unable to do so due to their own financial problems.

Concerns about the region's financial health are becoming widespread. Indeed, statements and conference calls by leading European banks, including Italy's UniCredit, the biggest lender to CEE, have expressed their belief that the region is extremely vulnerable to the credit crisis. They feel that the lack of financing could cause many of CEE's maturing economies to choke. Nonetheless, some banks have reaffirmed their commitment to continue

funding both consumers and companies in the area. These banks have called on peers to remain active in the region, and have asked international bodies such as the IMF to launch plans to counter drying funds.

A lack of available credit has forced companies to reconsider their operations. Restructuring is widespread across the market, bringing with it lower scale production and staff layoffs, as seen in most global markets. Kevin T. Connor, a partner and head of the Central European practice at Squire, Sanders & Dempsey LLP, notes that this trend is not confined to local companies. "The chief risk is that many companies will not be able to survive. Again, this includes foreign-owned companies which came to the markets in search of cheap labour, but whose cost structure and lack of market for product has forced closure." For those managing to remain operational, scaling back on salary increases and bonuses has become a priority. But the workforce remains upbeat. Despite having their bonuses cut to a minimum and awarded based on results, experts have observed that those still in work are simply relieved to have survived the cutbacks.

Distressed dealmaking

M&A deals targeting distressed assets are still being pursued. The number of distressed deals has risen this year, with healthy strategic and financial investors showing interest in undervalued assets. Of course the risks faced by investors have also increased. As such, thorough checks are now taken to ensure that assets can remain solvent. It is also wise to assess whether creditors are prepared to give adequate time for investors to turn failing firms around. Once markets around the world begin to pick up, distressed firms, provided their core operations are sound, are expected to rebound, giving current investors the prospect of creating long term value.

In general though, M&A volume in the region has waned significantly. "The reduction in deal volume is especially acute with larger value deals," says Mr Connor. "Mid to small cap deals continue to move albeit at a slower pace tied mostly to the uncertainty of financing. PE funds are looking at assets but much of the activity is in the distressed asset sec-

tor where buyers are looking to find the best possible valuation. I would expect that activity will begin to pick up in the third quarter," he predicts. A recovery period of nine months may seem optimistic, but many experts believe private equity firms can initiate on distressed investments.

But even private equity investors, with large pools of capital, are wary about investing too soon, feeling the market has yet to hit the bottom. "In our view private equity and venture capital firms are now waiting for better terms from their potential targets," says Mr Klyachin. "Among our clients in the private equity and venture capital sector, 50 percent openly state they are waiting till summer at least, and if we exclude state-funded investors, who are still active due to their obligations toward the State, this percentage would reach 80 percent. The funds are now busy with problems in their portfolio companies and are not willing to pursue new investment opportunities since nobody can estimate fair value of a business nowadays." However, he insists that transaction volumes will pick up again, given the necessity for fund managers to make deals in order to generate returns for investors.

Other experts argue that the amount of capital invested in CEE will always depend on the strategies of big players. Their fundraising leads to significant capital flows in the region. This is in contrast to the activities of smaller players, who raise less and are too few to fill the void in the absence of major private equity firms. Interestingly, according to some private equity players, private equity investment into Central and Eastern Europe's EU members is to have no extra risk compared to Western Europe, whereas

risk among non-members is less certain. Risk profiles across CEE can vary enormously but investors are more confident making investments within EU member countries.

Looking forward

Current conditions have played a large role in fashioning trends within the market in the last year. The inclination for distressed investments is currently strong and is expected to remain so during 2009. Focusing specifically on the CEE's largest market, Russia, Mr Klyachin notes that opportunities can be found in an array of sectors. "Traditionally the scope of investment and M&A activities here was more or less limited to real estate, retail and production of consumer goods as the most profitable spheres. Recently, other spheres like IT and telecommunications also began to provide opportunities for investors operating in Russia, while commodities, retail, real estate and consumer goods have kept their role as the leading investment spheres." However, he does warn that real estate and retail investments have become less popular, with the mounting debts of the industry's firms deterring investors. Rather, the spotlight is on infrastructure, the high-tech sector, and natural resource companies where profit margins are higher.

The slowdown in overall M&A will continue. Restructuring activity will pick up across all sectors as firms try to minimise losses. But interest in the region relative to other markets remains strong, and the availability of distressed assets with low market valuations is likely to prompt cash rich firms to make deals. Nonetheless, Mr Klyachin is keen to emphasise that making predictions regarding future activity is tricky during this uncertain period, as inves-

tors have become increasingly cautious. "Due to recent drastic disruptions private equity investors became very prudent in respect of new investment projects and transactions and their primary concern is to avoid big losses. The present dealmaking is concentrated in two main directions: investment of capital provided by the state through venture, nanotech and other funds, and investments in distressed assets where the price is sometimes much lower than the asset value," he says. Investments made in state projects such as infrastructure, have remained strong amid the economic crisis, as CEE governments look to improve their transportation networks. The second direction, despite risks mentioned previously, has the potential to be profitable in the long term once the current downturn has subsided.

The CEE markets are clearly weakening, and the situation is likely to worsen if struggling parent banks cut off funding channels to their subsidiaries in the region. IMF intervention is desirable at this stage, as it could prevent the situation from deteriorating further. Already, the region's largest economies are experiencing budget shortfalls and widespread unemployment as troubled companies, unable to access finance, have insufficient cash on their balance sheets to counter the downturn. But rescue could come in the form of private equity investment if large players such as KKR and Blackstone feel confident that new funds in the region could still generate good financial returns in years to come. As yet, most investors seem to be, bidding time until they perceive that the market has reached the bottom. However, investment at a later stage could prove unfruitful as by then firms in the region could be damaged beyond repair. ■



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