

Use of Central and Eastern European stock exchanges as a private equity exit alternative

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During the economic downturn of the early years of the new millennium many commentators were predicting the demise of Central and Eastern European ("CEE") stock exchanges. Private equity investors in CEE were lamenting the incipient loss of a potential exit route for CEE investments. Fortunately, CEE exchanges have rebounded from their moribund state to become a legitimate exit vehicle for private equity investors in CEE.

Development and legal convergence of CEE equity markets

The indices of the three most important CEE exchanges, the Warsaw Stock Exchange ("WSE"), the Budapest Stock Exchange ("BSE") and the Prague Stock Exchange ("PSE") significantly outperformed world indices in 2004. For example, compared to 2003 by the end of October 2004, the BSE's BUX had gained 38 percent, the WSE's WIG 20 was up 13 percent and the PSE's PX 50 had gained 37 percent. The gains for all of 2004 ultimately were 57 percent (BUX), 25 percent (WIG 20) and 56 percent (PX 50). The largest exchange, the WSE, was home to 32 IPOs in 2004 and 2005 is predicted to be strong there as well.

Reasons for resurgence of these key CEE exchanges include the high growth attributed to European Union accession countries, favourable valuation multiples being realised in these CEE markets and the large cash inflows into equities and bonds in these CEE

countries. Recent successful, sizable transactions in Poland, Hungary and Czech Republic, such as those by BorsodChem Rt. (Hungarian chemical company, €388m secondary offering and dual listing on the WSE), Cesky Telecom (Czech telephone company, €684m ABB), Telekomunikacja Polska S.A. (Polish telephone company, €350m ABB), MOL (Hungarian oil company, €275m ABB and dual listing on the WSE), Zentiva (Czech drug maker, €174m IPO) and PKO (Polish bank, €283m IPO) have given needed credibility to equity offerings in the region.

Legal convergence of these equity markets is taking place as part of these countries accession to the European Union ("EU"). The harmonisation of securities laws as part of the accession process is aimed at integrating EU equity markets to establish the legal framework for offering of foreign securities in these jurisdictions and the admission of such securities into public trading on regulated exchanges. In particular, Directive 2001/34/EC of the European Parliament and the European Council, dated May 28, 2001, addresses the admission of securities to an official stock exchange and the information to be published about those securities. The laws resulting from implementation of this Directive address both mutual recognition of prospectuses and use of abbreviated prospectuses with the clear benefit of allowing companies to list securities on more than one exchange with relative ease.

As a policy matter, legislation arising from the Directive allows a fast track timetable for dual listings and promotes the future strength of these regional markets as they work together to provide a strong investment community. Economically, such "dual listings" are thought to (i) create additional interest in, and visibility of, a company, (ii) access additional pools of investor demand, (iii) increase liquidity and aftermarket support, and (iv) provide a company with an additional acquisition "currency". Supported by this positive economic and legal backdrop, it is now a value creating exercise to use these equity markets when private equity exit opportunities arise.

Exchange related exits versus trade sales

The exchange related exit will need to make its economic case that it is preferable to a trade sale in a particular exit. Moreover, while the pros and cons of a trade sale are relatively easy to assess, the risks and rewards of an exchange related exit are more complex. The major advantage of an exchange related exit is access to a distinct investment community to facilitate sell-down by a selling shareholder and/or financing for the corporate. The major disadvantage is the inherent execution risk and complexity of the process. Breaking down the pros and cons of an exchange related exit reveals substantial opportunities and at the same time illustrates the complexity of the process: ▶▶

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Pro:

- Access to large and distinct external funding
 - geography
 - investment style
 - investment type (institutional/retail)
- Facilitates efficient capital structure
- Flexible structure
 - IPO metrics can be tailored to reflect market sentiment
 - control/influence can be maintained with additional stakes monetised over time
 - mix between primary/secondary share issues possible
- Market valuation on assets and comfort following a public exercise that the optimum price has been achieved
- Enhanced company profile

Con:

- Execution risk – damaging to pull back from IPO
- Complexity – substantial time and resource requirements
 - valuation/equity story
 - financial/operational structure
 - corporate governance
 - due diligence
- Exposed to market sentiment
 - price/rationale
 - corporate governance
 - legal/accounting standards
 - sector/market issues
- Increased disclosure requirements and continuing reporting obligations

The cons of an exchange related exit are mitigated in some respects by the corporate governance reforms generally initiated at the time of investment by private equity investors as part of the normal investment control process – implementation of reforms to increase transparency, adoption of IAS or GAAP accounting standards, addressing off balance sheet liabilities, and the like. Other potentially negative aspects of the exchange related exit are less controllable, such as market sentiment, but nevertheless are reasonably predictable (barring catastrophic events). Deal size is also an issue since the transaction costs of an exchange related exit are high in comparison to the trade sale route.

The trade sale route will generally offer the advantage of a relatively short timetable with the potential of a valuation premium. Where an investor seeks a complete exit in many instances a straight trade sale will be preferable. On the other hand where an investor desires a sell-down of interest as opposed to a sell-

out, the exchange related exit can have strong appeal by allowing an investor to sell-down while retaining both substantial influence on the company and creating a liquid investment with a market attributed value as well as keeping the company otherwise independent of a dominant shareholder.

This particular consideration has been a driving force in many of the transactions cited earlier where the government was privatising a state-owned enterprise but desired to keep a substantial stake and influence over the company for some period of time. This allows a government to simultaneously contribute to the growth of its capital markets while maintaining control/influence and reaping cash for its sale of shares. This process has been informed and legitimated by western-trained financial advisers and investment bankers and has accelerated the renaissance of CEE exchanges to the benefit of both private investors and CEE governments. Those governments in many cases still hold many fundamental industrial concerns as state-owned enterprises and view an exchange related exit as a method of assuring the receipt of appropriate value when it sells. The retention of a sizable stake and concomitant influence is often an important consideration in these governmental privatisations through the capital markets.

The single largest exchange related exit in CEE by a private investor illustrates the applicability of these issues outside the context of governmental privatisations. BorsodChem Rt. ("BorsodChem") is one of the largest listed industrial companies in Hungary in terms of both sales and market capitalisation and is a leading European producer of both commodity and specialty chemicals. The secondary offering of BorsodChem took the form of global offering of ordinary shares and GDRs pursuant to Rule 144A and Regulation S under the US Securities Act of 1933, as amended.

Prior to the secondary offering in October 2004, BorsodChem was listed on the BSE and in depositary receipt form London but more than 91 percent of its shares were ultimately owned by Vienna Capital Partners ("VCP"), a private equity/investment banking house with a focus on investments in CEE opportunities. VCP was invested into BorsodChem for some four years during which substantial improvements to the business and its growth were achieved. A number of approaches by strategic investors had been made regarding the potential disposal of VCP's BorsodChem stake. It was a natural time for VCP to evaluate its position and consider exit opportunities. It would be critical to the eventual choice of an exchange related exit

(a secondary offering which was in essence a "re-IPO" that dramatically increased the free-float of BorsodChem) that VCP was confident in BorsodChem's ability to continue to develop as an independent, leading CEE chemical company such that VCP would consider keeping a minority stake in BorsodChem.

In the final analysis the confluence of VCP's bullish view of the future for BorsodChem and the attractive development of the BSE and the WSE convinced VCP to embrace the exchange related exit for its sell-down resulting in a successful global offering of 51,700,000 ordinary shares and GDR's of BorsodChem while at the same time implementing a dual listing of BorsodChem on the WSE. The implementation of this additional listing generated additional investor interest, tapped captive liquidity in the Polish market (where open pension funds are estimated to contribute some €200m per month to the market) and positioned BorsodChem for future consolidation opportunities. The use of an exchange related exit allowed VCP to sell down its stake below 24 percent while still maintaining a significant voice in the future development of BorsodChem as the single largest stakeholder.

Lessons for private equity investors in CEE

The development of CEE capital markets and their convergence as part of the EU accession process has created a newly robust exit alternative for private equity investors in CEE. Recent transactions have signalled the convergence and consolidation of CEE equity markets to an international audience while at the same time confirmed the investment appetite and capacity of indigenous investors in CEE. The success of the BorsodChem global offering in London further demonstrated the broad demand geographically for investment in high quality CEE-based companies. This is a trend that will continue. These developments signify a CEE capital market that is maturing in a very positive fashion for private equity investors. The coming consolidation of CEE exchanges should only accelerate this process. While an exchange related exit will never be a "one size fits all" solution for private equity investors in CEE it can now be an attractive option which should only become more viable as the integration of CEE accession countries into the EU becomes more complete. ■

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