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ANALYSIS OF SELECTED MARKET BEHAVIOURS IN THE EUROPEAN AND POLISH PRIVATE EQUITY SECTORS IN 2000–2012

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Abstract: The Polish private equity sector is a relatively new segment of the Polish financial market, as it emerged only at the beginning of the 1990s. In terms of capital, it is strongly linked to firms from outside Poland, especially European and American ones. Moreover, international firms are also significant capital donors for private equity funds in Poland. Thus, the question arises as to how these facts influence the market behaviours of Polish private equity funds. The study is based on data from 2000–2012, with Poland compared to the European market.

Keywords: private equity, emerging market, correlation, private equity funds

INTRODUCTION

The term private equity denotes a class of transactions involving private capital investments either in private companies or in publicly listed companies on the stock exchange with a view to withdrawing them from the stock exchange in the near future. Such transactions may provide funding to companies at the early stages of their development in order to boost their growth or may be used to buy out mature companies, also publicly traded ones. In the first case, private equity funds become minority shareholders, while in the second case they usually acquire a majority stake. Such companies become part of the investment portfolios of private equity firms. The objective of private equity transactions is increase the value of the portfolio company as compared to the purchase price. Private equity firms receive capital from investors who believe that the transactions they make will lead to much higher returns than those in the other segments of the capital market [Payne 2011]. Private equity funds (initially understood as venture capital) emerged in the USA in the 1940s and 1950s. This technology of financing and

organization of investments was not brought to Europe until almost 30 years later. In Poland, such ideas appeared only at the beginning of the 1990s.

The benefits of private equity are manifold and include financial backing, managerial support, and the everyday presence of representatives of private equity firms in the activities of their portfolio companies [Kaplan, Stromberg 2008]. Private equity firms are a source of capital to their companies but are not interested in short-term returns, as in the short term their stakes are not liquid. Therefore, the focus is on long-term development of portfolio companies by new investments. Furthermore, the partial debt financing mode makes the companies use their cash prudently, as the management teams are aware of the repayment obligations. The management teams are strongly involved in initiating changes due to personal shareholding. Thus, private equity funds ensure close supervision of their companies' business [Kaplan, Stromberg 2008].

Many studies have shown that private equity plays an invaluable role in the developed economies. It is emphasized that private equity leads to faster growth of portfolio companies than that of stock indexes such as S&P 500 [Kaplan, Schoar 2003]. Private equity is also thought to alleviate unemployment, enhance remunerations in portfolio companies, boost the value of the companies, as well as increase the volume and value of their output [The Global… 2010]. Many authors argue that private equity firms exert a major, even if indirect, influence on national economies. They also lead to greater competition in capital markets, at the same time forcing companies outside private equity financing to improve their management standards [Campbell, Campbell 2008]. In many countries the role of private equity has become so prominent that this sector is now considered a major vehicle for enhancing recovery from the economic crisis. For instance, this is the general expectation in Great Britain, which is the European leader in the private equity sector. Some even believe that private equity funds may not only be instrumental in overcoming the crisis, but subsequently they could help keep pace with the fastest growing economies of the world (China, India, Brazil) [Barber 2010].

A BRIEF OUTLINE OF THE SITUATION OF THE PRIVATE EQUITY SECTOR IN THE 21ST CENTURY

The history of the private equity sector in Europe, which has been professionally monitored since the 1980s, shows that it has been developing in a cyclical manner. Growth periods have been followed by downturns [Kaplan, Stromberg 2008]. Around 1995, euphoria driven by IT companies and the related sectors took hold of the stock markets around the world. As a result, companies that conducted business on the Internet or intended to do so became increasingly overvalued. A period of realization of tremendous profits (of the order of 65%) through IPOs on American stock exchanges in 1999–2000 was followed by

a dramatic decline to 12% in 2001–2003 [Loughran, Ritter 2004]. This downturn is commonly called the burst of the Dot-com bubble [Ljungqvist, William 2003]. Looking back, one can argue that it was not caused by a global recession of the world's economy, but rather by adjustment processes within the IT sector (and IT companies are often backed by private equity funds due to their innovativeness). Statistical data show that the aforementioned crash, which hit hard private equity sectors around the globe, was followed by another period of dynamic development of this business model [EVCA 2001-2013].

The current situation differs in that the private equity sector, being an element of the financial market, has been affected by shock waves of the 2008 subprime mortgage crisis [Kaplan, Stromberg 2008], in which a major role was played by dysfunctional debt securitization [Christopoulos et al. 2011]. A global disaster was averted only thanks to the wide array of active measures undertaken by the governments around the world [Cohen 2012].

Initially, the understanding of the ongoing crisis in the context of the private equity sector was rather limited [Gurung, Lerner 2010]. The first reports on the global financial sector from 2008 and 2009 seemed to justify a quite optimistic outlook for the sector in Europe. Investments made by private equity firms exhibited high resilience to the crisis, at least in its early stage. As a rule, the portfolio companies of investment funds were not listed on stock exchanges, so they were not subjected to the often hysterical reactions of the destabilized financial markets.

Still, the number of new investments, and especially so-called mega buyouts, declined [Thomson 2009]. According to preliminary data for 2008, the volume of buyout transactions in Europe reached only EUR 49.9 billion, which means a decrease of almost 40% on the previous year. Thus, the investment volume shrank even more than in 2001, when the amount of capital invested was reduced by 30% from 2000 [EVCA 2003]. This situation was explained by the fact that many banks were no longer interested in leveraging transactions. Furthermore, if the cost of shareholder's equity is lower than the cost of debt financing, then private equity companies take advantage of that difference [Kaplan, Stromberg 2008]. Obviously, the cost of debt surged due to increased risk and a crisis of confidence in the financial markets. Consequently, the managers of private equity firms no longer perceived leveraged transactions to be a viable option.

Paradoxically, at the beginning of the financial crisis, considerable capital resources were channelled to the private equity sector, especially in the United States, as a result of withdrawal from other capital market sectors. Major contributors at the time were pension funds [Thomson 2009]. It was estimated that in the United States, where the crisis emerged as early as in the second half of 2007, the amount of capital raised by the private equity sector in the first half of 2008 was greater than in any other half-year in the history of private equity. Some even foresaw the beginning of a golden age for private equity [Butler 2008]. However, in 2009 this optimism waned [Thomson 2009].

Nevertheless, at a time of overwhelming uncertainty in the financial markets, investing in an area with strong fundamentals was undoubtedly a sound idea. Due to the low market value of many companies, the investment capacity of private equity firms significantly increased, while many other sectors faced technical or liquidity problems. This gave the private equity sector an opportunity to reinforce its position in the long term [Coller 2008].

On the other hand, private equity funds were now presented with problems concerning those companies that had been present in their portfolios for a longer time and were scheduled for divestment in the near future. Due to the low demand in the financial markets, the prices offered for their portfolio companies were unsatisfactory for the funds. This tendency hit the very foundations of the functioning of private equity firms. While making divestment decisions, they were faced with the dilemma of whether they should realize a low profit now or keep their capital frozen in their portfolio companies and bear additional management costs [Nazelle 2008].

Despite numerous difficulties, one could argue that the private equity sector is one of the few areas of the financial market that was, and, according to EVCA publications, still is, characterized by relatively good financial standing. However, given the above considerations, private equity managers will need to exercise considerable caution in the coming years [Coller 2008].

RESEARCH HYPOTHESIS

The Polish private equity sector is relatively little experienced or developed. Due to political reasons, it did not emerge until the transformation initiated at the end of the 1980s. However, despite its short presence in Poland, the section has gained an important place in the financial market in this country. This is confirmed by the fact that since the end of the 1990s it has been continuously, on individual basis monitored by EVCA, the top institution monitoring activity and implementing standards in this area. EVCA regularly releases data concerning about 20 countries having the most developed private equity sectors in Europe, including Poland.

A characteristic feature of the Polish private equity sector is a relatively small share of domestic capital as compared to the European standards, as can be seen from Tables 1 and 2.

Analysis of the above data shows that the private equity sector in Poland differs from the European sector in terms of the geographic distribution of the sources of funding. Table 1 shows that in Europe an important role is played by capital contributed by investors who are located in the same countries as the private equity firms they invest in. In the period 2000–2012, the share of such funding exceeded 40%, with another 20.5% of capital raised from other European countries. The remaining 40% came from non-European and unknown sources.

Table 1. Geographical structure of new funds raised by private equity firms in Europe in the years 2000–2012 in EUR billion

Europe in EUR billion	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total 2000-2012	% Share
Domestic	25	19	14	15	16	34	42	21	21	10	10	14	7	248	40.3
Non-domestic	10	7	6	4	5	13	26	13	16	4	5	11	6	126	20.5
Within Europe	35	26	20	19	21	47	68	34	37	14	14	25	13	374	60.8
Outside Europe	13	12	8	8	7	25	44	18	29	2	3	13	9	190	30.9
Unclassified	0	0	0	0	0	0	0	26	14	2	4	3	2	51	8.3
New funds raised	48	38	28	27	27	72	112	78	80	19	22	41	24	616	100.0

Source: Based on EVCA Yearbook from 2001–2013.

In turn, Table 2 shows that in Poland the private equity sector raised only 3.5% of its funds from the Polish capital market. Data analysis shows that this tendency continued throughout the studied period, during which the maximum amount of domestic capital channeled to this segment of the financial market was EUR 35 million (in 2006 and 2011). In other years, this amount was much smaller, often as low as zero or close to zero.

Table 2. Geographical structure of new funds raised by private equity firms in Poland in the years 2000–2012 in EUR million

Poland in EUR million	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total 2000-2012	% Sha-re
Domestic	25	10	0	5	0	3	35	25	0	18	9	35	0	166	3.5
Non-domestic	175	142	119	19	224	8	654	80	503	107	105	268	271	2 675	56.8
Within Europe	200	152	119	24	225	11	690	106	503	125	114	302	271	2 842	60.4
Outside Europe	133	24	0	1	79	48	247	102	249	10	0	140	146	1 179	25.1
Unclas-sified	:	:	:	:	:	:		616	9	11	1	0	50	686	14.6
New funds raised	333	176	119	26	304	59	937	824	760	145	115	443	467	4 707	100.0

Source: Based on EVCA Yearbook from 2001–2013.

This is a significant deviation from the European standards, as investors typically seek investment opportunities in local markets, while transactions outside domestic regions are only linked to some special investment strategies. This means

that the Polish capital market is not particularly interested in private equity processes.

This largely results from the low supply of cash in the capital market. In Europe, the predominant investors are pension funds, banks, and funds of funds (in the years 2000–2012 they contributed 22.7%, 15.4%, and 13.8% of the capital, respectively in average) [EVCA 2001-2013]. However, in Poland, pension funds emerged very recently (at the turn of the century) and are subjected to severe investment limitations with a view to the safety of future pensions. This means that pension funds may not actively support the Polish private equity market. The decisions made in Poland very recently (in 2011 and 2012) as well as the current sentiment imply a decline of pension funds in this country.

The Polish banking sector is relatively small as compared to its counterparts in Europe, and is mostly interested in deposit and lending activity and related services rather than in capital market investments.

In turn, funds of funds represent a relatively new idea in Poland and are at an early stage of development, so they cannot function as a major player in the Polish financial market.

Under the circumstances, the question arises to what extent Polish private equity firms, most of which were established by foreign entities and 97% of whose capital comes from foreign sources, mirror the patterns of market behaviours typical of the private equity markets in other countries in terms of the amount of capital raised, investments, divestments, and size of investment portfolios. The overwhelming dominance of foreign firms in the Polish private equity market would suggest that the pattern of its activity is closely connected to the European market in the aforementioned four areas. This research problem is addressed by means of statistical analysis presented below.

DATA AND METHODOLOGY

European and Polish private equity firms are compared based on the data provided for each year of the period 2000–2012 by EVCA in the form of yearbooks. The data were released in cooperation with PEREP_Analytics and some other contributors.

Analysis concerns Europe as represented by the European Union Member States plus Ukraine, the group of former Yugoslav countries with Slovakia, the group of the Baltic states, Norway, and Switzerland, and with the exclusion of Bulgaria, Cyprus, and Malta. To determine the strength of the relationship between the activity of the Polish and European private equity sectors, statistical correlations were computed.

CONCLUSIONS

Analysis of data from consecutive EVCA Yearbooks revealed the strength of the relationship between the activity of the private equity sectors in Europe and in Poland in the years 2000–2012. The results are presented in Table 3.

Table 3. Correlation of the activity of the private equity sectors in Europe and in Poland in the years 2000–2012

Type of activity	Funds raised	Funds invested	Divestments	Portfolio
Correlation coefficient	0.76	0.36	0.66	0.94

Source: Based on EVCA Yearbooks from 2001–2013.

Analysis of Table 3 shows that in contrast to expectations, Polish and European private equity firms do not behave in unison. This in particular concerns investment of the capital raised, as a coefficient of 0.36 indicates poor correlation. This means that decisions as to the amount of funds expended over consecutive years were made by Polish firms as a result of their independent market analysis, while suggestions from the owners (capital donors) and European market behaviour trends (e.g., those resulting from the crisis) had a lesser influence on those decisions.

The amount of funds raised (a correlation coefficient of 0.76) and divestments (0.66) are more consistent with the European patterns. Indeed, this correlation may be deemed strong, but even in this case Polish private equity firms do not seem to mirror the trends followed elsewhere in Europe.

The strongest correlation (0.94) was observed for the size of investment portfolios in the private equity sectors. This can be explained by the nature of economic developments, which were similar for Poland and Europe. Every year, the value of portfolios changes, as new investments and divestments are made. The value of both Polish and European portfolios increased each year throughout the studied period.

Increased portfolio values in non-crisis periods are a beneficial phenomenon and show that the sector is growing, as the size of investment portfolios reflects the volume of investments continued by private equity funds. This augurs well for prosperity in the sector over the following years, when the companies maturing in the portfolios will present an opportunity for the realization of capital profits.

In periods of crisis, portfolios grow for a different reason, which was mentioned earlier in this paper. The activity of private equity funds consists of purchasing assets interesting from the point of view of the buyer (the private equity firm), their restructuring, and selling in the capital market. The difference between the sale and purchase prices, less management costs, constitutes the profit of the funds. The investments typically have a time horizon of 5 to 8 years. In many

cases, in periods of crisis companies facing financial hardship sell off their property, including real estate and organized assets, at very low prices.

On the other hand, private equity firms whose portfolio companies have matured and are ready to be sold face obstacles in the form of low prices that potential buyers would be willing to pay for those companies. This leads to prolonged investment time as companies are retained in the portfolio with a view to obtaining higher prices in the capital market in the future. Thus, the fact that the growth trend in European and Polish portfolios is almost identical shows that the private equity sector in Poland is growing strong and follows the adaptation processes related to the crisis that hit Europe in 2008 and continues to this day.

In summary, it is not true that capital ties between Polish private equity firms and their foreign shareholders or other international entities contributing capital to be invested impose certain market behaviour patterns on the firms. It turned out that the private equity sector has elaborated independent features and it is relatively mature to pursue their own objectives within the framework of the Polish emerging market. A similar situation can be observed in the Polish banking sector, which is in 60% dependent on foreign capital.

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