Deloitte.

What goes up…

Private Equity Confidence Survey Central Europe

Winter 2022

What goes up...

The last two years have brought unprecedented uncertainty to many aspects of life, with lives and livelihoods affected alike. The initial shock of Covid-19 saw the Deloitte Central European (CE) Private Equity (PE) Confidence Survey plummet before rising six months ago to a near-high.

What goes up must come down, and it has always been thus. The latest Deloitte Survey shows the Index's stellar climb give way to a gentle fall, and our near-peak value has landed at a more sustainable 119, down from 149 but still above the 10-year average. Inflation on the other hand and therefore interest rates seem to be travelling in the opposite direction, and the fear of the impact may be contributing to the Index's fall.

The fall is less steep than its record climb in our last Survey, and indeed we see much to be positive about. Pricing in Western Europe and in our region to a lesser extent was climbing to very high levels, with increased levels of capital combined with very liquid leverage markets supporting this. These were comprised of banks, credit funds and LP co-invest, with other structures yet emerging.

For example ESG-linked revolving credit facilities are now taking off in Western Europe, enabling GPs to bridge capital calls from LPs, with banks lending against ESG-linked metrics. These are structured to give the manager a discount to its market margin by meeting pre-agreed KPIs at specified times during the life of the facility. With CE managers increasingly adopting robust ESG policies, it may be only a matter of time before we see this in the region, adding to capital efficiency.

Adding to this glut of capital has been a scarcity of quality assets coming to market, creating a perfect storm of demand outstripping supply. Good for selling, tricky for transacting. As a result, we've seen enhanced emphasis on diligence and, increasingly in 2021, houses approaching us and firms directly to develop a proprietary angle and relationship on deals prior to formal processes launching. This can make backers more confident of the firms they're investing in and the prices they're paying. Now it seems valuations may be cooling, with around a fifth of Survey respondents saying prices will come down and nearly half suggesting they'll stay the same in the first half of 2022.

We see interest in buy-and-build continue to grow. This is unsurprising given M&A's ability to transform companies by way of accelerating entry into new markets, verticals and geographies, and with experienced PE backers supporting, it should mean smoother processes for negotiating and integrating. We see in this Survey that nearly a third (30%) of deal-doers are looking more to create value through buy-and-build strategies.

Sourcing and assessing opportunities for experienced deal-doers and ambitious leadership teams is a challenge and opportunity for us. We remain ready to work with them on helping to drive sustainable growth for businesses partnering with the right financial backer in the region.

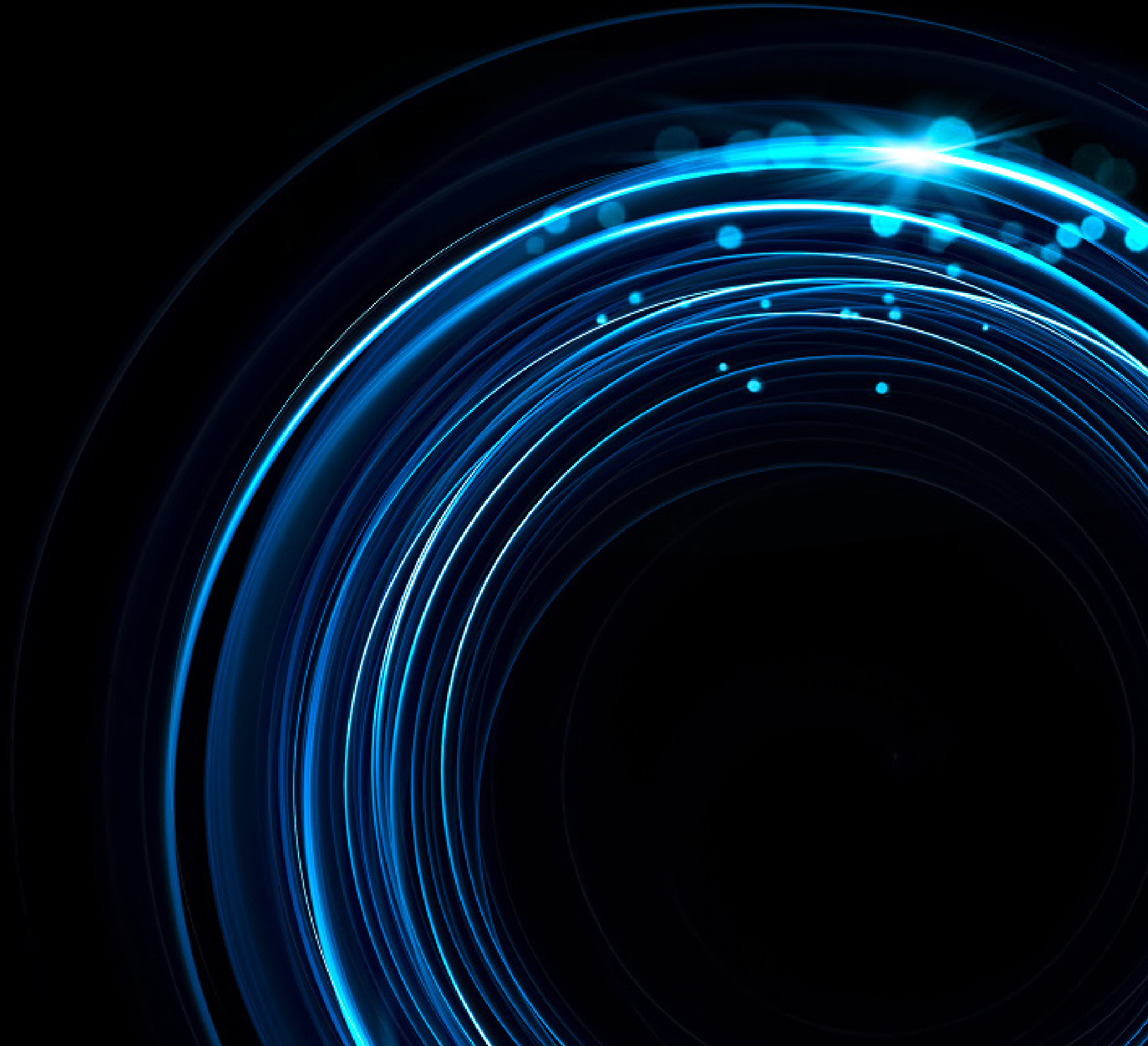
Dusan Sevc
Partner, Private Equity Leader,
Deloitte Central Europe

Central European Private Equity Index: Key findings

The Index has dropped but remains above the 10-year average and signs of positivity can be seen throughout our latest Survey. Confidence around the economy for example remains reasonably upbeat, with over half (58%) expecting conditions to remain the same (41%) or improve (17%). Additionally, over half of respondents (61%) expect to focus on new investments in the first half of 2022, a gentle increase on our last Survey and sign of investor confidence.

Deal sizes may be stabilizing, with over half of deal-doers (57%) expecting transaction sizes to stay the same, a marked increase from 37% in our last Survey. Likewise, the percentage of respondents expecting sizes to increase has fallen sharply, from 59% over the summer to 39% now. This may be linked to pricing, with 7% of respondents feeling vendor price expectations had come down in the second half of 2021. These outlooks may be a sign of a healthy market, since high valuations combined with increasing sizes can point to unsustainable metrics last seen prior to the Global Financial Crisis.

The high pricing environment of 2021 may be cooling according to our respondents' sentiment. While 43% feel pricing had increased in the second half of 2021, a similar percentage (46%) expect prices to remain the same over the first half of 2022. Additionally, just a fifth (22%) expect prices to rise in 2022, down from 41% expecting continued rises in our previous Survey. Another fifth (20%) expect prices to fall in the first half of 2022, up markedly from only 6% expecting this in our summer Survey.



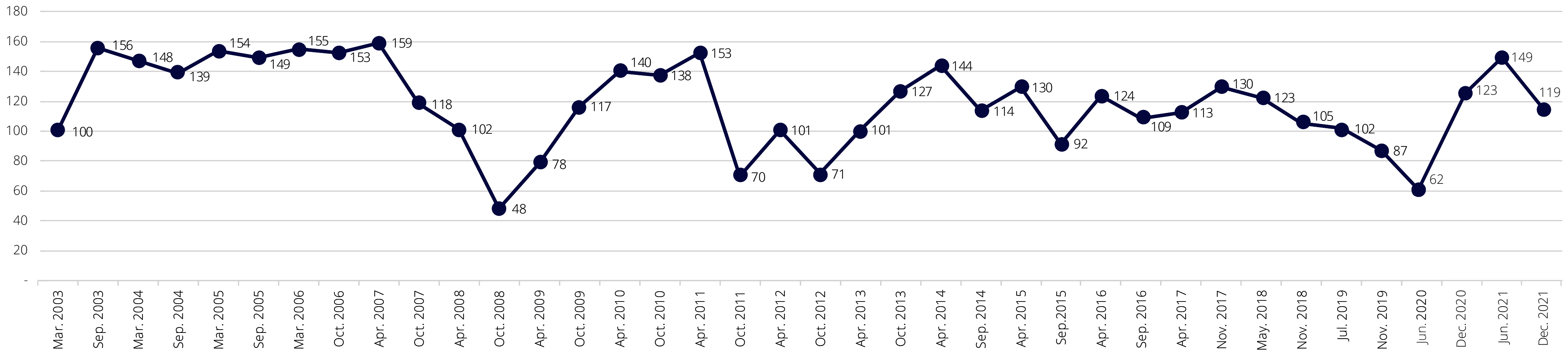
A year after undergoing its largest survey-on-survey climb, our latest report reveals a reversion to more sustainable levels of confidence, landing on 119, still ahead of the Survey's 10-year average and possibly pointing to signs of normalizing following a period of great uncertainty and the opportunities that went on to catalyze.

Despite the dip in confidence, a number of indicators in our Survey point to positive sentiment for the coming months. For example confidence around the economy remains reasonably upbeat, with over half (58%) expecting conditions to remain the same (41%) or improve (17%). Additionally, over half of respondents (61%) expect to focus on new investments in the first half of 2022, a gentle increase on our last Survey and sign of investor confidence.

Over half of deal-doers (57%) expect transaction sizes to stay the same, a marked increase from 37% in our last Survey. Likewise, the percentage of respondents expecting sizes to increase has come down by a third, from 59% over the summer to 39% now, a sign deal sizes may be stabilizing.

These expectations may be a sign of a healthy market, since high valuations combined with increasing sizes can point to unsustainable metrics last seen prior to the Global Financial Crisis.

Central Europe PE Confidence Index



Survey Results

Economic climate

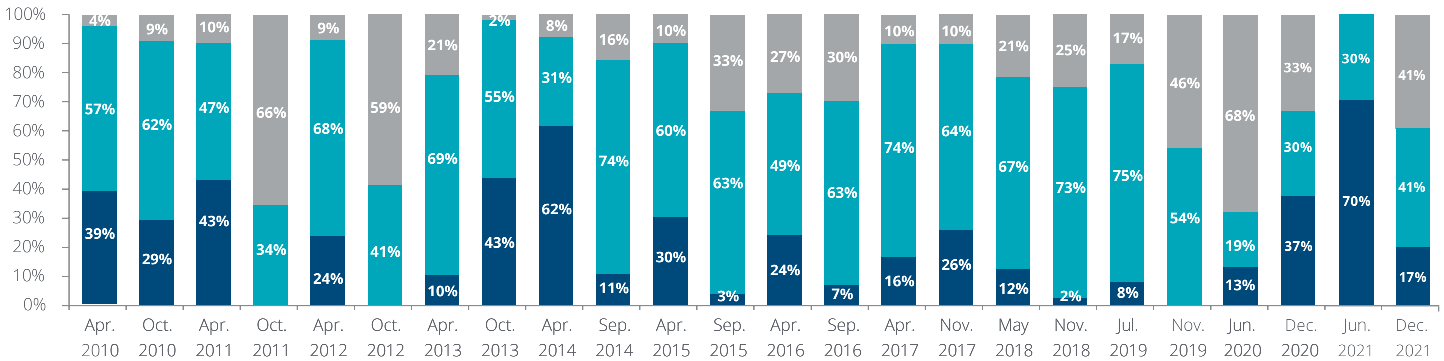
Confidence around the economy is waning but remains reasonably upbeat, with over half (58%) expecting conditions to remain the same (41%) or improve (17%). It was nearly impossible to maintain the trend of the last two years, which saw four consecutive Surveys of improving confidence culminating in last summer's result that no respondents expected conditions to worsen – the first time since 2007.

Our latest Survey was launched as Omicron swept the world, polling deal-doers as fresh waves of restrictions seemed imminent and another winter of discontent upon us. The previous Survey came out as Delta raged, but that was met with fewer restrictions, perhaps owing to the season, and so business prospects, particularly for the hospitality sector, were less bleak.

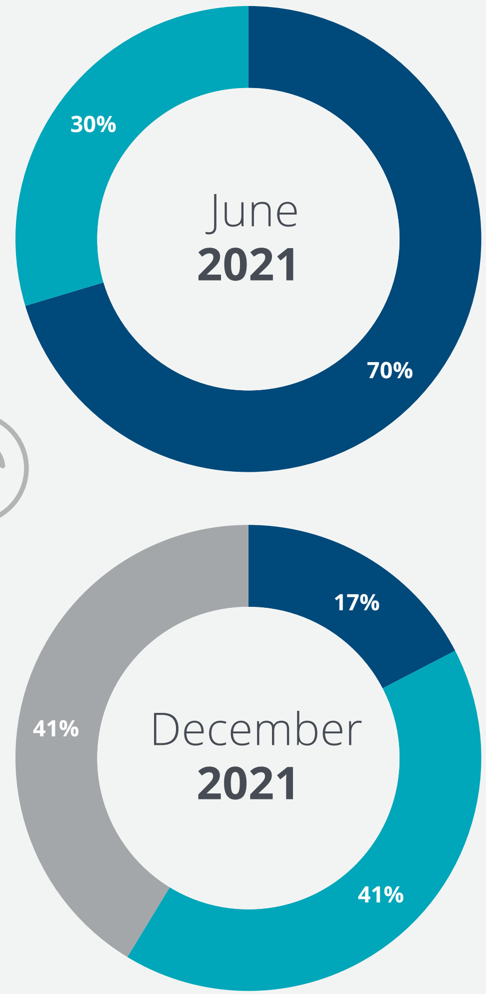
Inflation fears currently plague the entire world, with the cost of energy, materials and labor all rising rapidly. While some speculate it will be transitory, the IMF suggested it may persist throughout 2022 as this report was finalized. While the impact and duration remain to be seen, central banks had already started to react in some countries, including the National Bank of Poland, which in January announced its fourth rate hike in a row to 2.25% to stem inflation, which is at a 20-year high. Hungary ended 2021 with its seventh rate hike in as many weeks, while the Czech Republic saw its repo rates soar from 0.25% in the summer of 2021 to 3.75% by the end of the year. A board member of the Czech National Bank said in January that rates should not exceed 5% and that they may come down in the second half of the year if inflation eased, as is hoped for and expected.

Poland, Central Europe's largest economy, was forecast to grow at 4.9% in 2021, following a GDP contraction of 2.5% in 2020. Forecasts for 2022 point to a healthy 5%. Romania's GDP growth is expected to have grown at 7% for 2021, up markedly from contracting 3.9% in 2020 and forecast to grow at 5.1% for 2022. The Czech Republic is forecast to grow at 3.5% this year, up from 1.9% in 2021.

For this period, I expect the overall economic climate to:



Economic climate (June 2021 vs December 2021)



Improve

Remain the same

Decline

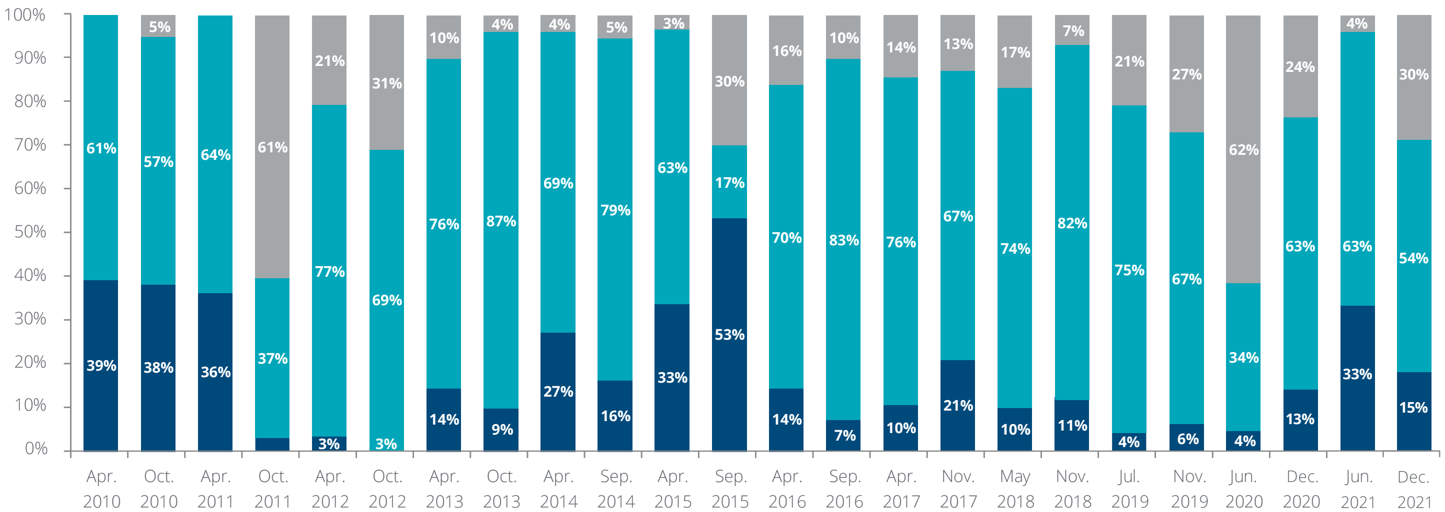
Debt availability

Leverage markets may constrict a bit, with nearly a third of respondents (30%) expecting liquidity to decrease and only 15% expecting it to increase. The results follow a huge boost in optimism last year, when a third of respondents (33%) expected the availability of debt finance to increase – then the highest level in six years. The latest sentiment is reflective of the last two winter Surveys, suggesting last summer may have been assuming an improvement on a relatively low base.

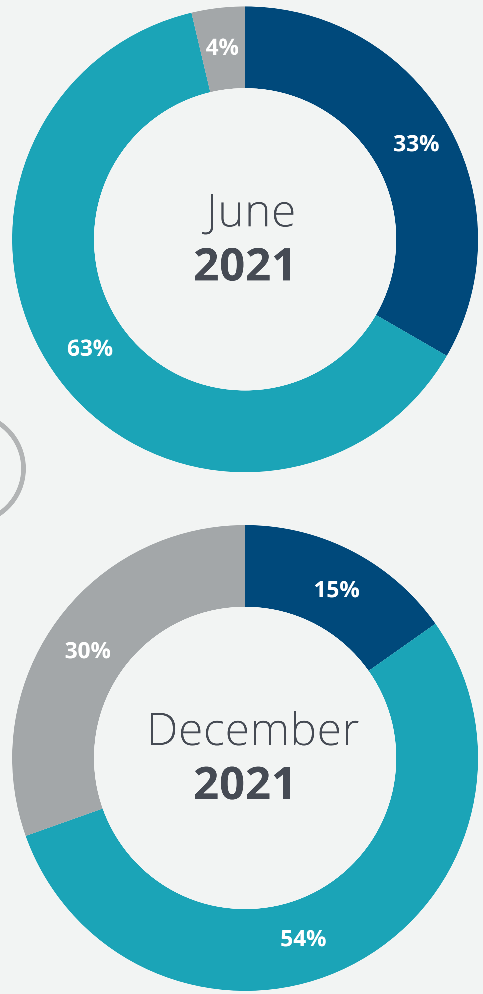
The reality is that the situation has proven more fluid than anyone imagined at the start of the pandemic, with a short sharp shock giving way to a cautious recovery, boosted by the agility and resilience many companies adopted out of necessity. Firms succeeding in today's backdrop have done so despite unprecedented adversity and uncertainty, and so may be better placed to continue than may have been the case a year ago.

Additionally, firms that take on private equity backing may have access to better business coping mechanisms. This is because experienced private equity backers have experience to draw on to help their investment companies navigate the ever-changing road ahead. This may include assistance with cashflow management, negotiating with lenders (with more strength than a company on its own may have), building plans for sustainable growth. They can benefit from their backers' experience as well as share knowledge with the wider portfolio.

For this period, I expect availability of debt finance to:



Debt availability (June 2021 vs December 2021)



Increase
Remain the same
Decrease

Investors' focus

It remains the case that over half of respondents (61%) expect to focus on new investments, a gentle increase on our last Survey and a sign of investor confidence. The increase may have been small, but it is welcome not only because it is a rare sign in this Survey of increasing confidence, but also because it reinforces the about-face seen in our last report, when the percentage was down. Then we attributed rising entry multiples with waning interest as lots of capital was chasing precious few deals. It may now be the case that deal-doers are accepting a slightly higher pricing level, or perhaps that there are expectations of a stabilization of prices (see page 14).

The proportion expecting to focus on portfolio management has increased to a third. This may be the result of investors preparing businesses for sale in a high valuation backdrop, or even pursuing buy-and-build activity in an effort to bring down average entry multiples paid on platform assets, particularly as the last two years have given way to fresh opportunities for consolidation.

Abris supported three acquisitions for its portfolio in H2 2021, including logistics tech platform Apaczka buying Sendit, dental specialist Dentotal acquiring Dentatechnica and most recently security software business Global Technical Group buying Lummetry in September.
Innova supported multiple bolt-ons for its portfolio including Inelo's purchase of CVS Mobile and Prime Label's acquisition of Label Print.

21 Invest supported Product Life Group's acquisition of ELC to enhance its capabilities in Romania and India.

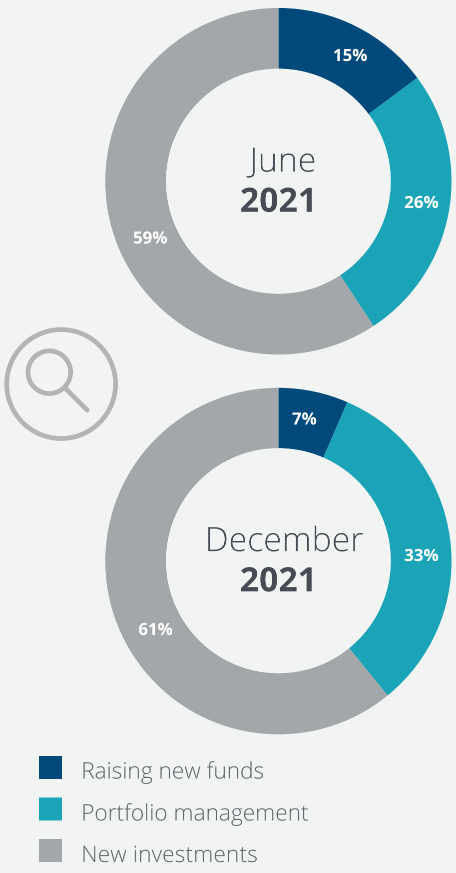
Waterland's portfolio also undertook a number of bolt-ons during the second half of 2021.

Skaylank, a cloud service provider backed by Waterland in 2020, acquired root360 in Germany in July and BTT Group in Lithuania in August, bringing to over 500 the number of employees across Skaylank's offices in Germany, Romania, Brazil and Lithuania. Waterland-backed Enreach also continued its acquisitive growth, purchasing OSS Networks in September to increase its Baltic offering.

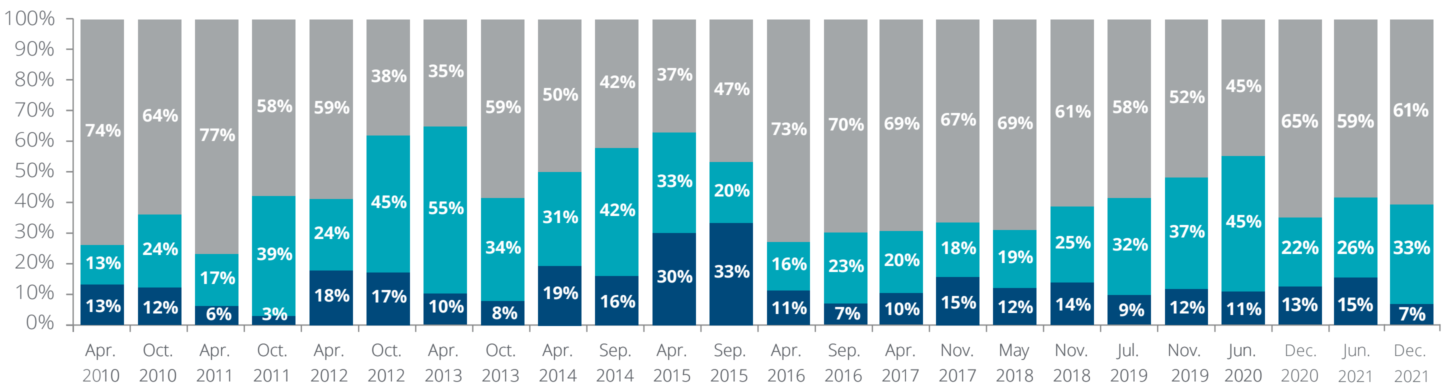
MidEuropa's digital design business intive enhanced its US footprint with the purchase of Spark Digital, intive's third purchase after SimTLiX and Ammeon.

MediGroup, which was backed by MidEuropa in 2018, acquired Talia Laboratories in August, rolling out its lab footprint in Serbia to become the countries largest network with over 50 laboratories.

Investors' focus (June 2021 vs December 2021)



For this period, I expect to spend the majority of my time focusing on:



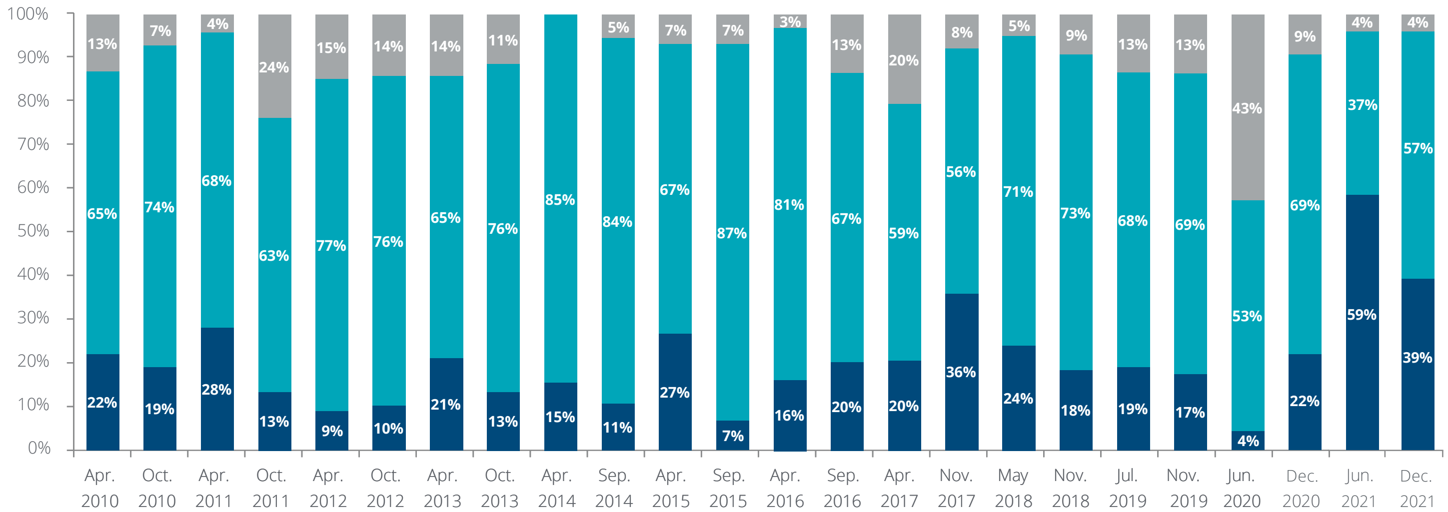
Size of transactions

Deal sizes may be stabilizing, with over half of deal-doers (57%) expecting transaction sizes to stay the same, a marked increase from 37% in our last Survey. Likewise, the percentage of respondents expecting sizes to increase has come down by a third, from 59% over the summer to 39% now.

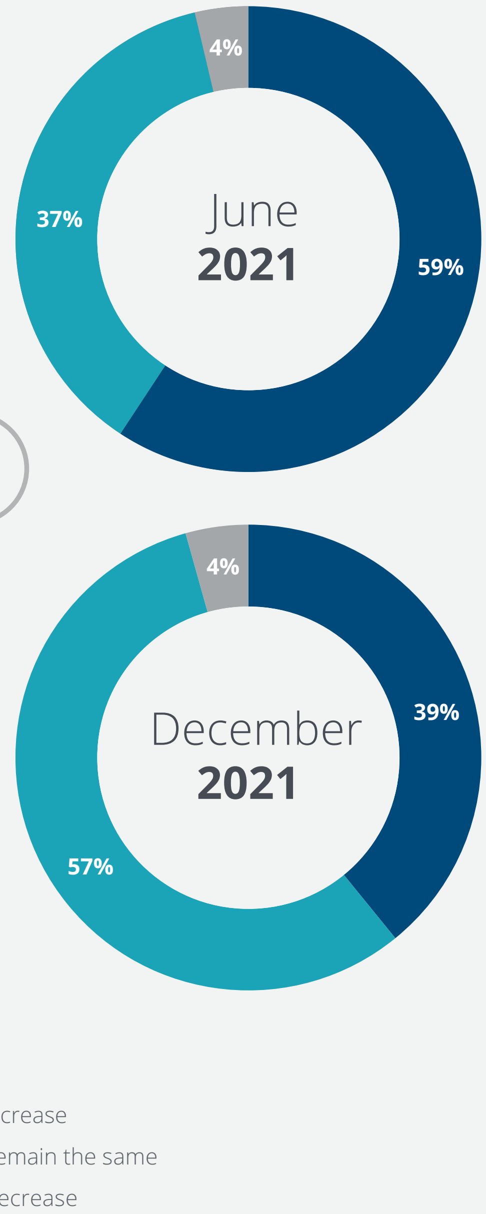
The expectations may be a sign of a healthy market, since high valuations combined with increasing sizes can point to unsustainable metrics last seen prior to the Global Financial Crisis. In fact the 39% expecting sizes to increase, though down on the previous Survey, represent the second highest level since 2007, when frothy leverage markets perpetuated by covenant-lite terms catalysed a sharp correction.

Large deals remain the exception in Central and Eastern Europe, which tends to be a mid-market opportunity. The handful of sizeable transactions in H2 2021 included Partners Group's acquisition of Baltic district heating business Fortum Oyj AB for around €800 million, and a €250 million series-F round for second-hand fashion app Vinted led by EQT Growth. The semester also saw Vitruvian Partners acquire Fotona for around €600 million from incumbent backer AGIC Capital, which is reinvesting to support the firm's international growth. The medical laser system maker was founded in 1964 in Slovenia and today has sales bases in the US and China.

For this period, I expect the average size of transactions to:



Size of transactions (June 2021 vs December 2021)



Market activity

Market activity may be stabilizing after the pandemic-induced standstill of Q2 gave way to increasing activity and pricing levels at the end of 2020 and all of 2021. Over 60% of respondents expect activity levels to continue, with just 30% expecting activity to increase – down from over 60% in our last Survey.

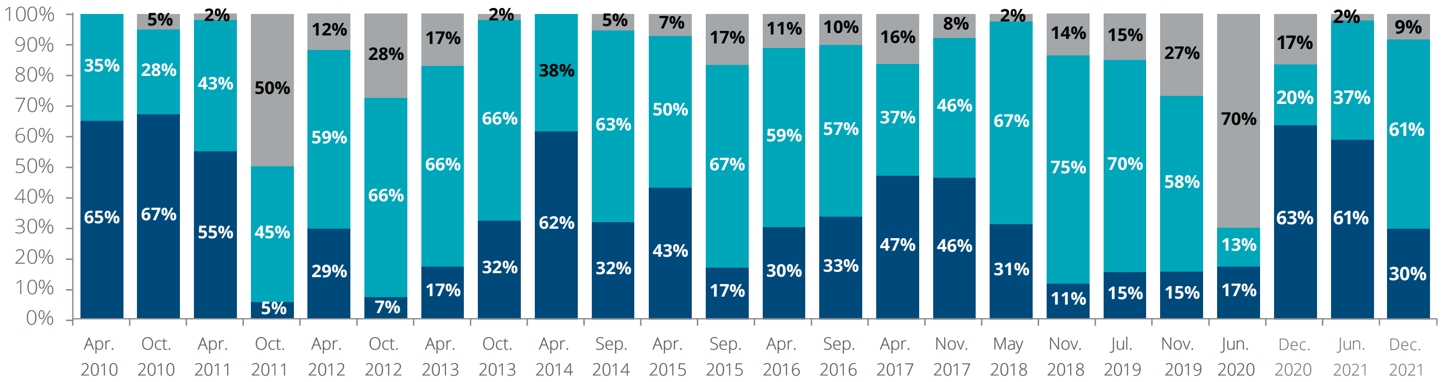
The resilience of the private equity market in Central Europe is illustrated by the fact that the Survey launched as Omicron landed and yet only 9% of respondents expect activity to decline. The region's longest-established investors have been building businesses for over 20 years and so have deep expertise to draw on to help firms negotiate challenging journeys. This has been proven in the last year, with portfolios shored up, stabilized and back on paths to growth.

Enterprise Investors recorded a number of deals in H2 2021. These included a minority investment in FinGO, a financial services intermediary based in Slovakia, investing €19 million for a 40% stake in October. The deal came shortly after Enterprise backed Focus Garden, an ecommerce platform for outdoor items. Two summer deals signed by the investor were Snap Outdoor, a distributor of mountaineering and climbing equipment, and Modular System, the largest Polish manufacturer of multi-function container and modular systems.

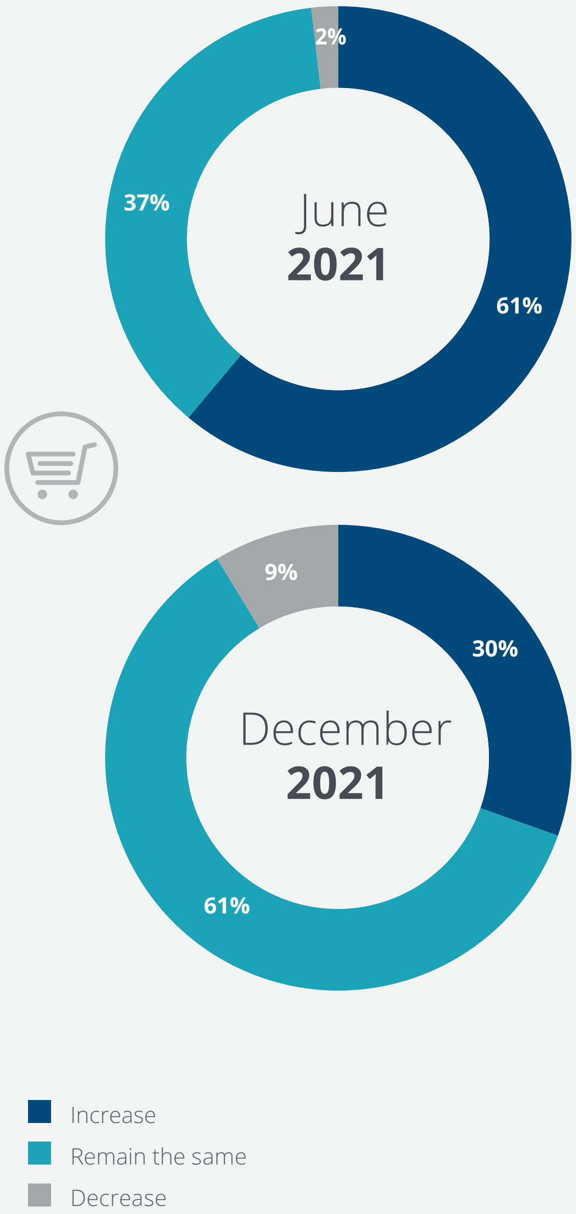
Another busy deal-doer was BaltCap. The Baltic investor, which raised the region's largest-ever PE fund at €177 million in April 2021, undertook a number of new and bolt-on deals in the semester. Most recently the firm acquired a minority stake in Estonian and Latvian omnichannel retailer Weekender, marking the seventh transaction from BaltCap's Baltic Growth Fund. The firm also announced an exit with the sale of Latvian fuel station operator Kool to a trade buyer. The divestment came shortly after BaltCap's sales of Eesti Keskkonnateenused and Labochema both in June, marking a busy summer for the investor.

Avallon also had a busy semester. The firm sold MPS International after a seven-year hold which saw revenues, EBITDA and headcount all increase, and Avallon sold EBS after a 3.5-year partnership. At the end of the year, Avallon acquired a majority stake in lighting specialist Norlys.

For this period, I expect the overall market activity to:



Market activity (June 2021 vs December 2021)



Investment return

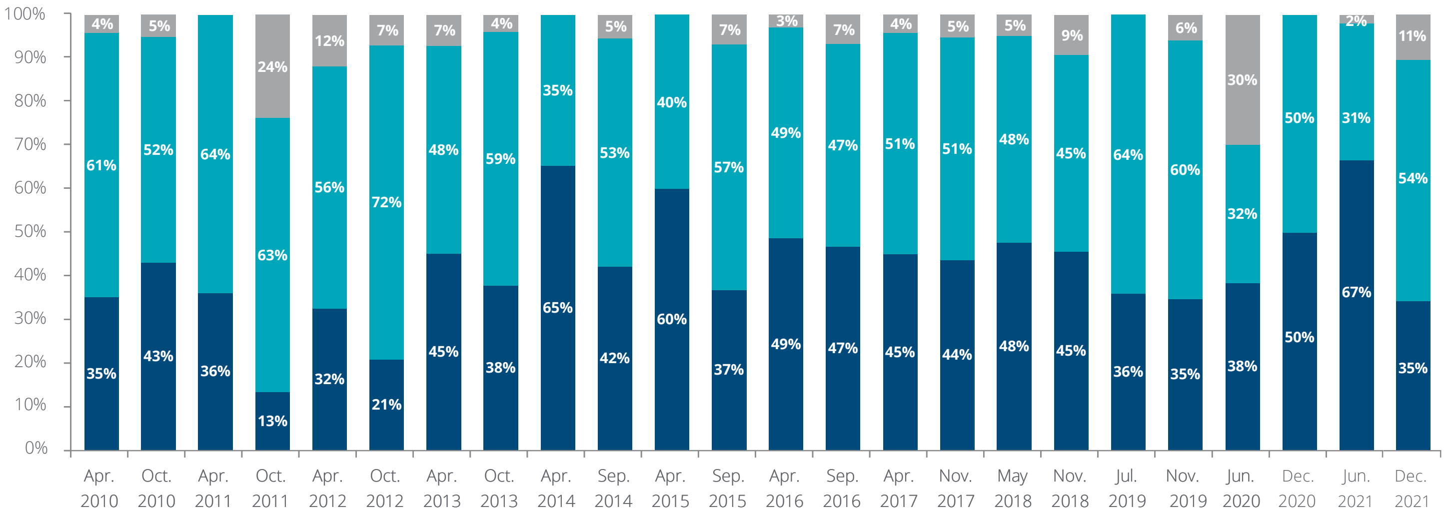
Confidence around financial efficiency of investments is waning, with 65% expecting it to remain the same (54%) or decline (11%), against 67% expecting an improvement in our previous Survey. Over a third (35%) remain optimistic and expect an improvement, but the figures do paint a very different picture to most of 2021. In fact stripping out the summer 2020 Survey, when the pandemic was newly upon us and 30% feared a worsening of efficiency, this Survey's 11% is the highest proportion of negativity in nearly a decade.

It may be that swelling vendor price expectations and the acceptance they are here to stay is impacting investors' sentiment (though there are signs this may be changing – see graph on page 14 on 'vendor pricing').

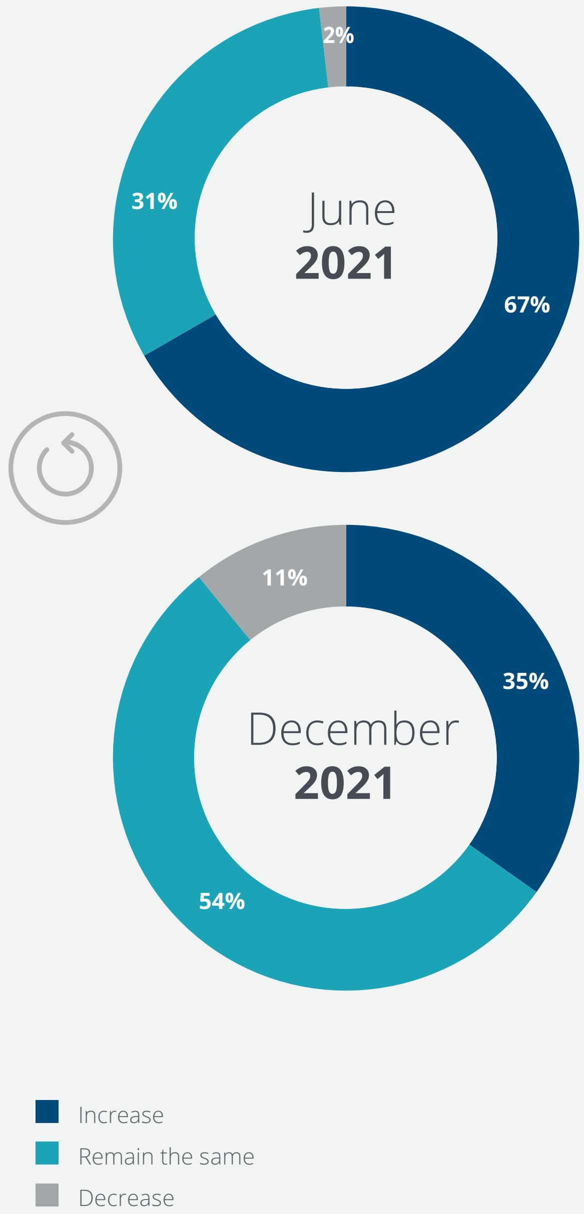
Growing coffers chasing a relatively finite number of deals means capital is flocking to quality and driving prices up for the strongest assets. In fact, the average multiple paid in PE-backed deals in all of Europe jumped to 12.4x in Q3, versus 11.8x in Q2. While Central Europe has historically lagged its Western European neighbour on pricing, the region climbed steadily in 2021 and broke into double-digit average entry multiples for Q3.

Full pricing makes it crucial for investors to add value to their investments through working with management to grow and drive alpha – something the experienced houses of Central Europe have proven adept at doing over recent years.

For this period, I expect efficiency of my financial investments to:



Investment return (June 2021 vs December 2021)



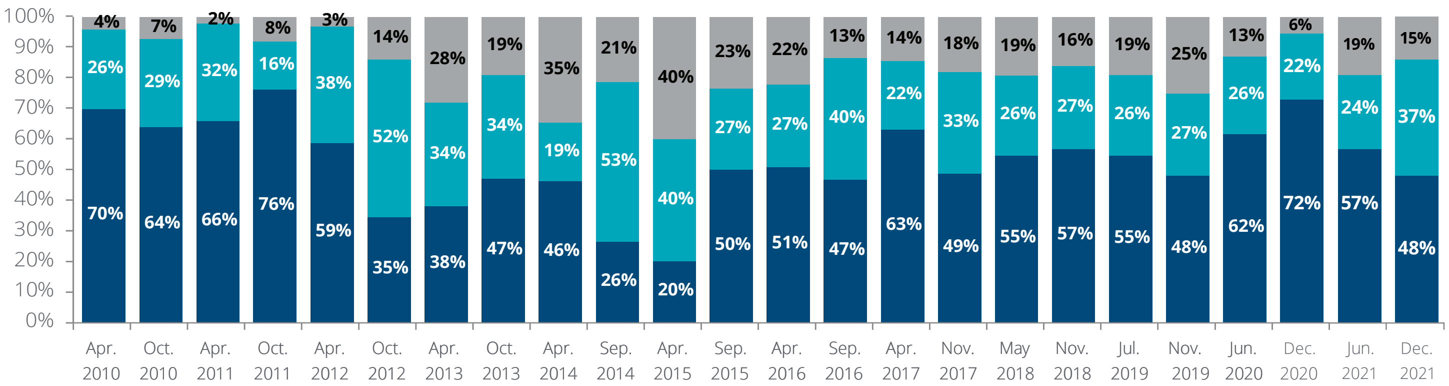
Investors' activities

The shift in pricing may be behind a gentle slide in enthusiasm for buying in our latest Survey, with less than half (48%) expecting to buy more in the coming months. This is down from 57% over the summer, and may mean more houses are looking to focus on harvesting assets in their portfolios. Indeed over half (52%) expect to sell more (15%) or buy and sell equally (37%) in the coming months.

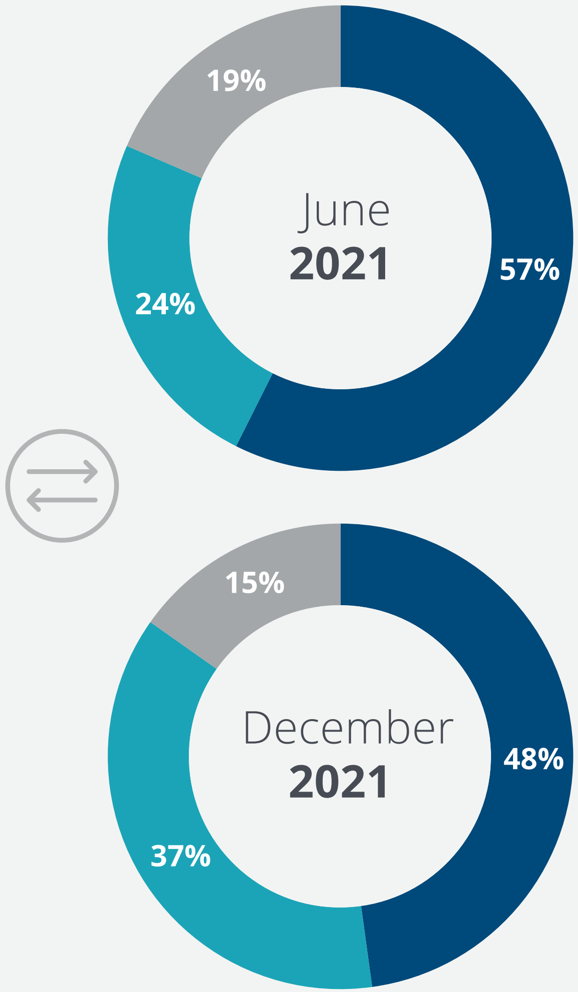
It has always been true that different assets will command different multiples and this is the case now more than ever. In addition to proving resilient over the last two years, assets in certain industries are in more demand from buyers, with firms in the healthcare, fintech and direct-to-consumer spaces benefitting from escalating bidder interest. It is also the case that firms ripe for digital enhancement, across a range of sectors, are sought after by firms well equipped to steer otherwise robust firms on that value-accretive journey.

Listed Polish investor MCI has been busy with exits. The firm sold RemoteMyApp to Intel Corporation in November[19], and telemedicine business SiDLY in July to another strategic buyer[20]. The exits came shortly after MCI's sale of Baltic ecommerce business Pigu to MidEuropa completed, generating €37 million of proceeds for MCI TechVentures, which had backed the business in 2015[21] and which has rolled up into the new entity. MCI is currently preparing corporate taxi business Gett, which has global VC and corporate investors, for a NASDAQ flotation[22]. The backer initially invested in the firm in 2015, supporting it to grow internationally through acquisitions and by attracting other investors including Volkswagen. Gett is a global business with Central European presence, headquartered in Israel, and marks MCI's first unicorn.

For this period, I expect to:



Investors' activities (June 2021 vs December 2021)



- Buy more
- Buy and sell equally
- Sell more

Competition for new investments

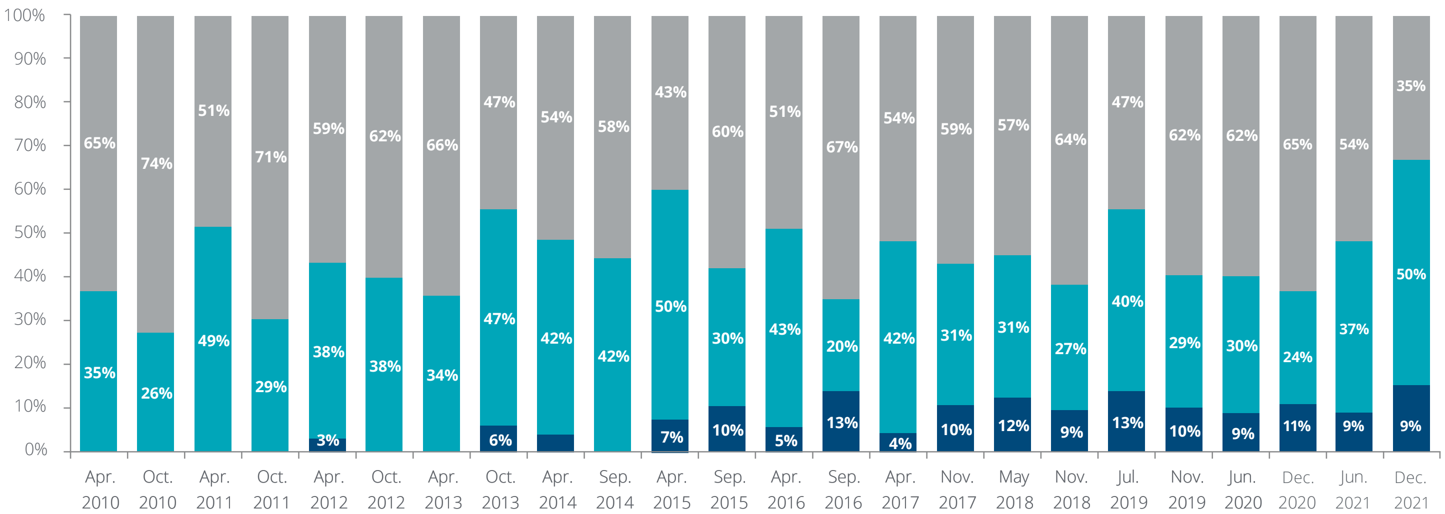
The popularity of market leaders is waning in favor of middle-size growing companies and start-ups: for the first time in over two years and only the fourth time in the Survey's history, market leaders will not be the most sought-after assets in the region. A notable drop from over half (54%) to a third (35%) expect these businesses to be the most in-demand over the coming months, with middle-size growing companies growing in popularity to 50% – only the second time in 17 years to have captured such a large share of votes.

Equally surprising is the expectation of start-ups to be most in demand by 15% of respondents, the highest level recorded in our Survey's history.

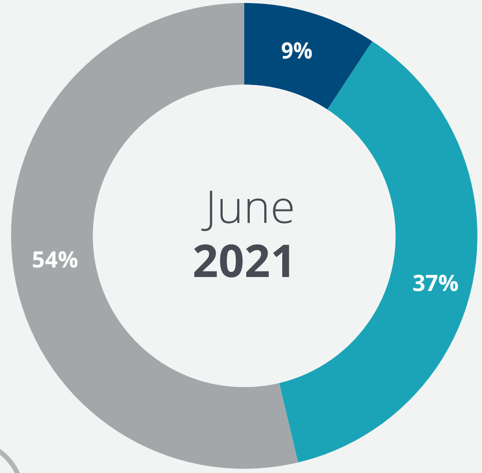
The marked shift away from erstwhile perennially popular market leaders may signify that experienced deal-doers are shying away from the premium typically placed on 'safe' assets with strong brand and market position and prefer instead to seek off-market proprietary angles with management teams they can work with to create leaders.

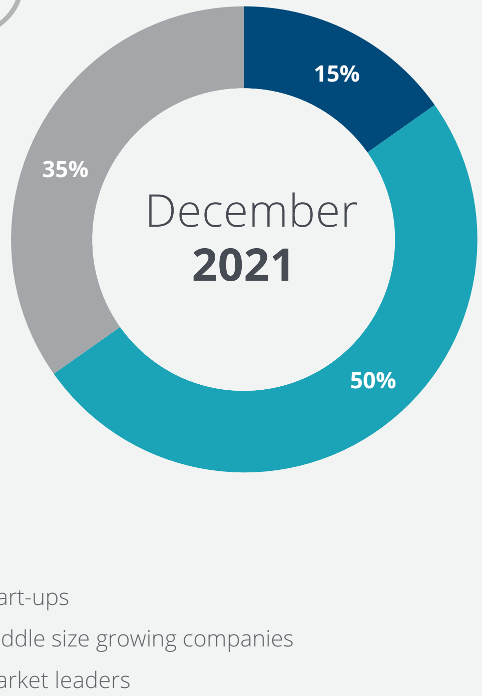
While the landscape for such assets was typically dominated by VCs, we've seen firms more traditionally associated with buyouts enter the space in the last 18 months. For example at the end of 2020 MidEuropa invested into Displate, an online metal prints marketplace that had been backed by Credo and Miton. Displate has stated its clear intentions to become a unicorn[23], an ambition usually associated with start-ups rather than more established companies.

For this period, I expect the highest competition for new investment opportunities in:



Competition for new investments (June 2021 vs December 2021)



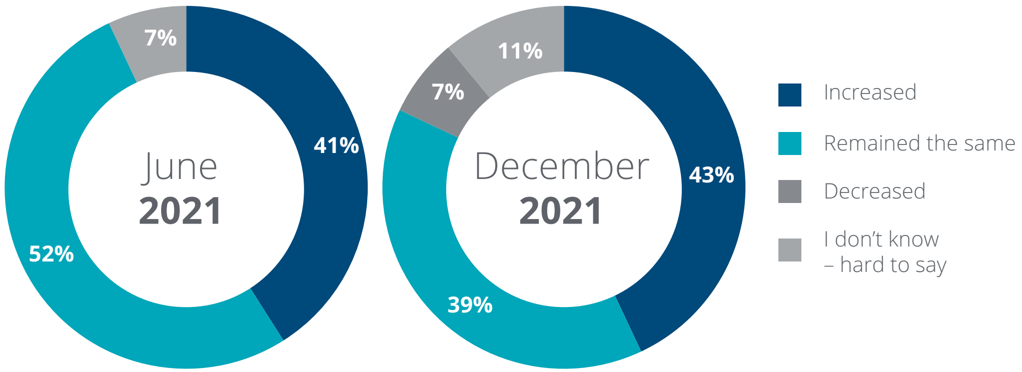


Vendor pricing

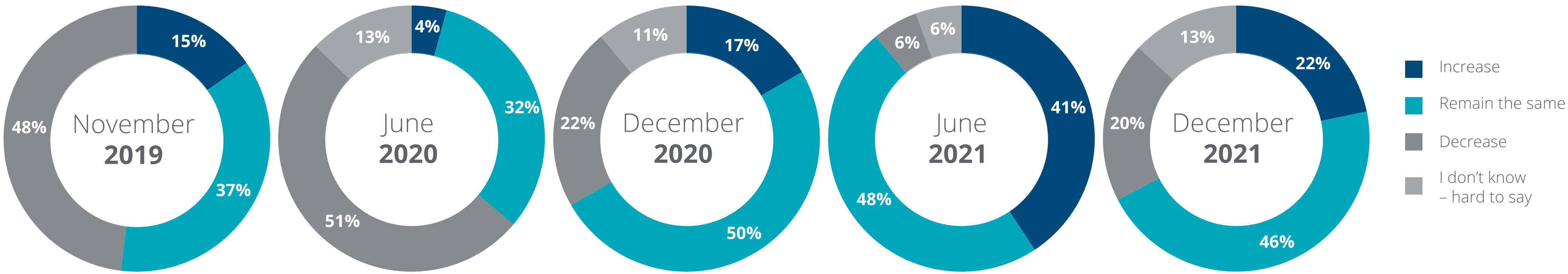
Vendors' price expectations may be stabilizing, with the high pricing environment of 2021 appearing set to cool off according to our respondents' sentiment. While 43% feel pricing had increased in the second half of 2021, a similar percentage (46%) expect prices to remain the same over the first half of 2022. Additionally, just a fifth (22%) expect prices to rise in 2022, down from 41% expecting continued rises in our previous Survey. Another fifth (20%) expect prices to fall in the first half of 2022, up markedly from only 6% expecting this in our summer Survey.

Pricing has been a big driver of deals in 2021: a wall of capital chasing high-quality deals meant entry multiples were very high for the most in-demand assets, and this encouraged owners to put assets up for sale. For example, the average multiple paid in PE-backed deals in all of Europe jumped to 12.4x in Q3, versus 11.8x in Q2[24], and Central Europe broke into double-digit average entry multiples for Q3[25].

Relative to 6 months ago, vendor pricing expectations have:



Over the next 12 months, we expect vendor pricing expectations to:



Covid Sentiment

Covid Sentiment

With nearly two years elapsed since Covid became a household name, we again asked the CE PE community about its thoughts on the pandemic's impact on the industry. It seems strategies are roughly unchanged, though some are undertaking deeper diligence and looking more to buy-and-build as a way to drive value in portfolios.

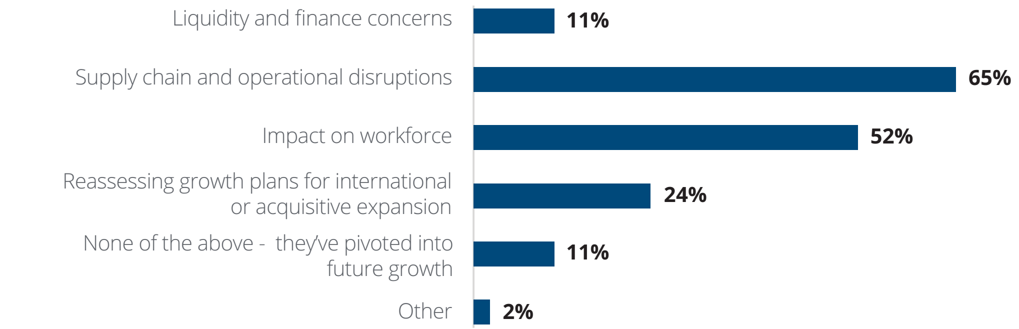
The impact of the pandemic remains varied across portfolios, with a mixture of challenges and opportunities. Disruption to supply chains and operations has been the most heavily impacted by our respondents over H2 2021, with nearly two-thirds (65%) citing this, up from less than half (46%) in our previous Survey. The impact on workforces is another heavily felt impact, with over half (52%) citing this effect. Nearly a quarter (24%) are reassessing growth for international or acquisitive expansion, likely a reflection of new opportunities which have arisen as the ongoing pandemic impacts businesses in different ways.

The last two years have encouraged some GPs to apply a keener focus on quality of earnings and buy-and-build strategies – but it's business as usual for a large portion, too. Just over two-fifths of respondents (41%) are placing more of an emphasis on quality of earnings to ensure a defensive position on transactions now in light of the last two years. While this suggests a more careful approach, a similar proportion (39%) admit to no change in how they approach transactions. Nearly a third (30%) are looking more to create value through buy-and-build strategies – and the deals data from H2 2021 backs this up. Nearly a fifth (20%) claim to be conducting enhanced diligence on targets prior to transacting – a number which is likely to have been far higher had we asked this question a year ago.

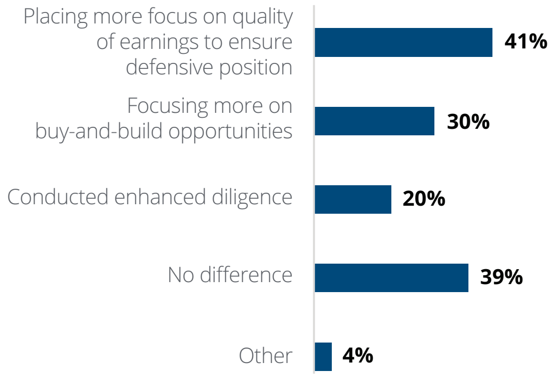
The shift to remote working has done little to impact talent management for private equity-backed companies. Over two-fifths of respondents (44%) claim they remain adept at attracting and retaining the best candidates for their roles, while over a quarter (28%) still find this task challenging. Nearly a third (30%) feel the shift to a hybrid workforce has made acquiring talent more competitive and it's forcing them to enhance packages. Just 2% find the current backdrop more conducive to bringing on board the best candidates.

CE deal-doers remain stoic as regards their strategies in spite of the pandemic. Backing up summer sentiment, two-thirds (67%) have maintained their investment thesis, roughly flat on last Survey's 70%. 15% are considering different growth strategies, likely as new opportunities arise in an evolving backdrop, and just 13% are looking at more or different sectors – down from a fifth in our summer Survey.

What impact is there on your current portfolio from the pandemic over the last 18 months?

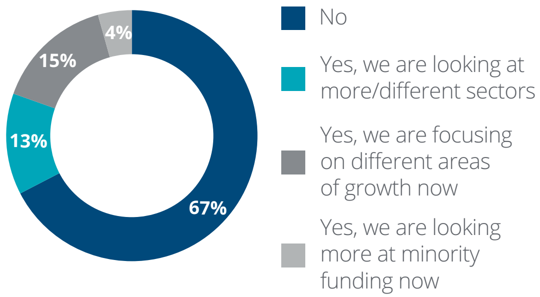


How are you approaching transacting now compared to pre-pandemic?

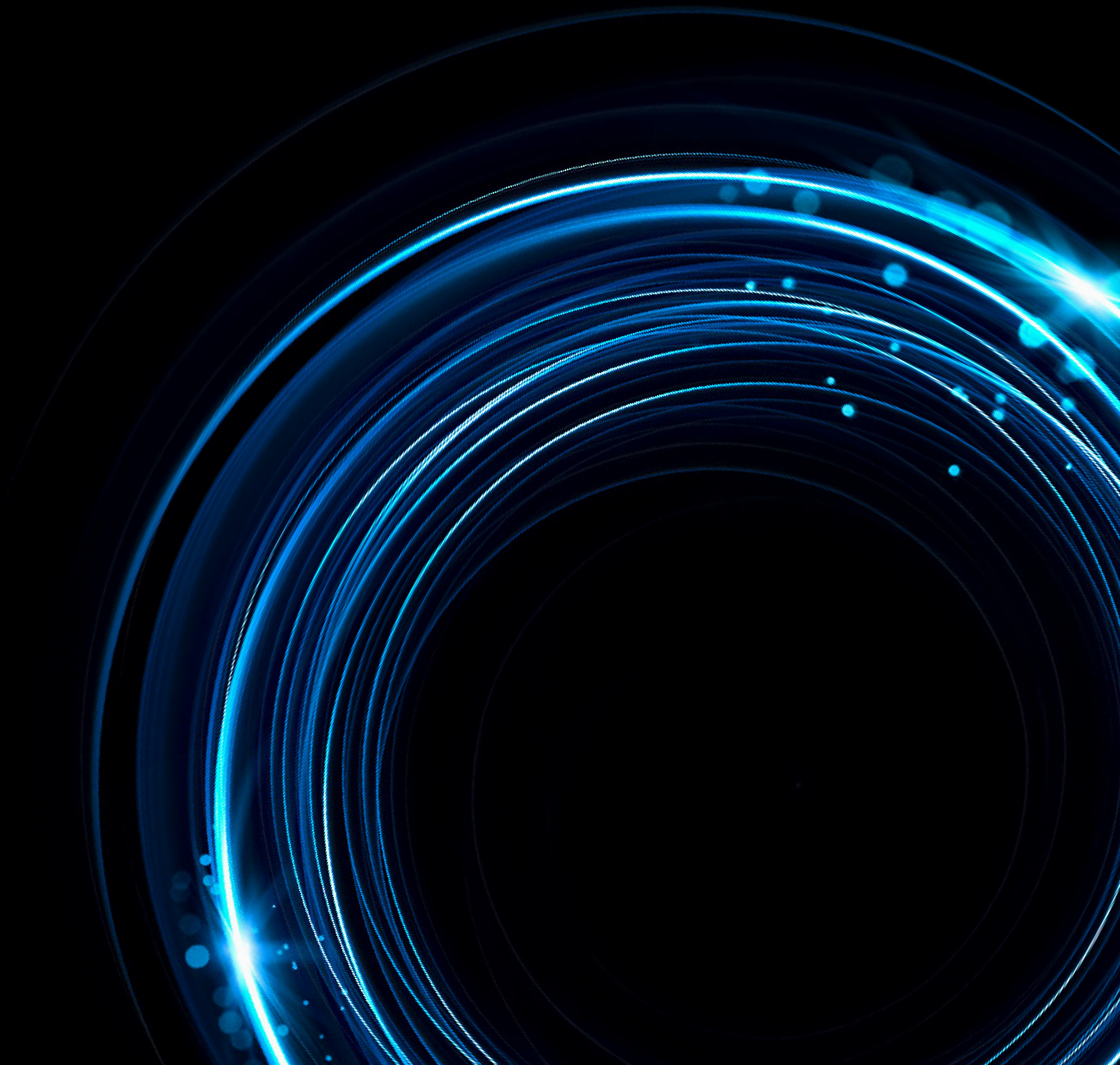


Has remote working changed your approach to talent within your portfolio?

Has the pandemic altered your investment thesis?



Sustainability and Technology



Sustainability & ESG agenda

Environmental, social and governance (ESG) factors have been a hot topic for years, as public concern over climate change arises around the world. More private equity firms are embracing ESG criteria, both when running their own operations and when making and monitoring investments. Our results confirm that private equity looking to divest businesses through IPOs or sales to other financial or strategic buyers must consider these issues to boost their valuations. In this way, private equity has a big role to play, particularly around decarbonization.

Our latest survey confirms this: 59% of respondents have either implemented formal investment policies (39%) or even applied specific measures (20%).

What is striking is the visible decline in percentage of funds saying that they have not implemented a formal policy yet but are moving in this direction – a decline from 28% in our summer 2021 report to 13% now. This may indicate that more funds are progressing from planning specific solutions to actually implementing them.

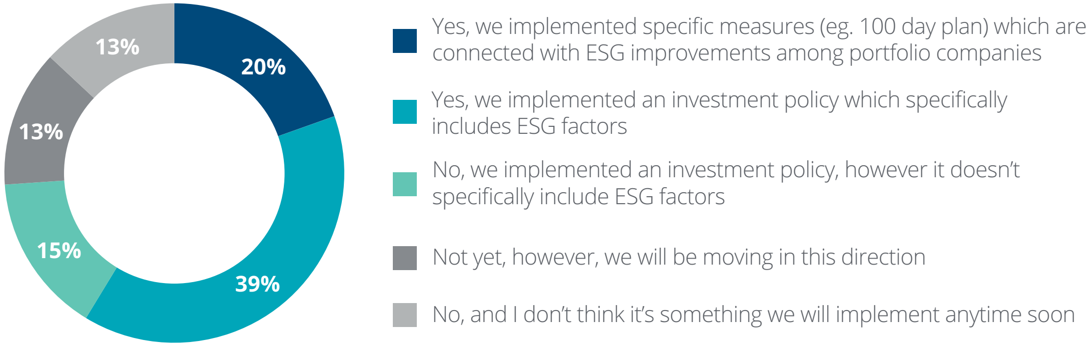
Commitments toward climate change neutrality are an important part of the ESG approach, and our latest survey shows that 40% of respondents either implemented a formal decarbonization commitment (9%) or started to develop future commitments and targets (30%).

While the level of those who have already implemented such policies is steady (11% in the last Survey versus 9% now), we see a big increase in the proportion who are developing their future commitments and targets –from 9% up to over 30%. Simultaneously, we see a reduction in those who aren't yet implementing from nearly half (48% last time) to just a third now (33%).

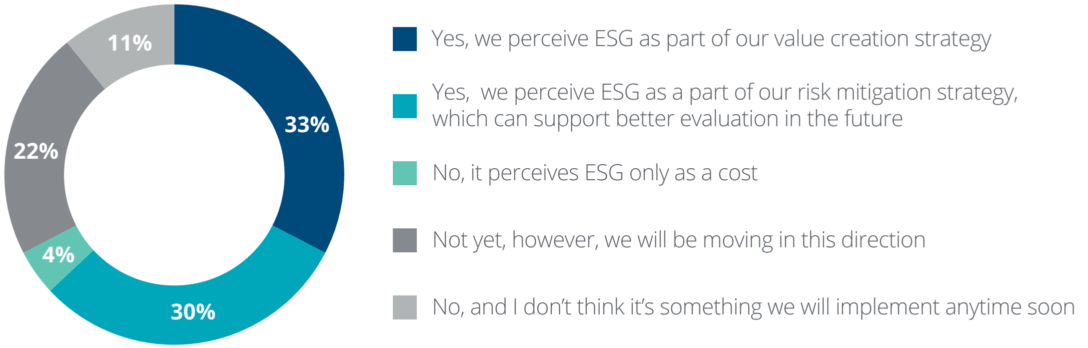
This Survey also asked respondents if they integrate ESG as a part of their value creation strategy. The vast majority (85%) see ESG factors as a chance to build value and mitigate risks. Only (4%) deem it a pure cost and 11% are not interested in moving into ESG strategies (11%).

A third perceives ESG as part of their value creation strategy, while a similar percentage of respondents (30%) deem it part of their risk mitigation strategy. Over a fifth (22%) plan to move in this direction in the future.

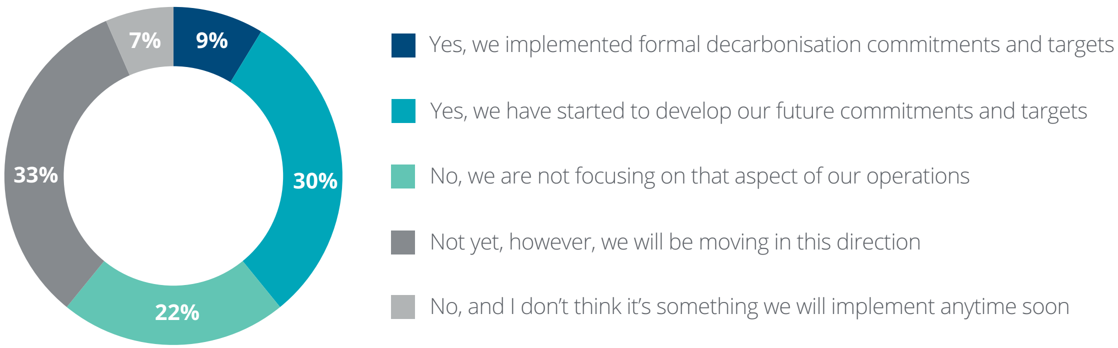
Has your fund implemented a formal investment policy which incorporates ESG (E-environmental, S-social, G-governance) and sustainability factors as part of investment decision considerations?



Does your fund integrate ESG as a part of value creation factors?



Has your fund made any commitments towards climate neutrality?



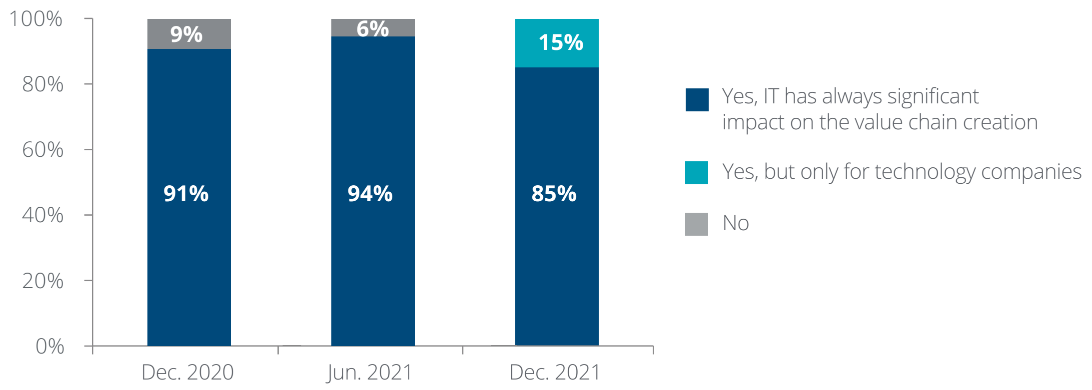
Technology

As 2022 gets underway, the world remains affected by the COVID-19 pandemic, with various disruptions to societies and business organizations still felt across the globe. Over the past two years, businesses have been forced to accelerate their transformation to digital to maintain operations in the changing business paradigm. Restrictive lockdowns catapulted digital channels to the fore as – often the only – touchpoints between business and customers.

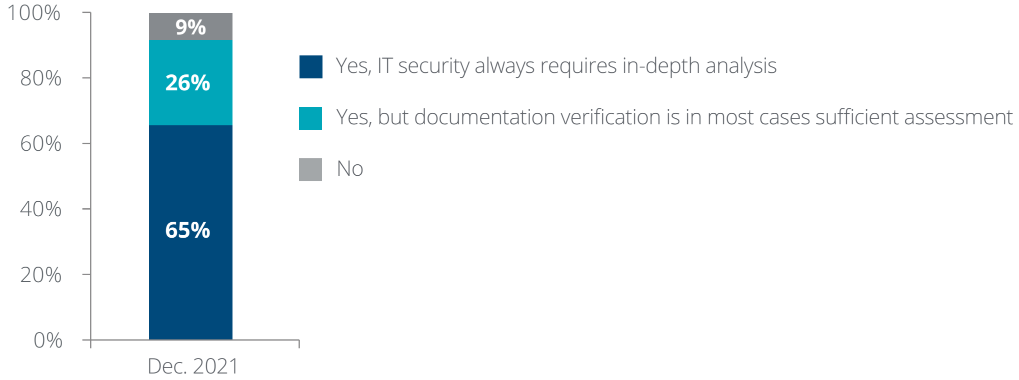
It is therefore unsurprising that private equity funds are strengthening their belief in the importance of digital capabilities on businesses. As the survey shows, all respondents are confident that technology can be used as a value creation lever, and just 15% feel IT impacts significantly only technology companies.

Regardless of the potential IT role in the value chain, technology infusion deepens every day. The growing impact of "digital" on all kinds of businesses significantly increases the risks related to cyber threats. This problem is also noticed by the PEs. They believe that IT security aspects are important to ensure companies' business continuity. 91% of respondents are convinced that the area of cyber-security should always be investigated before an M&A transaction and over half of them give IT security priority, requiring in-depth analysis prior to closing.

Do you believe that IT capabilities of a portfolio company can be used as a value creation lever?



Do you consider IT security as an important aspect of company's operations necessary for verification?



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“The Index’s drop is unsurprising as it was at a very high level. Experienced deal doers in the region may be pausing as pricing became unsustainable for certain assets, and are pivoting towards more cautious and value-adding approaches in the transactions they pursue now. They are also awaiting more clarity on inflation and rising interest rates.”

Dusan Sevc, Deloitte Partner and Private Equity Leader

Deloitte.