Private Equity in Poland: The Foundational Blocks of Industry Development

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Introduction

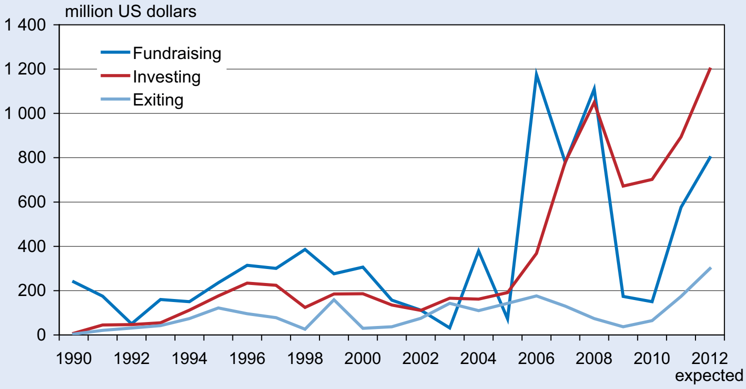
For two decades now, Poland has been undergoing an in-depth economic 'overhaul', changing from a socialist to a market economy. The major macroeconomic goals accomplished since then have included the stoppage of 'galloping' inflation and its systematic reduction, a decrease in interest rates, the stabilization and convertibility of local currencies, and the privatization of state-owned enterprises. Product and service prices were liberalized and allowed to find equilibrium with the market. The achievement of these ambitious macro-economic objectives, as well as the creation of legal and administrative foundations to encourage competition and free-market economy behaviour, has led to strong private-sector growth.

In the microeconomic scale, private firms in Poland have undergone transformation in two critical areas: competitiveness and external financing. Many firms that previously enjoyed monopolist positions within their respective industries began to compete with private, newly created local firms and Western multinationals. In response to this increased competition, many firms in Poland started to better match their products to consumer expectations (both in terms of quality and price), to introduce modern internal management systems (mainly in the areas of finance, marketing and logistics), and to focus on improving human resources. Competition, however, has also produced undesirable results, with many firms either permanently losing their market positions or forced to wind-up their operations.

The development of a strong private equity industry in Poland is no coincidence. Economic stabilization, strong business growth, and a favorable business outlook have provided a strong foundation for an active and developing private equity industry in Poland. There are about 40 private equity firms currently investing in Poland. Around 19 private equity firms are dedicated to the Central and East European (CEE) region, six firms seek to invest in Poland as a part of their global mandate, and 11 firms are only targeting Poland. To date, cumulative statistics from the European Private Equity and Venture Capital Association (EVCA) and other sources indicate that the total amount of venture capital fundraising in Poland is equal to 8.1 billion US dollars (investing equals 7.8 billion US dollars, exiting equals 2.2 billion US dollars – see Figure 1 for the key industry statistics related to fundraising, investing, and exiting).

Figure 1

Development of the private equity industry in Poland between 1990 and 2012



Source: Klonowski (2011).

Venture capital can be most simply defined as risk-equity investing. It is a combination of capital and provided by institutional investors to private firms aimed at accelerating their development and exploiting available market opportunities. In practice, venture capital includes a

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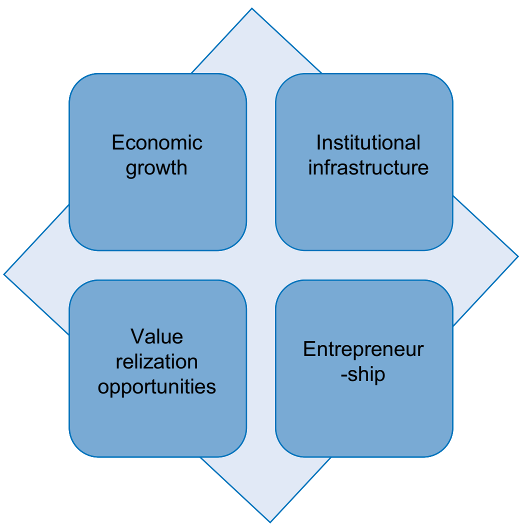
variety of different types of financing: the provision of start-up finance; specialist portfolio investment in small unquoted companies; the provision of second and subsequent rounds of development capital for later stages of business expansion; and the financing of management buy-outs or buy-ins. It is a 'business of building businesses'.

This article focuses on the development of private equity in Poland and, specifically, on its four key developmental underpinnings (economic development, institutional infrastructure, entrepreneurship and exit market development). The topic of private equity in Poland is important for many reasons. Firstly, Poland represents the most developed private equity industry in Central and Eastern Europe as shown by fundraising, investing, and exiting statistics. It also has one of the most developed private equity industries across all emerging market countries. Secondly, research confirms that private equity firms have performed well in Poland in terms of returns. In the last ten years, the average rate of return for private equity deals has been equal to 15.6 percent. The twenty year rate of return is equal to 8.6 percent – a respectable average given that the figure reflects initial developmental challenges, the closure of some underperforming funds, and a significant amount of write-offs. Private equity returns in Poland are also favorable in comparison to other regional averages across CEE (13.9 percent), Asia (7.8 percent) and Latin America (1.9 percent). Thirdly, the private equity industry has been a source of know-how and inspiration to young Polish entrepreneurial firms. The participation of private equity in entrepreneurial firms has often resulted in increased operational efficiency, improved human resources, a more robust strategic management planning process, and enhanced profitability. Lastly, the strong development of the Polish private equity industry may serve as a blueprint for other private equity industries in the CEE region (i.e. Bulgaria, Romania or Croatia) or other emerging market countries that share a development pattern similar to that of Poland. Several initial developmental problems can be avoided through an understanding of the dynamics seen in the private equity industry in Poland.

The four pillars of private equity development in Poland

There are four pillars of private equity development that have played an important role in developing the private equity industry in Poland (see Figure 2 for the diagram construct): economic transformation, systemic infrastructure improvement, entrepreneurial sector development, and exit market development. These components are interconnected; they co-operate with each other in a symbiotic manner by providing synergistic effects that have collectively amplified the growth of the private equity industry in Poland. As an example, strong economic development, growing market demand for products and services, and the stability of macroeconomic indicators encourages entrepreneurship. Strong economic growth also encourages local policy makers to continue to develop suitable and 'user-friendly' institutional infrastructure (i.e. laws, accounting regulations, and corporate governance standards), provide further business development incentives (i.e. reducing taxes), and eliminate unnecessary bureaucratic problems. Strong economic development also invites the entry of foreign capital, either indirectly through public markets or directly by way of mergers and acquisitions. Improvements to institutional infrastructure fuel entrepreneurial and economic growth as the private sector is guided by transparent and consistently applied laws, rules, and regulations. Strong legal, accounting, and fiscal infrastructure also attracts foreign direct investors who – in addition to the strong macroeconomic statistics – appreciate institutional stability and democratic rule. Moreover, a flourishing entrepreneurial sector translates into a thriving economy. The transition of small firms to larger firms and middle-sized firms to large enterprises ensures a steady influx of firms into public markets. Entrepreneurial firms flourish in an environment of friendly institutional infrastructure; it is a

Figure 2
Four pillars of private equity development in Poland



relatively straightforward process to set up a business, bureaucratic requirements are limited, disputes and settled quickly and fairly, and unsuccessful businesses are wound up effectively. Lastly, the sound development of capital markets acts as a conduit for economic growth, a platform of value exchange for local and international investors, and provides firms with access to capital.

It is important to note that the four pillars, especially those related to institutional development and local entrepreneurship, have shifted away from their initial states and are continuously improving. Nevertheless, some areas have continued to present minor or modest challenges to the local private equity community.

Economic transformation of Poland

In 1989, the Polish government opted to pursue an austerity reform program drafted on the basis of neoclassical economics that stressed three components: macroeconomic stabilization, liberalization and privatization. Unfortunately, the implementation of these reforms resulted in a recession – Poland's GDP fell by 11.6 percent in 1990 and 7.6 percent in 1991; industrial output fell by 24.2 percent and 11.9 percent; real wages fell by 32.1 percent and 1.9 percent; and unemployment increased to 6.3 percent and 11.6 percent. By the middle of 1992, however, the effects of the austerity program were becoming visible – GDP grew from 2.6 percent in 1992 to 7.2 percent in 1997, inflation was reduced, and unemployment figures lowered. The period between 1998 and 2002 was one of economic slowdown as the authorities implemented stricter monetary measures to cool off the fast-growing economy; this resulted in a GDP decline from 5.0 percent in 1998 to 1.4 percent in 2002 (unemployment rose to 19.2 percent by the end of the same period). Conversely, the years between 2003 and 2007 marked a return to positive GDP growth, declining unemployment and further public finance reforms. The period of 2006–2010 was one of slower economic growth. To surmise, Poland has achieved the highest average GDP growth per annum among the emerging markets of Central and Eastern Europe, with an average growth of above 3 percent. In 2009, Poland experienced 1.8 percent growth in GDP, the highest and only positive GDP growth among European nations. These facts have led Poland to be nicknamed the 'green island of Europe'. Strong economic growth continued after 2009 too (and at a higher rate than the European Union average).

The economic reforms undertaken in Poland have helped to shape the private equity industry in at least three ways. Firstly, without economic reform, there would not have been as rapid a deployment of capital from the private equity community. Capital flows to countries with stable macroeconomic indicators and political structures, solid institutional infrastructure, liberalized institutions, and modern capital markets; Poland has been able to meet these criteria. Secondly, the privatization program has helped to provide a steady stream of investable projects for private equity firms and propelled other firms further towards development (many of these privatized firms have subsequently become viable investment opportunities). Moreover, the privatization program has proven to be a strong training ground for new investment managers, who – building on their consulting and restructuring experience – have either commenced activities in the private equity sector or become indirectly involved as financial intermediaries. Thirdly and most importantly, the Polish economy and the private equity industry have developed a positive and reciprocal relationship. Private sector firms have been able to obtain access to finance and know-how, and the private equity industry has been exposed to a wide canvas of investment opportunities.

Improvements to systemic infrastructure

Systemic competitiveness broadly relates to the manner by which local governments provide appropriate institutional and administrative support to the private sector. In the case of private equity in Poland, the major determinants of development relate to legal infrastructure (i.e. property rights and ownership laws, various corporate laws, judicial and court systems), accounting regulations (i.e. convergence toward international accounting regulations, overcoming the tax-oriented reporting traditions of the accounting profession, assuring compliance with accounting legislation), and taxation (i.e. fiscal policies, tax collection policies, tax rates and so on).

Issues related to the establishment, dissolution, and activities of firms are regulated by the Commercial Companies Code, which has been regularly amended over the last two decades. The amendments have broadly aimed to limit the role of the government in regulating economic activities. The most significant changes to the Code have included the introduction of new types of legal entities (i.e. professional partnerships, limited joint stock partnerships, and limited partnerships), the concept of authorized but unissued share capital in a joint stock company, and the extension of provisions related to transformations and mergers. The Code also introduced changes to the minimum amounts of share capital available to limited liability companies and joint stock companies. A significant number of the changes made to the Code were editorial and served to eliminate any confusion related to the interpretation of the practical applications of the new concepts.

Polish regulators have also taken multiple steps to reduce the gap between Polish accounting regulations (PAR) and international accounting standards (IAS). Embracing the idea that higher accounting standards translate into a higher quality of earnings for local firms, the regulators' main goal was to harmonize Polish accounting regulations with those of the EU. It is estimated that about 50 percent of Polish accounting standards are compatible with IAS. No Polish regulations seem to exist for at least 30 percent of international accounting standards on accounting and auditing. An additional 20 percent of international standards are comparable to the Polish regulations in text, but different in practice (resulting in inconsistencies between PAR and IAS).

The Polish tax system has evolved over the last two decades. There have been three general trends. The first trend relates to the reduction of the corporate taxation burden, which encouraged entrepreneurship, new business formation, and scientific research. Corporate income tax in Poland is equal to 19 percent, a figure that establishes Poland as one of the most competitive tax zones in Europe (Britain – 30 percent; Germany – 25 percent; the Czech Republic – 24 percent; Russia – 24 percent) and other emerging markets (Brazil – 34 percent; Argentina – 35 percent; China – 33 percent; India – 30 percent). The second trend relates to the harmonization of local tax laws with the various provisions of the EU. Key elements here include adjustments to VAT regulations, excise taxes, and other direct or indirect charges, and the elimination (i.e. turnover tax) or changing (i.e. VAT regulations, excise taxes) of certain methods and procedures of taxation. The third trend relates to the establishment of special economic zones to provide special corporate incentives (i.e. tax exemptions) to investors willing to establish operations in the geographic regions of Poland characterized by high structural unemployment. Though the tax exemptions depended on the level of investment expenditure, the number of new employees hired, and the length of the employment commitment, the corporate tax could be reduced by 50 percent of the value of the investment.

While significant improvements have been made to institutional infrastructure, there are still some challenges. For example, in the area of legal infrastructure, key challenges relate to enforceability, legal costs, deal structuring, and jurisdictional decision-making. The key concerns in the accounting sphere relate to financial reporting and disclosure, internal procedures used for drawing up financial statements, and taxation disputes (i.e. frequent changes to the tax code as well as random and inconsistent interpretations of Polish tax laws).

Development of the entrepreneurial sector

Small and medium-sized enterprises (SMEs) play a key role in shaping national economies throughout the world. Poland is no exception. There are 1.72 million active firms in Poland. The SME sector accounts for 99.8 percent of all firms in Poland. Total employment in the SME sector is equal to 5.9 million employees, or 70.1 percent of all employed workers, with micro and medium firms as the largest employers (micro – 3.5 million people; medium – 1.4 million people). About 35 percent of all employment comes from the retail sector. The Polish SME sector makes a significant contribution to national GDP (equal to 47.7 percent) and accounts for over 60 percent of the total revenue generated by all firms. The total investment commitment of the SME sector is equal to 17.8 billion US dollars per annum. Firms from the SME sector also enjoy a relatively high rate of survival (60 percent) in their first year of operation, with the four-year rate of survival estimated to be about 30 percent. New firm creation has been increasing steadily at an average rate of 250,000 firms per annum, with the newly created firms generally focusing on wholesale and retail activities.

Entrepreneurship in Poland has evolved in three stages. Local entrepreneurs emerged immediately in the aftermath of economic transformation in Poland. Many of the early 'apparatchiks-turned-entrepreneurs' came from state enterprises, and their political connections proved critical to obtaining favorable access to real estate, external financing, business contracts, a supplier base, etc. This class of entrepreneur is often described as lacking managerial skills and having poor ethical considerations and corporate governance orientation. On the other hand, these entrepreneurs operated in the most difficult business conditions, characterized by a highly fragmented market, cluttered distribution structures, an uncertain taxation and legal infrastructure, the existence of small and inefficient distributors, and problems of access to high quality raw materials. Only a small number of true entrepreneurs were operating in their local regions prior to the 1990s (i.e. limited 'national-wide' entrepreneurs), and the scale of their operations was restricted by the communist regime to a small geographic market and a limited product or service range. Many Polish entrepreneurs set up their operations in the early 1990s having had no prior business experience; these entrepreneurs typically possessed a post-secondary education and varied professional backgrounds. The majority of them began their careers in state-owned enterprises, where they achieved managerial posts before commencing their entrepreneurial activities. The state firms proved to be a good training ground, and the entrepreneurs were able to develop business skills and extend professional contacts. The average entrepreneur of this era was between 35 and 45 years old, communicated well in foreign languages, and was generally optimistic about his business prospects.

The early 2000s marked the development of a new class of entrepreneur: young (between 25 and 35 years old), Western-educated (by local educational programs operated in co-operation with Western universities), and new technology-oriented. Many of the entrepreneurs in this class have spent time abroad studying or working for major international corporations. This era also saw two other trends: a robust growth in female entrepreneurship, and the emergence of serial entrepreneurs and business angels. In the Polish entrepreneurial landscape, female entrepreneurs, generally characterized as 'late bloomers' (i.e. average age between 40–45 years, two children, strong educational background obtained later in their career), represent a large and rapidly growing segment of the Polish private sector. Females now account for about 37 percent of private sector employers (an increase from 3.5 percent in the early 1990s). Serial entrepreneurs and business angels have also been active in the Polish market (since the early 2000s). This group organizes their activities within formal networks and informal associations. It is estimated that they review between 500 and 700 business plans per annum and invest about 155 million US dollars in business ventures.

Limited access to finance has motivated the Polish government to embrace the idea of public assistance to the SME sector in an attempt to close the 'liquidity gap' inherent to the sector. Public intervention has been driven by multiple factors. Firstly, there is pressure on emerging economies like Poland to sustain their level of economic development in order to catch up to their regional competitors. Secondly, in recognizing the importance of the SME sector and its role in stimulating economic development in the West, the SME sector in Poland continues to receive disproportionate attention from government agencies and institutions. Government assistance programs focus on addressing a wide spectrum of issues related to entrepreneurs, including human resource and advisory functions, the provision of finance, encouraging the participation of women in business, and developing exports.

Exit market development

For private equity firms, the most critical part of the private equity investment process is the exit, or the point at which illiquid investments are monetized. The exit serves as a final confirmation for private equity firms that their selection and analysis of investee firms, their negotiations of legal terms and protections, and their collaborations with respect to strategic expansion and operational execution have been performed correctly. Most private equity firms seek to pursue one of the two most desired exit modes: exit through public listing, or exit through a trade sale to a strategic investor.

The experience of private equity firms in Poland with respect to exit opportunities has been vastly positive. Evidence suggests that, on average, a public listing of shares is a more profitable exit route for private equity firms than a sale to a strategic investor (a 3.5 cash-on-cash multiple for public listings versus a 2.5 cash-on-cash multiple for trade sales). Such outcomes are rooted in at least two observations, both of which point to the general unwillingness of strategic investors to overpay for acquired businesses. Firstly, public markets in Poland have experienced extraordinary returns (16.9 percent per annum) over the last two decades, with returns particularly pronounced between 2003 and 2006. Strong increases across all market indexes reflect a combination of P/E multiple expansion, improved operating results for listed firms, and strong demand for new listings from institutional investors (i.e. pension funds, mutual funds, and so on). Private equity firms have benefited by selling their shares to the public at high valuations. Strategic investors, on the other hand, have resisted buying firms at inflated valuations. Generally, strategic investors have been unwilling to pay for firms on the basis of economic cycles or market anomalies. Cyclical and sharp upward movements in public market indexes have tended to exaggerate and distort business valuations and have 'crowded-out' strategic investors from the M&A market.

A strong local public exchange has benefited the local private equity community. Private equity firms investing in Poland have achieved 46 exits through public listing on the Warsaw Stock Exchange (WSE), and private equity-backed firms represent over ten percent of all firms listed on the exchange. Enterprise Investors is the leader among firms on the exchange, with 26 listings.

The local private equity industry has achieved good financial returns from selling its equity stakes to foreign strategic investors or local trade buyers. However, the average cash-on-cash return from a sale to a strategic investor is lower than in the case of public listing. The experience of local private equity firms selling to strategic investors can be summarized in the following manner. Firstly, the best exit results are often generated when strategic investors are involved in competitive bidding for an investee business. Strategic investors are more motivated when they are seeking entry into a new market (as outlined by strategic expansion plans) or when the existing local business is especially difficult to compete against. Secondly, strategic investors seem to pay less for the business if they already have a local presence. Under such circumstances, strategic investors may only be willing to assign value to a specific part of the business (i.e. manufacturing capability, management, consumer list, proprietary supplier access, and so on) or limited value to other areas of operation (i.e. distribution). Lastly, timing is crucial in the sale of any business. Strategic investors prefer to acquire businesses that are profitable, that have an appetite for growth, and that are able to access cheaper external financing (i.e. debt or equity at limited dilution to existing shareholders). Such businesses typically exist in periods of strong economic growth and prosperity; during an economic downturn, strategic investors tend to look inward and focus on either optimizing their costs or restructuring.

Other contributing factors

There are two other forces that have played a role in developing the private equity industry in Poland: financial assistance from major international financial institutions, and Poland's accession to the European Union. The two organizations that have most made an impact on the development of the Polish private equity industry are the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC). The efforts of these two organizations have stimulated the development of the local industry in at least two major ways: they became 'cornerstone' investors for private equity firms, and they instilled corporate governance practices into the industry.

EU accession and membership, conversely, has played a vital role in modernizing the Polish legal and accounting systems. Recognizing the need to harmonize Polish business law with EU legislation and international accounting standards, the Polish government introduced significant amendments to local business laws, banking regulations, public equities markets, and so on. Poland has also benefited from a broad European push to implement the general rules of corporate governance.

Conclusions

The private equity industry in Poland experienced its initial 'teething' problems in its early days and is now continuing to develop along a steady growth trajectory. There have been many success stories and, surprisingly, relatively few problems across a diverse range of firms in the private equity firms' portfolios. Private equity firms remain optimistic that the favorable economic conditions in Poland, improvements to the country's legal, accounting and fiscal infrastructure and balanced exit opportunities will continue to support business in the future.

The main conclusion of this article is that the development of a flourishing private equity segment in Poland has been based on four major pillars (stable economic growth, strong entrepreneurship, improvements to institutional infrastructure, and well-functioning exit markets). These pillars have not developed sequentially, but continue to operate in a symbiotic manner.

References

Klonowski, D. (2011), *Private Equity in Poland: Winning Leadership in Emerging Markets,* New York: Palgrave MacMillan.