2009

MANAGEMENT CONSULTANT INTERACTION WITH PRIVATE EQUITY AND THE IMPACT ON GROWTH DEVELOPMENT PATTERNS IN SOUTH EASTERN EUROPE

Experience-based paper

April 2009

Viktor Manev, *Managing Partner*
viktor.manev@mmconsult.biz

Elena Todorova, *Project Manager*
elena.todorova@mmconsult.biz

Milen Manev, *Financial Analyst*
milen.manev@mmconsult.biz

MM Consult EOOD
65 Shandor Petiofi Str., Apt. 5
Sofia 1463, Bulgaria
Email: office@mmconsult.biz
Phone: (+359 2) 953 36 21
Fax: (+359 2) 952 53 43

Contents

MANAGEMENT CONSULTANT INTERACTION WITH PRIVATE EQUITY AND THE IMPACT ON GROWTH DEVELOPMENT PATTERNS IN SOUTH EASTERN EUROPE

I. Abstract

The dynamic expansion of entities from developed countries to emerging and fast growing markets increases the challenges faced by foreign investors. Investment in these markets carries threats such as: currency, operational, regulatory, language, and cultural risks. This requires extensive analysis of legal, financial and ownership considerations, facilitated by the management consultant.

These difficulties overwhelm the industry analysis, as well as analysis of business strategies and determining the intrinsic values of the companies. This requires the narrow collaboration between the companies' management, seeking capital or strategic foreign partner, and management consultants, who are familiar with the local business environment.

On the other hand, there is an increasing need for financial advisors and professionals to more aggressively assist clients in their needs. Consultants' role is no longer limited to passive analysis of the client's financial performance and position, but active deal facilitation and professional advice of the shareowners. Clients need a deeper expertise and involvement of the management consultants in the business planning process, strategy development, financial planning and analysis. In this process, the establishment of long-term commitment between companies and their management consultants are of a major importance for their future development and implementation of better corporate governance practices.

Nowadays, in times of crisis and uncertainty, management consultants and private equity funds play vital role in bringing value to the companies in South East Europe. The growth of the economy will be driven by execution, backed with management and industry knowledge transfers. This will require closer interaction between

management consultants and PE funds though the entire post-closing stage of a transaction.

This paper is an experience-based description from the last 10 years of an investment boutique that operates in South-Eastern Europe. The paper studies recent changes in private equity business mode of operation in transitional economies and the role of management consultants in the post-closing phase of deals. The paper specifically studies the need for growth-development of investee companies within the context of the current global financial crises and the role of consulting and advisory support in this process. Another aspect which emerged in our research is the need for business-model re-building in the post-closing stage of a transaction.

The paper will review and survey the experience of the private equity participants in the region and looks at the best practices that involved collaborative work of the consulting and advisory organizations and the private equity.

II. Methodology

The paper is developed based on the experience MM Consult has drawn during its ten years of operations in the area of corporate finance and management consulting. We base our assumptions on our practice and build our hypothesis about the changing nature of the market and the future development we see in it.

In section IV. we make a description of the up-to-the-moment scenario of the interaction of the management consultants with the private equity (PE) funds. In section V. we describe the changing nature of the business environment in South Eastern Europe (SEE) vis-à-vis the current financial crises. In section VI. we summarize results from the interviews with management consultant and PE professionals, with whom we have tested our hypothesis. We also present our respondents' point of view on the current development and the changes they see.

As a base for our predictions in change of business models we used statistics, data and analysis from major bank and companies with expertise in the field.

Our projections are developed mainly by proprietary MM Consult's analysis, experience and industry expertise, and strongly supported by the projections of our colleagues.

This experience-based paper is built on the knowledge and background of industry experts and professionals.

III. Main hypothesis

Nowadays, in times of crisis and uncertainty, management consultants and private equity professionals play vital role in preserving and increasing value in the companies in South East Europe. The growth of the economy will be driven by execution, backed by management and industry knowledge transfers. This will require closer interaction between management consultants and PE funds though the entire post-closing stage of the investment transaction.

IV. Pre-crisis scenario

Private Equity Fund - business model

Private equity funds make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Capital for private equity is raised from retail and institutional investors, and can be used to fund new technologies, expand working capital within an owned company, make acquisitions, or to strengthen a balance sheet.

The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time. Private equity investments often demand long holding periods to allow for a turnaround of a distressed company or a liquidity event such as an IPO or a trade sale to strategic rivals.

Prior to the 2008-9 financial crisis, many private equity firms conduct what are known as leveraged buyouts (LBOs) where large amounts of debt are issued to fund a large purchase. The companies generally use the funds for investments in the company itself and realization of their expansion plans, with the so called expansion capital. Private equity firms then try to improve the financial results and prospects of the company in the hopes of re-sells the company to another firm or cash out via an IPO.

Management consultancy firm - business model

Management consultants help organizations improve their performance, primarily through the analysis of existing business problems and development of plans for improvement. Organizations benefit from management consulting though gaining external advice, access to the consultants' specialized expertise, or extra temporary help during a one-time project.

Management consultants may also provide organizational change management assistance, development of coaching skills, technology implementation, strategy development, or operational improvement services. Management consultants generally bring their own, proprietary methodologies or frameworks to guide the identification of problems, and to serve as the basis for recommendations for more effective or efficient ways of performing business tasks.

Interaction and impact on the growth patterns in South East Europe

PE funds and management consultants have vital role in the overall transaction process. Management consultants have greater impact on the “preparation” of a company for a transaction. They provide professional advice and guidelines on the company performance, plans and future development. They assist their clients with knowledge and specific management expertise in the pre-investment phase (Chart 1).

Entering the next stage of the investment process is Marketing and Negotiation, management consultants have the closest interaction with PE fund. This stage involves a lot of communication and negotiation between management consultants, PE fund and company’s management, in order to finalize the deal, execute due diligence, etc.

The final stage of the investment transaction is the post-closing, where the PE funds manage their investment and implement the business plan. At this stage PE funds add value to companies’ performance through various management tools. For the PE professional it is not the company but the investment in the company that is the instrument for making profit, for achieving the goal. First and foremost the focus is on managing the investment. From this moment on, the PE professional manages the investment and monitors the investee company (Nagtegaal, T., 147)

Chart 1: The transaction process

In South Eastern Europe (Bulgaria and Romania) a lot of entrepreneurs made their start-ups in that period of 1991 – 1992. Since then, except for the period of financial crises in Bulgaria in 1996-7, the markets were growing, consumption was rising and there was a continuous growth in sales across the sectors. This led to overall growth of businesses. Entrepreneurs had the confidence of doing business predominantly through the vision of growth perspective of increasing market share and increased sales. These favorable market conditions did not force both entrepreneurs and PE funds to focus on internal company management, processes optimization, etc.

In the last five years, companies were performing with steady, sometimes double-digit, annual growth without the explicit need for professional services support of management consultants in the period of their post-closing stage of a PE transaction. This was especially true for small- and mid-sized PE deals. Private equity funds were confident with these favorable conditions, extracting additional value through the easily-accessible leverage in their business model, thus created investment opportunities and high exit multiples.

This business model was centered at the grab of the market share, powered by cheep capital and abundant liquidity.

Delays in target achievement did not hamper overall business plan implementation and the value creation model. The projections, made during the planning and preparation stages, namely pre-closing, were often missed (see Practical example, p.10).

The need to focus on strengthening investee companies’ operational performance was not as crucial as the target of gaining higher market share, which was easily backed by rapid deployment of cheep capital.

This is all changing with the key issue at present being the lack of liquidity and managing investee companies’ relations with the lending institutions. Today, managers have more to focus on improvement of working capital management and optimization of internal processes and resources.

Practical example

The aim of this example is to visualize a pre-crises growth-pattern for a PE investment in SEE.

In the pre-financial crises period, the close cooperation between PE funds and management consulting companies generally was during the preparation and planning as well as the Marketing and Negotiation stages out of the overall transaction process. Thus, some of the operational targets set in the pre-investment business plans are missed the post-closing Investment management and monitoring stage.

EBRD private equity investment in Boliari EAD, Varna, Bulgaria

Boliari EAD was a regional supermarket operator in Varna, Bulgaria with total estimated sales of approximately € 21 million in 2003. The company was established in 1994 and it operated three supermarkets under the Piccadilly Supermarkets brand in the city of Varna.

<u>Project description and objectives:</u> In 2003 Boliari decided to expand its Piccadilly brand to a national retailer which required the support of growth capital. The project was supported by EBRD in the summer of 2004. EBRD provided a financing package of up to € 14.5 million, including loan and equity financing which was aimed at helping expand Boliari's operations in the cities of Varna and Bourgas, alongside the Black Sea coast,

- Established in 1994
- Financing package – 14,5 million Euros
- PE partner: EBRD
- PE investment closing: June 2004
- PE deal size – est. Euro 2 mln.
- PE exit: September 2007
- PE money multiple: e 5.5x
- Revenue, pre-investment: Euro 21 mln, 2003
- Revenue, at exit: Euro 110 mln, 2007

and eventually support the transformation of the company expansion into a national chain.

Operational results through the PE investment: the company consistently missed its pre-investment business plan targets for operational margins but strongly outperformed revenues and market share targets, reaching revenues of Euro 110 mln for 2007 at the time of the PE investor exit.

Initially during the investment, throughout 2004-5 there was a delay in the expansion plan execution, due to tactical delays in the strategy implementation.

Sources: EBRD, ISI DealWatch

V. Current market overview – South East Europe

Negative cash flows

In the beginning of 2009 Central and Eastern Europe have the world's biggest negative cash-flow. In the Baltics and South East Europe, current account deficits are running at 10-15% of GDP, while domestic credit has been growing at over +40% annually. This borrowing spree has largely been financed in foreign currencies (not just Euros and Swiss Francs but also Dollars and Yen) – and the creditors are major banks in Scandinavia, Austria, Germany and Italy. The CEE countries are extremely vulnerable to tighter liquidity conditions because they have overvalued real exchange rates and much smaller reserves than Asian emerging markets (Gave, P., 16).

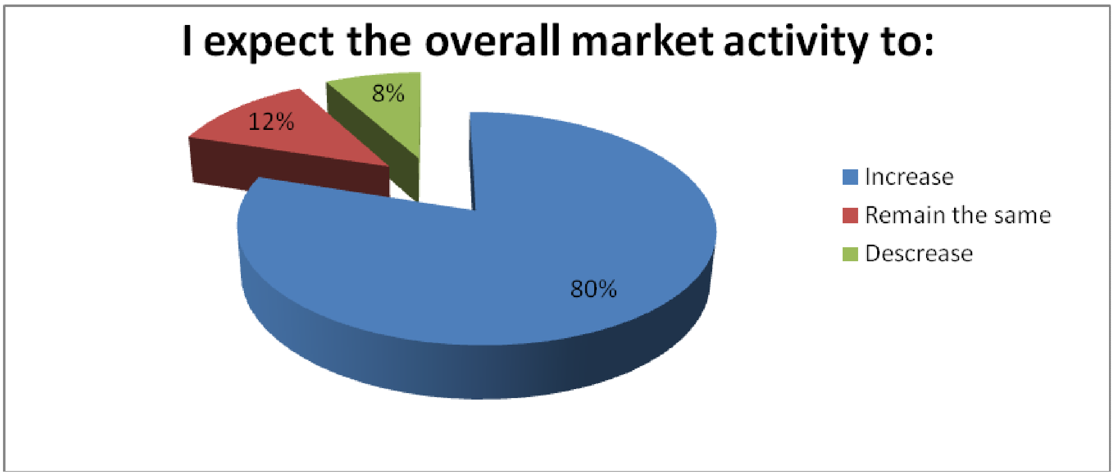
Banking system and Eastern Europe borrowings

The Eastern European binge has been almost exclusively financed by Western European banks. For a banking sector that is already struggling under the weight of exposure to US toxic assets, this is very worrying (Gave, P., 17). The bank headquarters are pulling out the Euros from South East Europe's branches, which additionally limit the liquidity and increase the value of funds. This impacts local branches and they start calling back the installments from companies. Another issue is that price of money rose up and banks do not finance.

The overall expectations are that the economic climate will decline (92%) and only 7% of the PE funds expect it to remain the same (Ibid, 18).

This also leads to decrease in the overall market activity. 80% of PE funds predict decrease in the activity, where 12% expect to have the same level as in 2008, and only 8% of PE funds are positive and expect increase in market activity. These expectations also shape the change in business model of PE funds (Chart 2)

Chart 2: Changes of market activity expectations



Source: "Central European Private Equity Confidence Survey", Deloitte

Financial flows

At the 2007 peak, emerging Europe was the largest recipient of net financial flows to emerging markets with 40% of total flows, equivalent to 13% of GDP. In 2008, net private flows to emerging Europe declined 35% compared to 2007. The forecast for 2009 is a decline of 90%. Banks are responsible for over 50% of flows, accounting for significant part of decline as banks dramatically reduce loan book and repatriate profits to Western Europe as financial flows turn negative in 2009 (Butcher, C., 94).

There is a swing in expectations regarding debt financing and 78% of PE funds expect to experience decrease in availability of debt financing. The rest believe that in 2009 the availability will remain the same. (Byrne, G.)

Global risk aversion has reduced the dealflow for private equity companies and virtually eliminated the large end of the buy-out spectrum as well as shunning non-core markets.

PE funds focus areas

A major piece of the PE value-added investment strategy was the multiple arbitrages. Prior to the financial crisis, PE funds were able to enter a deal at 5-6 times EBITDA and then exit at 10 times EBITDA.

Investors are currently focusing on portfolio management (55%), and new investments (42%). Only 3% of PE funds say they will focus on raising new funds in 2009. PE fundraising has slowed significantly (down with 68% from Q1 2008 to Q4 2008) and it is not expected to change in the near-term (Byrne, G.).

The acquisition multiples are expected to decrease, as well as the average size of the deals in 2009 will also decrease. The market activity will be around mid to small deals with low level of leverage. Leverage has significantly declined, requiring more equity infusions.

Confidence in PE's ability to generate superior returns has been strongly challenged in the current environment. We expect to see cross–border industry consolidations in 2010.

VI. Changes in business models

Private Equity Fund Business Model

After the current collapse of the LBO model operation of the PE funds, the latter are looking at their core model of operation from 70's and 80's. The success formula is expected to be a combination of growth capital and venture capital, again. Now, value should be created by developing companies' strengths and not through multiple arbitrages. The funds are changing their value creation approach, thus moving closer to the hands-on management of their portfolio companies.

In order to successfully manage their portfolios, the funds will require more sector expertise and operational management knowledge. We project that only those companies with dedicated management in these fields will bring superior value to it shareholders. The financial crises will definitely take the rest out of business.

As key solution to the issues we identify knowledge transfers and execution.

Knowledge management:

In our interviews, fund managers expressed their view that at times they do not have full-scope and specific industry and sector expertise. The external environment had changed, which requires flexibility and at least adaptation to the new economy. Only the proactive companies will achieve growth, and the active ones will survive the crisis.

PE funds use the external expertise and advice from management consultants.

Execution:

The major focus of the PE funds now is towards review and improving management operation in their current portfolio companies. We project that board members will have more active role and should be deeply involved in the management of the company.

The PE fund will have to make sure they have closer observation of how a company is managed and what are companies' internal processes and

There is a need for development of a new growth and survival plans and its subsequent execution. This should be created from the management of the company, with the support of external and specialized consultants (management consultants) and the strict monitoring from the PE fund. It is viewed extremely positive to have external independent directors who are industry experts and will support company's growth, which will lead to stabilization of the PE fund's portfolio.

The way to improve a company now passes through improvement of its operations and procedures.

This happens though a change management plan, lead by talented management teams who will provide knowledge and expertise to the management and the teams within the company. Based on a deep analysis a re-modeling of the company's operations should happen, in order to improve its competitive position in the current market. This should be followed by strong execution.

operations. The PE fund will have to strictly monitor the plan, regularly revise the deliverables and keep the management accountable for the results achieved.

Major issue in the current state of the economy is cash generation and its availability. The management should focus on cost optimization, cash flow management and servicing of the company's liabilities. We project that this will probably be the toughest task for managers due to the lack of bank financing and overall decrease of consumption and sales (down with 25-30% from the previous year).

Managers of companies in South East Europe are not in favor of tying down their payments with the performance of the company. There should be a clear definition of expected deliverables, which should be prepared with the support of external experts, and controlled by the shareholders.

One of the most important aspects of execution is speed. We see a dynamic market, which changes every day and companies do not have the luxury to postpone the execution of the plan.

Management consulting business model

Management consultancy companies provide its clients with professional advice on improving their overall business performance. Through deep analysis and understanding of the nature of the business, management consultants develop strategies for growth management, improving of processes and operations, solution of a specific problem, etc.

In the times of crisis management consultants should focus their efforts on long-term relations with their clients. We believe that a change in the business model should be made, and the management consultant companies should build their revenue structure on a performance-based approach, and not purely on retainer-based approach. This means that they need to take higher risk, and be paid on delivery of specific results. However, this should be very clearly defined, managed and monitored effectively.

Here follow the returns on this topic from the respondents in relation to: knowledge transfer and execution.

Knowledge transfer:

The role of the consultants is to add value to their clients' business by providing skills to the company's management.

Consultants should bring in knowledge that is currently missing and highly needed for companies during tough times.

Consultants should focus on providing services for limited period of time and

Execution:

We project that in the period of 2009 – 2010, the companies in South East Europe will focus on strategies to survive, not to grow. The growth plan are projected to be implemented in 2010, the earliest.

Management consultants do not have the control over the execution of a the company's plan.

It is a common investment practice in

should teach and facilitate processes in companies. The expected result is that the client should be able to manage its business after that period of advisory work without the support of the management consultancy company.

Consultants are sought today for advice and expertise on operational level and very close interaction with the management of the company. Major fields of development is cash-flow management, working capital management, operations optimization and building of survival (and then growth) strategies.

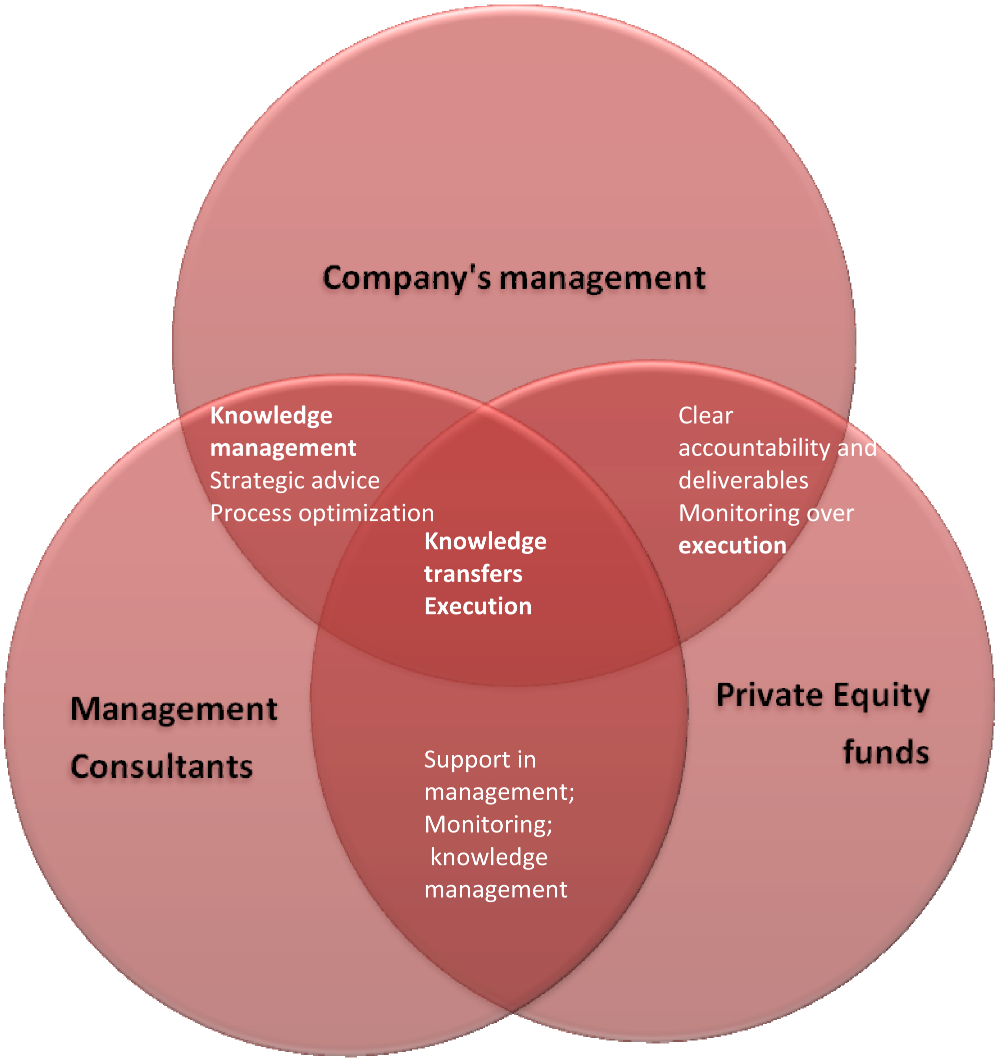
We see as major areas of consulting:

- Transferring specific industry knowledge
- Operational knowledge (working capital, liabilities, cash-flow, etc)
- Distress situational management

Western Europe to to attract external, independent professionals as board members, representing PE fund in their investee companies. We also have an early example of this happening in South East Europe.

The role of the management consultant, serving as board members, with a specific knowledge transfer mandate from PE investor is considered to bring value by the PE professional that were interviewed. Being part of the board, the management consultants have control over the plans execution and directly impact the company’s performance. Their role is not limited to providing advice and skill, but also in the overall growth development of the company – on operational level, processes and resources management, as well as strategic vision for growth.

Chart 3: Interaction and impact on growth development patterns in South East Europe



The financial crises of 2008-9 rapidly changed the economic conditions for PE funds, management consultants and entrepreneurs which all have to adapt to the new environment.

PE funds should focus their efforts on execution through strict monitoring over their portfolio companies (Economist Intelligence Unit, 4). The fund should set clear targets and measurable goals towards the management of the companies. This is something that entrepreneurs generally want to escape from. Another issue here at the pre-crises period was the lack of clear accountability system. Each party has to have clear and measurable deliverables that are expected from him/her and the performance should be measured and evaluated.

PE funds will need to implement a hands-on approach towards their current portfolio. However, they are limited in knowledge capacity to support the companies within the spectrum of industries and processes with the entire knowledge requirement. The general mantra at this moment is for cost-cutting which is counterproductive when executed at any cost.

Management consultants are needed in various operational areas of advising, as well as giving strategic direction and vision for development. However, they do not have the executive power to implement their deliverables and to monitor the change.

These are the fields of expertise and operations where PE funds and management consultants can build a synergy model in order to contribute to the growth of South East Europe. The successful model we see is the deep involvement of management consultants and PE funds in the monitoring and management of the investee company. Another aspect is the increased involvement of non-executives board members, which may lead to a successful model for further interaction of management consultants with PE industry.

VII. Conclusions

We project that PE funds and management consultants will both change their business models in a way to support the development of the companies in the current crises. Each party has its specific qualifications and fields of expertise and together, they build a synergy model that has value-creation positive impact on companies.

PE funds are focusing on current portfolio management and management consultants are required to provide operational advice and knowledge transfers. As soon as we start seeing stronger collaboration on execution and knowledge transfers by these stakeholders in the process, then this will lead to value-growth of the investee companies in South East Europe.

Sources:

- Alt Assets, "Venture capital in CEE" (12. January 2009)
- Arnold, M., "Buy-out bosses warn of private equity cull as "tourist" quit", Financial Times (16. March 2009)
- Arnold, M., "Private Equity expects industry consolidation", Financial Times (2. February 2009)
- Arnold, M., "Private equity must adapt or face irrelevance", Financial Times (4. February 2009)
- Arnold, M., "Tide turns against big buyu-out groups", Financial Times (24. February 2009)
- Butcher, C., "Gutmann Investorentag", Mid Europa Partners Kft (1. April 2009)
- Byrne G., "Central European Private Equity Confidence Survey", Deloitte (2008)
- Economist Intelligence Unit, Mapping the recovery, New Strategies for private-equity market (2008)
- Emerging Markets Private Equity Association "Limited Partner Interest in Emerging Markets Private Equity" (May 2008)
- Gave, P., "Gutmann Investorentag", GaveKal Research Ltd. (1. April 2009)
- Ivanov R. "Company Development with Private Equity Financing in Transition Economy: Evidence from Bulgaria", Dissertation for MBA in Finance Degree in The University of Sheffield, City Liberal Studies College, Thessaloniki, Greece (2006)
- Nagtegaal, T., "Post Investment – Venture management", Private Equity Guidebook Central and Eastern Europe, European Venture Capital Association, Zaventem, Belgium (1993)

Appendix 1:

We have conducted interviews with the following PE professionals in the period March-April 2009:

- Higgins, Tom - Managing Partner, Balkan Accession Fund, Sofia, Bulgaria
- Ivanov, Roumen – Certified Management Consultant; Member of the Board of Directors at Teletek Group JSC, Sofia, Bulgaria
- Knaflewski, Stanislaw – Partner, Enterprise Investors, Warsaw, Poland
- Luke, Robert - Managing Director, GED Capital Development S.A., Bucharest, Romania
- Simov, Ivaylo – Director, Global Finance, Sofia, Bulgaria
- Vilaihongs, Vinarom – Partner, Société Générale Asset Management Alternative Investments, Paris, France