

VENTURE CAPITAL AND PRIVATE EQUITY INVESTMENTS IN HUNGARY – CHARACTERISTICS AND PROSPECTS

Jeno Konecsny

Szent Istvan University Institute of Finance and Accounting
Pater Karoly street 1, Godollo, 2100, Hungary
E-mail: konecsny.jeno@gtk.szie.hu

Dora Havay

Szent Istvan University Institute of Finance and Accounting
Pater Karoly street 1, Godollo, 2100, Hungary
E-mail: havay.dora@gtk.szie.hu

– Abstract –

Hungary, just like the other countries in the Central-Eastern-European (CEE) region passed through a specific transition process during the late 1980s and the early 1990s when it started to lay down the basics of a market economy. Near at the time of the transmission, venture capital (VC) and private equity (PE) appeared as an alternative vehicle of corporate financing. As an industry, the VC and PE market built itself a quite well developed status relative to its counterparts in the CEE region. But the industry had to adapt to the country's peculiar economic, political and capital market conditions and also to its entrepreneurial and business culture, which all determined the frames of the investors' operating environment.

Our paper's aim is to shed light on those attributes which characterize the Hungarian VC and PE industry and which can also relate to the country's specific economical-cultural circumstances mentioned above. Nevertheless, the paper deals with the VC and PE market's future prospects, while stressing some of the key factors which are essential for the industry's successful development.

Keywords: venture capital, private equity, characteristics

JEL Classification: G24

1. INTRODUCTION

Private equity investments¹ as special types of corporate financing constructions spread from the Anglo-Saxon countries lately though but also appeared in emerging markets. Within these markets, a separate entity was made by the Central-Eastern European (CEE) region. The majority of these countries started to build a market economy system at the late 1980s and at the early 1990s. The transmission process created a special economic and corporate environment, to which the gradually appearing private equity investors had to adapt.

Within Central-Eastern Europe, this paper concentrates on the Hungarian private equity market. The first part provide a literature overview about what kind of unique characteristics and differences can be seen in the private equity investors' operation in Hungary and in the wider region compared to the financing activity of their counterparts' in developed (Western Europe or Anglo-Saxon) markets. The second part focuses on the attributes and outlooks of the Hungarian private equity market based on the recent near decade's statistical data and further information obtained from business press.

2. LITERATURE OVERVIEW

The characteristics of the Central-Eastern European region's private equity industry have been analysed from several aspects by the relevant literature. One of this approach meant to describe the attractiveness of the whole region as an investment target location. Anson (2003) stated that although having a stimulating impact on investment activity with its considerable growth potential it is also important to consider the serious risk factors in the CEE area. Among these factors he mentioned the low capitalisation of the local stock markets, making it harder to implement profitable exits via public sales, the specific banking environment not really favourable for leveraged buyout transactions and the rigidity of the legal system. Wright et al. (2004) made the private equity industry's stage of development in the CEE region depend on four specific factors: the supply of investment opportunities, i.e. from where can the investors hope for impressive projects, the demand for private equity as a source of financing, the infrastructure surrounded the implementation of the deals and the existence of different profitable exit opportunities. The authors mention, that all of

¹ Private equity investments provide equity financing primarily to corporations operating in the mature or later growth stage, whereas venture capital concentrates on start-up or early-growth companies. Although venture capital creates a part of the wider private equity investments, in this study we handle these two concepts as synonyms.

the CEE countries went through considerable development and structural changes (e.g. more active M&A market, western like corporate culture and governance), which created a private equity environment with a promising higher rate of return compared to the overstocked Western European markets. Based on questionnaires conducted among limited partners (the institutional investors who allocate capital for private equity funds) Groh et al. (2010) concluded that for limited partners the primary allocation criteria were the economic activity of a given geographic region and the inner business and project opportunities. Based on these conditions, limited partners ranked first the Central-Eastern European region among emerging markets, although stressing the ineffective protection of the institutional investors' claims towards private equity fund managers.

The other part of the literature emphasizes the examination of the operation and decision making process implemented by investors. A nine step decision making model specialised to the Central-Eastern European region's private equity industry was shown by Klonowski (2007). All of the steps could be described with document, information and decision channel. The study emphasized the importance of inner documents, which can be explained by the investors' lack of local experience, higher risk and by the use of a cautious decision making process. Based on questionnaires carried out among industry practitioners, Karsai et al. (1997, 1998) and Wright et al. (1999) compared the Hungarian, Polish and Slovakian private equity investors' valuation and screening activity to the similar practice implemented by private equity firms in the more developed United Kingdom. The research showed that due to the rapid dynamic change in the local economic environment, the region's investors kept their portfolio companies under tighter control than their British counterparts with a required majority ownership stake. Generally, they strove for reaching a standard level of return, during project evaluation they depended heavily on their own due diligence results rather than making use of services offered by external advisors. Meanwhile, the anticipated time of the exit and the management's own financial contribution counted as crucial risk mitigating criteria. Among country specific studies, Bliss (1999) concluded that polish private equity investors have to be more proactive in deal generation and they also have to establish alternate methods to evaluate the abilities of their future portfolio companies' management. Due to the limited access to different exit routes, examining the prospects of possible divestment strategies meant to be crucial at the early phase of the entire investment process. Beside the monitoring and exit activity Farag et al. (2004) also examined the contracting technique used in the Central-Eastern European private equity transactions compared to the practice implemented by German

private equity investors. The study showed that ensuring the availability of direct control rights in order to reduce risk, CEE investors used convertible securities more often to finance their transactions than German private equity firms did. According to the questioned investors the most serious problem related to the region's portfolio companies, and the major cause of write-downs was the existence of an ineffective upper or mid-level management.

3. THE HUNGARIAN PRIVATE EQUITY INDUSTRY

3.1. Relative position in the Central-Eastern European region

The attraction showed by private equity investors to the Central-Eastern European region and within Hungary was increased significantly thanks to the eastern enlargement of the European Union. According to Karsai (2012/a) the more intensive inflow of Foreign Direct Investments (FDIs), the CEE countries' outstanding economic growth and the existence of a qualified but low cost labour supply gave the region's private equity industry a boost. This growing interest can be followed by *Table 1*, showing private equity investments as a percentage of GDP in CEE and in the EU. Considering the numbers, in 2006 the region approached nearly the half of the EU's level and exceeded it in 2009.

Table 1: Private equity investments as a percentage of GDP in selected countries, in CEE and in the EU, 2002-2010* (%)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Bulgaria	0,0160	0,1010	1,1100	0,0000	0,1430	1,9500	0,2650	0,5300	0,2280
Czech Republic	0,0370	0,0520	0,0190	0,1120	0,3150	0,1430	0,2940	1,0100	0,1330
Hungary	0,1100	0,1540	0,1500	0,1670	0,8830	0,2080	0,4220	0,2230	0,0680
Poland	0,0690	0,0980	0,0690	0,0450	0,1180	0,1410	0,1670	0,0890	0,1920
Germany**	n. d.	0,1160	0,2310	0,2470	0,3130	0,4370	0,3700	0,1140	0,1860
United Kingd.**	n. d.	0,8520	0,5640	0,6620	1,2580	1,0330	0,7420	0,3000	0,7500
Total CEE	0,0540	0,0880	0,0960	0,0730	0,2210	0,1900	0,2010	0,2410	0,1190
Total Europe**	0,2770	0,2840	0,3210	0,3880	0,5520	0,5700	0,3940	0,1860	0,3140

*according to the target country of investments, **according to investors' residence

Source: EVCA (2004), EVCA (2005-2011), Karsai (2006).

Although in 2010, as a consequence of the recent crisis the region's attractiveness was brought to a standstill but that year's level of 0,119% was still higher than the levels measured before 2006. Within the examined period Hungary achieved an especially illustrious position in the region. According to the GDP figures Hungary ranked the first or second place between 2002-2006 and its proportion

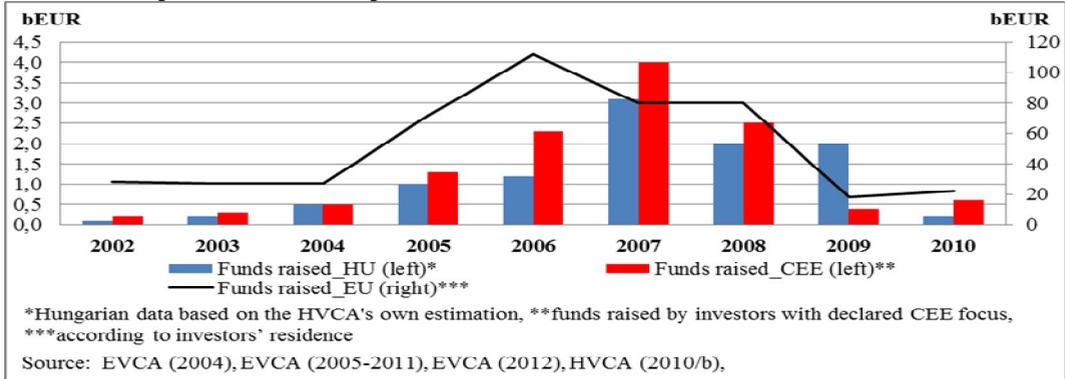
exceeded the CEE's average level in every year until 2008. These favourable ranks were disappeared in 2009 and 2010 due to the negative impacts of the economic crisis and the investors' increased risk aversion about the entire region (*Table 1*). On the other hand Karsai (2012/a) warned the contradiction connected to judging the importance of private equity investments by the proportion of GDP ranking. Filtering out the buyout transactions from the volume of investments it clearly appears that concerning venture capital investments the region and Hungary have a serious lag compared to Europe. The developed countries' advantage is also significant in the aggregate level as the average annual value of private equity investments as a percentage of GDP in the United Kingdom was 2.7-fold higher than the Hungarian, and 5-fold higher than the entire CEE region's average data between 2003 and 2010.

3.2. Funds raised for private equity investments in Hungary

The volume of funds available for private equity investments in Hungary was mainly determined by the foreign institutional investors' (e. g. pension funds, insurance companies and endowments) growth perceptions about the entire region and their capital supply. Between 1989 and 2010 the 90% of private equity invested in Hungary came from abroad, making up an average of 6% of FDI inflows (Karsai, 2012/a). The change in volume of allocated capital did not show a smooth tendency. As it appears in *Figure-1* fundraising activity jumped seriously from 2005, which can be explained with several facts. The first reason is the previously mentioned EU accession's lowering impact on investment risk, which advanced a favourable opinion from investors about the entire region. The second reason was connected to a shift occurred in the structure of private equity funds. Beside the Hungary-specialised country funds and the CEE-focused regional funds, global funds earned a crucial role in the private equity industry with their bigger deals between 2005 and 2008. As a third reason buyouts started to overtake the market with their significantly higher demand of capital (Karsai, 2012/a). Although a similar trend described the fundraising activity in the European Union, *Figure-1* shows that the changes in allocated capital for private equity investments in Hungary and in the CEE followed the European processes one year later. Compared to the peak registered in 2006 in the European Union, fundraising only topped at 2007 in the CEE, while at the same year, limited partners retained their commitments for European transactions because of the financial crisis. Relating to the future prospects of fundraising Groh et al. (2010) showed that institutional investors changed their views on several Central-Eastern European countries. The research stated that due to its worsened position in competitiveness and its unstable government policy, Hungary lost its previous

attractiveness, making the Polish and the Czech market as the primary target for capital allocation.

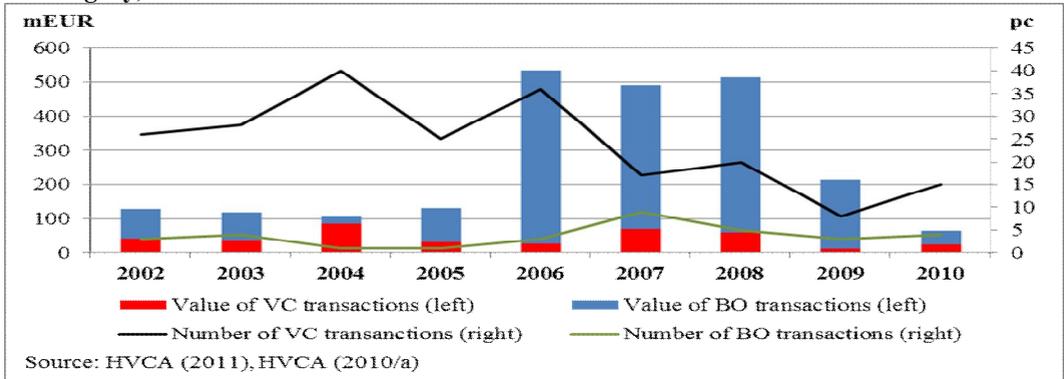
Figure-1: Annual value of funds raised for private equity investments in Hungary, Central-Eastern Europe and in the European Union, 2002-2010



3.3. Investments and divestments in the Hungarian private equity market

After the examined fundraising activity in the recent decade the temporal changes in private equity investments also pointed at the cyclical evolution of the Hungarian private equity market. Between 2002 and 2005 private equity investments barely exceeded 100 million euro while on the contrary, the volume jumped to more than 500 million euro by 2006. The following two consecutive years the value of investments remained nearly at the same level but during the economic crisis, it dropped back to 200 million euro first in 2009 then to 60 million euro in 2010 (*Figure-2*). The booming of investments in 2006 and then the fall in 2009 were occurred a year later than the doubling of allocated capital in 2005 and its plunge in 2008. Considering the stage of financing, *Figure-2* shows that buyouts took over the dominant role in the value of investments from 2006 pushing classic venture capital transactions into the background. The shift towards larger scale deals was indicated by the 14,56 million euro yearly average of investment size between 2006 and 2010, which was nearly four times higher than the average value of 3,93 million euro in 2002-2005 (HVCA, 2011). Although the number of venture capital transactions exceeded the number of buyouts in every year during the entire 2002-2010 period, the downward overall trend started in 2007 reflected a decline in investment activity.

Figure-2: Annual value and number of private equity investments by the stage of financing in Hungary, 2002-2010



Compared to the European Union, the Hungarian private equity market has an underdeveloped early-stage financing segment (seed capital, start-up stage). These transactions made a yearly average of 2% of the total investment value between 2002 and 2009 while the corresponding average proportion in the same stage was 6,7% in Europe (based on HVCA 2010/a, 2011 and EVCA 2004, 2005-2011). Considering this unfavourable situation and the marginal role of the Hungarian private equity industry's informal segment created by the early-stage focused business angels, the government tried to replace their activity with direct measures. Generally the interventions happened through the establishment of state-owned investment firms, which directed their operation to finance enterprises in early- or expansion stage. During the two decades passed between 1989 and 2010 a total number of 218 government funded investments were executed with the average volume of 3 million dollar per deal (Karsai, 2012/a). Although these firms exerted themselves to help businesses struggling with lower level of capital scarcity, the major value of capital was invested in the expansion stage. The efficiency of the state's replacement activity was questioned by Karsai (2002, 2007) who stated that governmental investments functioned as hidden loans (with conditions as: pre-fixed return requirement, prescription to secure collaterals, passive investor participation and selling the equity stake to the original management owners) focusing on traditional sectors rather than high-tech industries. The so-called Jeremie-program², launched in 2010 indicated a change

² Within the Joint European Resources for Micro to Medium Enterprises (Jeremie) program 31,5 billion HUF (nearly 115 million euro) was secured by the EU and it was complemented by 30% to 44,9 billion HUF (ca. 163 million euro) by private investors. According to the program all of the capital have to be invested by the end of 2013.

in government policy. Within the framework of the new initiative the government started to raise hybrid funds in cooperation with private investors by allocating capital partly from the European Union's Structural Funds and partly from the private investors' own equity. A public tender was announced by the government and after its appraisal in 2009, eight winner private equity investors started to execute investments in 2010. As a favourable effect of the program the number of seed capital and start-up deals more than doubled (from 4 to 11 pc) and increased their value more than tenfold (from 1,6 to 18 million euro) by 2010 from 2009.

Considering private equity divestments, the most frequently used exit method in Hungary and also in the entire Central-Eastern European region were the trade sales for strategic partners. Even before the crisis, public sales did not represent a significant volume in exits stressing the lower liquidity of the local stock markets. Meanwhile, towards the end of 2000s sales to another private equity firm as an exit route started to play a more important role, due to the growing demand of further development of buyout-involved, mature enterprises (Karsai, 2012/a).

3.4. The Hungarian private equity market in 2011 and its prospects

The most recent data about the Hungarian private equity industry gave evidence of a recovery in 2011. By that year, the volume of investments jumped to 195 million euro from 65 million euro registered in 2010, while the number of transactions increased from 17 to 37 pieces by 2011. As a positive outcome of the Jeremie-funds activity, a considerable improvement occurred in the financing of seed and start-up stages as the 20% of the volume and 80% of the number of total private equity investments were connected to these early-stage ventures in 2011. (Karsai, 2012/b). The second half of 2011 brought a serious uncertainty to the investors not just in Hungary but in the major part of continental Europe. Due to the negative effects connected to the lasting European debt crisis, institutional investors' risk aversion increased dramatically and the Central-Eastern European region lost a lot from its attractiveness. This is particular true for Hungary, which had to suffer deterioration in its economic position relatively worse than their neighbours in the region. Considering the new government policy applied from 2010, which couldn't handle the country's economic slowdown so far and the Hungarian private equity industry's great dependence on foreign financial sources, it is expected to see a decrease in the volume of allocated capital in the near future. Meanwhile the operation of the Jeremie-program and its second round (with the name of Jeremie II) launched in 2012 gave occasion for confidence as these initiatives could raise the value and number of investments further in early and expansion stage in the upcoming years. Jeremie II would channel an

additional 28,5 billion HUF (ca. 96,4 million euro) capital from the EU to the Hungarian private equity market. Amended by the private investors' 30% contribution the new program would ensure the financing of innovative businesses with seed or expansion capital until 2015 (NFU, 2012). It's a question however, that the number of viable projects will be sufficient to avoid ineffective capital allocation.

4. CONCLUSIONS

Following the Central-Eastern European countries' economic transition a special business and economic environment was appeared in the region, to which private equity investors, as a new type of equity providers had to adjust their business models. Among CEE countries Hungary has a well-developed private equity market although it has lost appreciation from investors by the end of 2000s helping Poland to become the best candidate for investments. Besides the similarities with the developed private equity industries, the Hungarian market is highly influenced by direct public interventions, which will hopefully have a more effective strategy with the recent launch of the Jeremie-programs. On the other hand it would be necessary for the market to increase its capital supply with domestic sources in order to ease the industry's dependence on foreign capital.

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