Western-style leveraged financing is taking hold in Emerging Europe, adding liquidity to a maturing M&A landscape.

Levered Best

A decade ago, financial crisis erupted in the emerging markets of Asia, spreading rapidly to Russia and around the globe to Latin America. The causes of the 1997 Asian financial crisis are still debated today, but most experts agree that a major contributor was the lack of local currency financing in the emerging markets–principally Thailand and Indonesia–that added currency risk to already incendiary financial conditions. There is no such threat hanging over Emerging Europe today, even as signs of a potential leveraged finance bubble appear across the continent's burgeoning market for mergers, acquisitions and private equity investments.

Despite the spread of loose credit and more aggressive financing across Europe, bankers and financiers throughout Central and Eastern Europe (CEE) see no cause for alarm. Just the opposite; most say that financing–now dominated by the big European banks that in recent years have swallowed most of the locals–remains solid; much of it is available in domestic currencies or Euros, keeping risk profiles manageable.

"You have a real consolidation in banking," says Peter Goldscheider, co-founder and managing partner of the Vienna-based European Privatisation & Investment Corporation (EPIC). (Also see sidebar, page 5). "You have one Hungarian bank that is still independent, OTP [Bank plc]. But in most countries, all the big lenders have been taken over by European banks–Raiffeisen, HSBC, UniCredit, are examples."

The ratios of debt to equity for M&A deals in most of Emerging Europe are extremely consistent with those in the West, says Michal Dlouhý, a partner in the Prague office of law firm White & Case LLP, who specializes in private equity, M&A, privatization, securitization and restructuring transactions. "This may be the high-water mark, but certainly this year has been going very strong. And virtually every M&A deal is leveraged there, as it is [in the West]."

Dlouhý cites the increased availability of local currency financing, which offers lower rates and less foreign exchange risk on the investment, as a key factor in spurring M&A and private equity investments in the region. "For the local banks–they're not really local banks, they're the local branches of the European banks–they will offer either domestic currency financing or basically Euro financing for the acquisitions," he notes. "If the revenues are in local currency, you don't have the exchange risk."

"Eastern Europe has become almost boringly similar to the rest of the world," agrees Klaus Requat, co-head of UniCredit Group's EEMEA Investment Banking unit (formerly Creditanstalt Investment Bank, or CA IB.) "You can run the secondary and tertiary leveraged deals. You can run them at the classic loan structures. There's no more difference. The main difference originally was that such financing didn't take place at all."

Bubble Trouble?

Dealmakers throughout the region see Central and Eastern Europe as the best of both worlds: booming markets that are awash with available credit yet still offer emerging market opportunities for those with the patience and local connections to find them. Though the ascendance of the big European banks has made financing easier, the markets are not yet getting out of control as they seem to be in the West. The European leveraged finance market is an unsustainable bubble, according to nearly 60 percent of respondents in a new White & Case survey out of London, though nearly 70 percent said there is room for further increases in the debt multiples being employed in European buyouts.

"Like all bull runs, there will have to be a slowdown at some point," notes Mike Goetz, co-head of White & Case's London-based European leveraged finance team. "What is unclear is when this will happen, what will trigger it and how rapidly the brakes will be applied."

Ninety-seven percent of survey respondents, which polled senior figures at banks and private equity firms as well as turnaround specialists, believe the current bull run of acquisitions will continue for at least the next six months, with the same percentage thinking leveraged lending volumes will continue to either increase or remain steady during the same period. Yet most of the froth in the market remains in the West, where more than 12,900 publicly disclosed M&A transactions hit more than $1.5 trillion in value in 2006, compared to 1,760 deals valued at $95.3 billion in Eastern and Central Europe last year.

"For Bulgaria and the rest of the region as well, acquisition finance is a quite a new product," notes Ken Lefkowitz, managing partner of New Europe Corporate Advisory (NECA), a Sofia-based corporate finance and consulting boutique that is part of the EPIC network. "And there's a relative dearth of private equity deals here, simply because it's difficult to find local entrepreneurs who like that kind of structure and understand it and want to play that way."

Despite Bulgaria and Romania's ascension into the EU in January, Bulgaria's lending standards remain tight, and the market for acquisition finance is far from saturated. "Companies in general are not overleveraged here," Lefkowitz notes, describing a recent attempt by a Bulgarian manufacturing company he represents to buy a competitor in the U.K. "The Bulgarian bank didn't understand that deal at all. We went to London, and even there it was too much of a stretch for them," he says. "Our client wanted to reach too far, and we just couldn't put it together."

The emerging markets have yet to see the rampant growth of high yield, mezzanine and second-lien financings that are growing in popularity in the West, yet are untested in many European jurisdictions and could cause problems at the turn of the current credit cycle, experts warn.

Banking sectors in Emerging Europe "appear relatively sound, with adequate capitalization, solid profitability and good asset quality," notes the most recent Global Financial Stability (GFSR) report published by the International Monetary Fund in April. "Strong macroeconomic performance and the expansion of foreign financing continue to support buoyant lending to the private sector in most countries."

"When you do an acquisition, the local branches are there because they have a certain allowable credit exposure to the local market, which maybe the headquarters won't have," notes Lefkowitz, "but the real know-how you're going to find is in Vienna or Athens or London or wherever. There aren't many bankers locally who are doing leveraged finance."

Though its annual growth rate over the past five years has been close to 16 percent, total assets of banks operating in the entire CEE region amounted to only 846 billion Euro last year, notes Dr. Herbert Stepic, CEO of Raiffeisen International. Yet that region-wide total is only slightly more than half the total assets of a single bank–albeit the world's largest–London's Barclays Bank at 1.592 billion Euro. That leaves plenty of room for growth, he says, projecting total banking assets in CEE will grow by nearly 18 percent annually, reaching 3.717 billion Euro by 2014.

"The promotion of international integration is among the important functions international banks can contribute to the development of emerging economies . . . both with regards to foreign investments as well as promoting international trade," Stepic says. "Could be that I am not objective in this matter, but I consider CEE as the most important banking market in the world."