Private Equity Market in Romania. Why Is its Infancy so Long?

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Abstract

The aim of the paper is to analyze the evolution of the Private equity market in Romania in the aftermath of the latest global financial crisis. Using data provided by European Private Equity & Venture Capital Association (EVCA), we found that the development of the Romanian private equity market has been affected by the low size and liquidity of the Romanian stock market, the high level of taxation, and the consequences of the latest global financial crisis. We consider that government support is needed in order to create a functional private equity in Romania. Our findings are useful for policy makers, academics, and practitioners.

Key words: private equity, venture capital, Romania, emerging markets, public policy.
J.E.L. classification: G24, G30.

1. Introduction

In the developed economies, private equity (PE) is considered a vital financing source for high-growth and innovative SMEs. The importance of private equity is well recognized in the extant literature. Several papers have highlighted that PE-backed firms are more efficient innovators (Hellman and Puri, 2000; Kortum and Lerner, 2000; Popov and Roosenboom, 2009; Lerner *et al*, 2013), create more jobs than their peer (Belke *et al*, 2003; Fehn and Fuchs, 2003; Boucly *et al*, 2009; Davis *et al*, 2009; Bernstein *et al*, 2010), and have higher profitability (Kaplan, 1989; Guo *et al*, 2011; Meles *et al*, 2014).

In the last decades private equity has been receiving increasing attention from policy makers and the academic community and there is a growing interest in understanding which factors determine the level of private equity investments in a country or in a region.

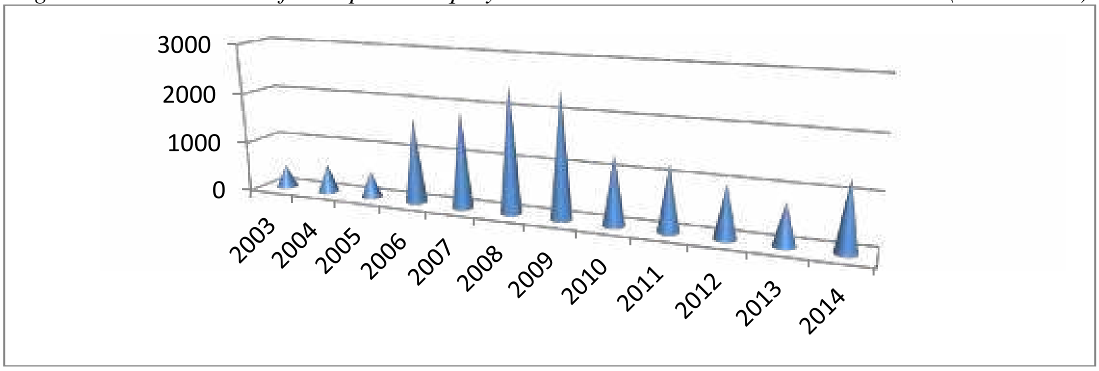
The paper aims to analyse the evolution of the private equity market in Romania, to identify the main factors that hindered its evolution, and to propose several measures for future development. The paper is organized as follows. Section 2 provides a brief overview of private equity investments in Central and Eastern Europe (CEE). The third section presents the evolution of private equity market in Romania and highlights the main factors that hindered its evolution. Concluding remarks and policy recommendations follow in the last section.

2. Private equity investments in Central and Eastern Europe

The private equity market in the Central and East Europe has been very dynamic until the onset of the latest financial crisis, in compliance with the economic evolution of the countries from the region (Onofrei and Anton, 2010). Figure 1 presents the evolution of annual PE investments in the CEE region over the period between 2003 and 2014. PE investments in the CEE region increased steadily from 2003 to 2008. Over this period the level of PE investments grew by 5 times. After the onset of global financial crisis, the PE investments followed a declining trend until 2014, when we noticed a strong rebound.

The PE activity can also be measured as the value of PE investments related to the GDP. In 2002 the ratio of PE investment to GDP in EU countries was 0.27% and rose to 0.40% in 2008. PE investments have suffered badly since the onset of the financial crisis and their share in GDP decreased to 0.27% in 2014. In CEE PE investments represented 0.05% of the GDP in 2002 and in 2008 this proportion rose to 0.21%. After a sharp decline during the financial crisis, CEE private equity investments as a percentage of region's GDP rebounded significantly to 0.104% in 2014. However, the CEE share is still less than 40% of the Europe-wide average in 2014 (European Private Equity & Venture Capital Association, 2015).

Figure no. 1. Evolution of total private equity investments in CEE countries 2003-2014 (in €million)



Source: (own representation after European Private Equity & Venture Capital Association, 2015, 11)

Table 1 shows that PE investments declined severely after the onset of the latest financial crisis in all CEE countries, except Poland, where the ascending trend continued until 2011. More than half of the PE investments concentrated in five countries from the region: Poland, Czech Republic, Hungary, Romania, and Bulgaria. The highest concentration was recorded in 2009, when these countries registered 93% of the total investments in the region and 73% of the total number of PE-backed companies.

Table no. 1. PE annual investments in selected countries from Central and Eastern Europe, 2007 – 2014 (in € million)

Country	2007	2008	2009	2010	2011	2012	2013	2014
Czech Republic	181.07	422.98	1,357.98	228.84	143.93	105.87	134.44	299.45
Hungary	222.72	464.03	213.64	65.05	194.84	102.95	56.26	169.93
Poland	434.19	635.72	274.57	652.69	678.44	473.01	380.03	250.92
Romania	212.45	293.96	220.87	119.14	65.92	27.61	70.35	77.97
Bulgaria	178.99	91.63	185.17	82.24	7.23	84.17	11.10	2.33
Total CEE	1887	2438	2432	1336	1247	1004	789	1311

Source: (own representation after data provided by European Private Equity & Venture Capital Association, 2016, http://www.investeurope.eu/research/activity-data/annual-activity-statistics/)

Poland is the regional leader in attracting PE investments, followed by Czech Republic. The successful story of the Polish private equity market is explained by the existence of a developed financial market and strong economic activity. Having the largest number of IPOs among all European exchanges over the period between 2009 and 2012 (European Private Equity & Venture Capital Association, 2013), Warsaw Stock Exchange offers good exit opportunities to the PE investors.

3. The evolution of the private equity market in Romania

In general, the Romanian private equity market followed the same trend as most of the countries from CEE region, but there are significant differences regarding the value and its structure. Table 2 presents the evolution of annual PE investments in Romania over the period between 2007 and 2014 by stage of financing. In 2008, Romania recorded the highest level of PE investments in his history (€293 million). The deepening of the financial crisis has severely affected the private equity investments in the following years, their value dropping at €27.6 million in 2012. PE investments rebounded in 2013 and 2014, but the value is still low compared to the pre-crisis value.

Table no. 2. PE investments in Romania over the period 2007 – 2014 by stage of financing (in € million)

Stage	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**Total 2007 - 2014**	**% of total PE investments**
Seed	0	0	0	0	0	0	0	0	0	0
Start-up	32.45	5.43	4.17	1.90	0	0	0	1.82	45.78	4.21
Later stage venture	1.32	36.56	0	3.18	4.00	3.05	2.98	3.47	54.59	5.02
Total venture	**33.78**	**41.99**	**4.17**	**5.08**	**4.00**	**3,05**	**2.98**	**5.30**	**100.37**	**9.22**
Growth	52.36	49.65	89.93	52.04	31.76	7.85	10.07	22.42	316.11	29.05
Rescue/ Turnaround	0	0	0	0	0	0	0	1.06	1.06	0.10
Replacement capital	14.50	5.00	22.04	12.00	18.50	0	9.45	0	81.49	7.49
Buyout	111.80	197.31	104.72	50.00	11.65	16.70	47.83	49.18	589.20	54.14
Total Investment	**212.44**	**293.96**	**220.87**	**119.13**	**65.91**	**27.60**	**70.34**	**77.97**	**1088.25**	**100**

Source: (own representation after data provided by European Private Equity & Venture Capital Association, 2016, http://www.investeurope.eu/research/activity-data/annual-activity-statistics/)

In Romania, most of PE investments focused on buyout (54% of total PE investments) and growth stage (29%). On average, venture capital represents only 9.22% of total private equity investments. Romania is the only country from CEE region which didn't attract any seed financing over the period between 2007 and 2014. In Romania, venture capital investments represented on average 0.004% of GDP over the period between 2010 and 2014. Analyzing the private equity market we found that there are no corporate venture funds established by private or public Romanian corporations.

Table 3 provides an overview of the total number of Romanian companies receiving private equity financing over the period between 2007 and 2014. The largest number of PE-backed has been registered in 2008 (29), followed by a declining trend in the next four years. Most of the PE-backed companies were in the growth stage. Also, over the period between 2010 and 2013, when financial constraints severely affected SMEs' activity, only one start-up and four later stage ventures attracted investments.

Table no. 3. PE-backed companies in Romania by stage of financing, 2007-2014

Stage focus	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Seed	0	0	0	0	0	0	0	0
Start-up	1	5	4	1	0	0	0	2
Later stage venture	2	2	0	1	1	1	1	4
Total venture	**3**	**7**	**4**	**2**	**1**	**1**	**1**	**5**
Growth	4	10	12	12	10	8	8	8
Rescue/Turnaround	0	0	0	0	0	0	0	1
Replacement capital	2	2	2	1	1	0	3	0
Buyout	10	11	5	2	2	1	4	6
Total Investment	**17**	**29**	**23**	**17**	**14**	**10**	**16**	**19**

Source: (own representation after data provided by European Private Equity & Venture Capital Association, 2016, http://www.investeurope.eu/research/activity-data/annual-activity-statistics/)

Table 4 presents the evolution of PE investments by sector over the period between 2007 and 2014. The top five sectors that attracted the largest PE investments were life sciences (19.45% of total investments over the period 2007-2014), consumer services (10.74%), consumer goods & retail (9.50%), energy & environment (8.17%), and communications (7.90%). In CEE region, the most targeted sectors for PE investments were communications, computer and consumer electronics, consumer goods and retail (European Private Equity & Venture Capital Association, 2015).

Table no. 4. Annual investments in Romania by sector, 2007-2014 (in €million)

Sector focus	2007	2008	2009	2010	2011	2012	2013	2014	% of T I
Agriculture	0	20.00	0	9.32	0	0	2.50	0	2.92
Business & industrial products	17.50	5.46	0	0	0	0	0	0	2.10
Business & industrial services	17.47	15.98	2.70	3.01	5.15	0.25	0.49	0.41	4.17
Chemicals & materials	0	46.42	6.25	0.69	2.54	0.88	12.51	0	6.36
Communications	45.00	1.07	4.40	13.90	0	3.95	12.01	5.66	7.90
Computer & consumer electronics	1.12	0	25.72	0	4.00	0	4.65	14.63	4.60
Construction	3.60	38.73	2.09	3.14	7.60	1.92	0.82	0.68	5.38
Consumer goods & retail	3.70	15.81	66.00	6.27	10.00	0.31	0.22	1.10	9.50
Consumer services	46.20	10.01	22.00	0	18.50	0	2.05	18.21	10.74
Energy & environment	0	2.40	17.15	16.97	5.93	20.00	14.83	11.70	8.17
Financial services	18.00	18.97	18.52	12.63	9.18	0.27	0	1.06	7.22
Life sciences	23.96	86.00	54.74	40.00	0	0	0	7.00	19.45
Real estate	35.87	33.08	1.25	3.18	0	0	0	0	6.74
Transportation	0	0	0	10.00	3.00	0	20.25	17.50	4.66
Unclassified	0	0	0	0	0	0	0	0	0
Total investment	212.44	293.96	220.87	119.13	65.91	27.60	70.34	77.97	

Source: (own representation after data provided by European Private Equity & Venture Capital Association, 2016, http://www.investeurope.eu/research/activity-data/annual-activity-statistics/)

The global financial crisis changed the attractiveness of several sectors for private equity investors. After the onset of financial crisis, energy & environment and transportation attracted more PE investments in Romania than in the previous period. On the other hand, life sciences, real estate, and consumer goods & retail were less attractive for PE investments over the period 2011-2014 relative to the pre-crisis period.

Private equity activities are influenced by institutional environment. Groh et al (2010) proposed a Venture Capital and Private Equity Country Attractiveness Index in order to measure the attractiveness of countries for investors in the venture capital (VC) and private equity (PE) asset classes. In this index the author included six key drivers of VC and PE attractiveness: (1) economic activity (GDP, inflation, unemployment rate); (2) depth of the capital market (size and liquidity of the stock market, total trading volume, IPOs and public issuing activity); (3) taxation; (4) investor protection and corporate governance (quality of corporate governance, security of property rights, quality of legal enforcement); (5) human and social environment; (6) entrepreneurial culture and deal opportunities. Table 5 presents the evolution of VC/PE attractiveness index for Romania over the period 2009-2015.

Table no. 5. Evolution of VC/PE attractiveness index for Romania over the period 2009-2015

	2009	2011	2013	2015
VCPE Index / Rank	48	59	65	46
1. Economic Activity	19	76	48	36
2. Depth of Capital Market	53	62	66	57
3. Taxation	111	113	87	48

4. Investor Protection and Corporate Governance	55	52	68	49
5. Human and Social Environment	56	66	81	70
6. Entrepreneurial Opportunities	48	47	44	41

Source: (The Venture Capital & Private Equity Country Attractiveness Index, 2016, http://blog.iese.edu/vcpeindex/romania/)

The Romania's position in VC/PE attractiveness index has improved significantly in the last years, but it still lags behind other countries from CEE region. Among the factors that reduce the Romania's attractiveness to receive institutional VC and PE allocations over the period 2009-2015, we found the depth of capital market, the level of taxation, and human and social environment (labor regulations, bribing and corruption). If some of the above mentioned factors have improved in the last year, the depth of capital markets represents a serious issue for Romania. In our opinion, the low size and liquidity of the Romanian stock market, the low number of IPOs, the high ratio of bank non-performing loans to total gross loans and the low value of M&A market severely affected the development of a significant VC/PE market. In addition, numerous changes in labor regulations and high level of bribing and corruption influenced negatively the value of PE investments.

Romania hasn't had a strategy to support the development of private equity market. Also, there is no government supported programme for venture capital in Romania. Anton and Onofrei (2016) highlighted that most of the previous public programs to support SMEs' financing focused on providing grants to start-ups and SMEs and on loan guarantees. Numerous developed (Australia, USA, Canada, United Kingdom) and developing economies (Latvia, Hungary, India, and others) have implemented in the last two decades public programs to support private equity/venture capital markets and the results are mixed (Cumming and MacIntosh, 2006; Cumming and Li, 2013). Karsai (2015) provides some theoretical arguments for and against the government's participation in the venture capital market. EVCA (2014) showed that over the period between 2009 and 2013 European governmental bodies provided almost 40% of equity raised by venture capital funds focused on regional investments. Avots *et al* (2013) reported that Latvia has established five public venture capital programs over the period between 2005 and 2014. Due to government supported program, the value of venture capital investments in India increased from $600 million in 2006 to $1.4 billion in 2014 (Ernst & Young, 2014).

4. Conclusions and policy recommendations

The existence of a sound private equity market is important for the Romanian economy and companies. The extant literature confirms that, in general, private equity investments increase employment, improve operational performance and spur innovation.

Even if the first private equity transactions took place almost twenty years ago, the Romanian private equity market is still in its infancy. The underdeveloped stock market, high level of taxation, and the lack of a strategy to support venture capital market have negatively affected the evolution of private equity market in Romania in the last two decades. One potential solution for the development of a vibrant private equity market in Romania is the governmental support.

As the latest global financial crisis severely affected the private equity market in Romania, we consider that public support is important for market recovery and development. The Romanian government can support the development of private equity market in several ways. Firstly, government could participate direct in the venture capital market by creating venture capital funds or co-investment funds. The management of these venture capital funds could be conducted by independent fund management companies or state-owned management companies. Secondly, government could provide tax and regulatory incentives in order to boost venture capital investments. Thirdly, equity raised by venture capital funds could be increased by allowing pensions funds to invest (more) in this new asset class. Fourthly, public support for business angel networks represents other examples of supply side measures.

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