hvca

Hungarian Venture Capital and Private Equity Association

# Jubilee 20 Years Yearbook

2011

# Hungarian Venture Capital and Private Equity Association

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Treasurer **András Szombati**

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The Hungarian Venture Capital and Private Equity Association represents the interest of the venture capital and private equity in Hungary, helping the work of its members as well as creating and adhering to in the highest possible professional and ethical standards.

20

# Table of Contents

# Nikolaus Bethlen
President

# President's Greetings

Since its formation 20 years ago, the HVCA has become the undisputed voice of the Private Equity and Venture Capital industry in Hungary. The association has come a long way since its inception by five founding members in 1991 and today represents the interests of 74 firms in aiding public understanding of its members activities, promoting the industry to entrepreneurs and investors as well as maintaining a regular dialogue with public policymaking bodies at national and international level.

The growth of the industry over the last twenty years has coincided with the ongoing economic convergence of Central and Eastern Europe with the European Union. At the same time, it facilitated the successful development and growth of a large number of companies in Hungary and the region, such as Euromedic, Invitel, Hungarocamion, Euronet and Graphisoft, to name but a few. The contribution of the industry to economic growth is starting to become more widely understood and today the need for equity investment in CEE is arguably greater than ever before: difficult bank lending conditions for SMEs and entrepreneurs, stretched balance sheets, a tightening public purse and companies' reluctance to invest all support a growing role for investors willing to commit equity capital. In addition, European Union funded initiatives such as the JEREMIE program mark the advent of a more prominent role of equity investment to drive innovation, economic growth and faster convergence in Central and Eastern Europe.

The HVCA is actively supporting this development through a number of initiatives to increase the public awareness among businessmen, investors, politicians as well as the public at large through targeted information campaigns and the launch of a new website in 2012. At the same time, we will continue to provide essential services to our members such as networking opportunities, seminars, publications, maintaining an active dialogue with regulators and policymakers on behalf of the industry.

That the association is a vibrant and growing organization that looks positively into the future is exclusively due to its members as well as its former presidents, who stand out as having dedicated time and efforts as well as vision and leadership over the last twenty years:

| | |
|---|---|
| 1991-1993 | Mr. András GESZTI |
| 1994-1995 | Mr. László OLÁH |
| 1996 | Mr. László CSOKNYAI |
| 1997-1998 | Mr. Károly Szigeti |
| 1999 | Mr. Géza SZÉPHALMI |
| 2000 | Mr. Peter FODOR |
| 2001-2002 | Ms. Vikória ZOMBORY Dr |
| 2003-2006 | Mr Julián TZVETKOV |
| 2007-2010 | Mr. László OLÁH |

# Welcome note

András Geszti
President: 1991-1993

Our Association was founded 20 years ago. As one of the five founders, I feel privileged to have been given the opportunity by the Board to give all current and former members and officers of the Association a warm welcome.

The idea of founding the Association was first raised by Mr. Albert Kloezen, the president of Euroventures BV at the time. Those were early days for venture capital in the Hungarian market. Only a few people had relevant professional experience. One of those was our first treasurer, Max Schimmelpenninck, who used to work for ABN AMRO Bank VC before he moved to Budapest. Significant contribution came from Mr. Karoly Hübner, the first head of MAVA, the Hungarian-American Enterprise Fund, who brought with him the American culture of the profession.

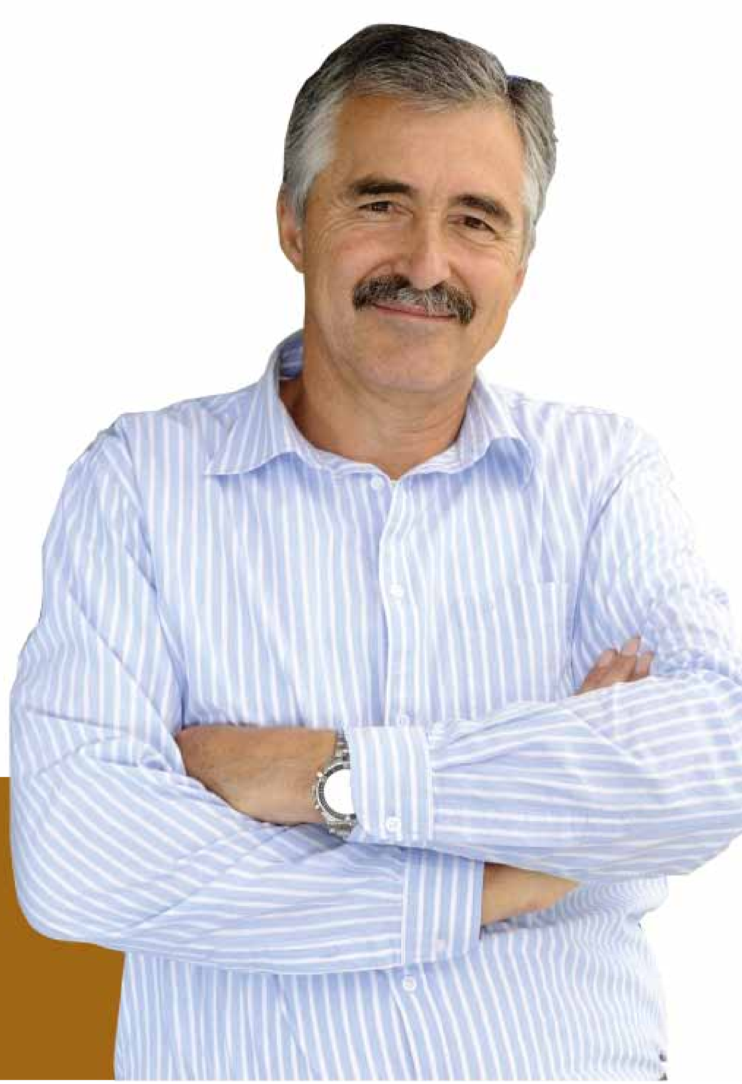
Once our association had been established, we joined EVCA, the European Venture Capital Association. On their training courses and events we had the opportunity to meet the most outstanding figures of the profession in Europe and to familiarize ourselves with the English venture capitalists' way of thinking.

The initial professional and financial support received from Coopers (now PriceWaterhouse Coopers) and other auditors, as well as from Baker and McKenzie and other legal firms was invaluable for our association.

These past 20 years also coincided with the first twenty years of the Hungarian venture capital and private equity industry. It was great to see the large number of venture capitalists, lawyers, auditors and other professionals with excellent qualifications joining us. The contribution by the officers succeeding the founders, Viki Zombory, Peter Fodor, Geza Szephalmi, Julian Tzvetkov, Laci Olah, Bela Lendvai-Lintner, Peter Tanczos and many others was crucial for the Association to achieve the prestige it enjoys today.

We all may well be proud of the many successful investments our members have made, the financial results of the domestic and international companies that benefited from such investments, as well as the several thousands of new jobs that were thus created. It is good to see that investors as well as portfolio company managements recognize the contribution of our members to their successes. On top of all of these achievements we are happy to acknowledge the valuable personal relationships that were built over the years and that the Association's Ethics Committee hardly had any work during these past twenty years.

The EU Jeremie program gave our industry an excellent opportunity in 2010. I hope that we will all be able to make good use of it and that our members can help many entrepreneurs, business angels and investors to enjoy its benefits, too.



# András Geszti
## Founder President

# Happy 20th Anniversary, HVCA

Dr. Viktória Zombory – Former President of HVCA

In 2011, the Hungarian venture capital and private equity industry celebrates the 20th anniversary of the Association's foundation. When the Association was founded in 1991, one table in the office of Andras Geszti at Antra/Euroinvest was large enough to seat all of us. The HVCA played a pioneer role in Central Europe and continues to be one of the most active professional organizations of the region. We are glad to see that there are more than 70 members in the Association at present, and that many of the founding members still play an active role in the Association's life.

It has been an active past 20 years of growing up and we are proud of the results we have achieved in the development of the Hungarian market economy and enterprises. Close to 400 companies operating in Hungary have been supported by venture capital and private equity investors through investments amounting to approximately USD 3.2 billion. The Hungarian venture capital industry is actually as old as the change of the political regime dating back to 1989. During the 90s, venture capital played an important role in Hungary's transition to a market economy and in strengthening the private economy sector. In addition to capital investments, it has introduced the responsible corporate governance system to hundreds of Hungarian companies and played a key role in the development of strategic governance and management information systems.

Regional and global funds appeared in Central Europe as of the second half of the 90's. Following the EU accession, due to the strong confidence of international investors and the favorable global economic environment, the amount of investments has grown dynamically. Such positive trend was then broken in 2008, as a result of the crisis affecting the world economy. By the end of the decade, the opportunities for private equity investors to use their funds have shrunk and they became more cautious in their investments. Instead of identifying new targets, they focused on supporting their existing investments.

Still, the second decade in the Association's history has also brought about a number of positive factors in the life of the Hungarian venture capital and private equity industry. Partially as a result of the persistent professional work and advocacy of the HVCA, the regulation facilitating the foundation of Hungarian venture capital funds came into force in 2006, as part of Act CXX of 2001 on the Capital market. This regulation replaced the preceding Venture capital act of 1998 that contained excessive restrictions. The current regulation provides for a framework that adequately supports the operation of the venture capital funds and fund managers and ensures a good foundation for the venture capital organizations headquartered in Hungary.

Due to the appropriate legal environment and the EU-aided JEREMIE program, a number of new venture capital funds have been established in 2009. The Association is proud to share the success of the operation of the 15 venture capital funds currently registered in Hungary. The JEREMIE funds have filled a niche in the venture capital and private equity industry due to an investment strategy that focuses mainly on early-phase innovative companies. In correlation with European trends, from the end of the 90s the financing of buy-outs had come to the forefront in Hungary as well, while start-up investments have lost relevance by the mid-2000s. Since 2009, due to the JEREMIE funds, early-phase companies have had significantly better chances in obtaining capital despite the economic crisis. Fast growing, innovative enterprises typically require capital investments in several rounds in order to extend their activities.

Further, in order for enterprises to continuously develop, it is essential that a stable regulatory environment and an entrepreneur-friendly taxation system be in place. Such factors facilitate the operation of the foreign and Hungarian private equity funds and enhance the possibility of using the capital of institutional investors. We trust that the economic and regulatory environment will continue to support the operation of the enterprises as well as investors after the recovery from the crisis.

I wish further success and endurance for the entrepreneurs, investors and all those who serve the development of the Hungarian enterprise and the economy.

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Riverside
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Judit Karsai Dr.

# Development of the Hungarian venture capital and private equity industry over the past two decades

# Development of the Hungarian venture capital and private equity industry over the past two decades

Dr. Judit Karsai[1]

On the occasion of its 20th anniversary, the Hungarian Venture Capital and Private Equity Association conducted a survey on the development of the Hungarian venture capital and private equity sector over the last two decades. The survey covered **three topics**: the **funds raised** that were available for **investments,** the amount and the functions of investments, and the techniques used for **exits.** This survey is based on the annual surveys of the European Venture Capital and Private Equity Association, which, in turn are based on: data collected from investors and information collated from business journals and news publications.

In 2005, the Hungarian Venture Capital and Private Equity Association prepared a similar survey[2], which focused on fifteen years of development of the Hungarian venture capital and private equity industry. As such, the current analysis follows on from the earlier review, up to 2010[3]. The previous review was updated from that of 2005-2010. The data was collected from the Hungarian Venture Capital and Private Equity Association's own annual surveys[4], using its own members, between 2008-2010, with the data from the European Venture Capital and Private Equity Association PEREP Analytics database.

In the course of the last two decades, all of the key players in the Hungarian venture capital and private equity sector were members of the Hungarian Venture Capital and Private Equity Association; therefore, the survey carried out by the Hungarian Venture Capital and Private Equity Association adequately represents the investments made in Hungary as analysis is underpinned by the data collected from the industry investors. The survey accounts for 100% of the capital allocated to investments, two-thirds of the estimated invested capital volume and almost half of the total number of transactions. However, as the data reported by the investors was incomplete the exits were only partially enumerated and thus should only be used as a guide.

## I. The significance of the venture capital and private equity industry in Hungary

The analysis, reviewing more than two decades between 1989 and 2010, enumerates the investments of 126 funds with interests in the Hungarian market. These funds (based on current price data) have been managing capital totaling more than USD 20 billion. Out of these funds' capital

[1] KARSAI, Judit is a senior research fellow at the Institute of Economics, Hungarian Academy of Sciences, and the chairperson of the Statistical Committee of the Hungarian Venture Capital Association.

[2] KARSAI, Judit – BARANYAI, Gabor: The development of the venture capital and private equity industry in Hungary 1989-2004, HVCA, Budapest November 2005, p47

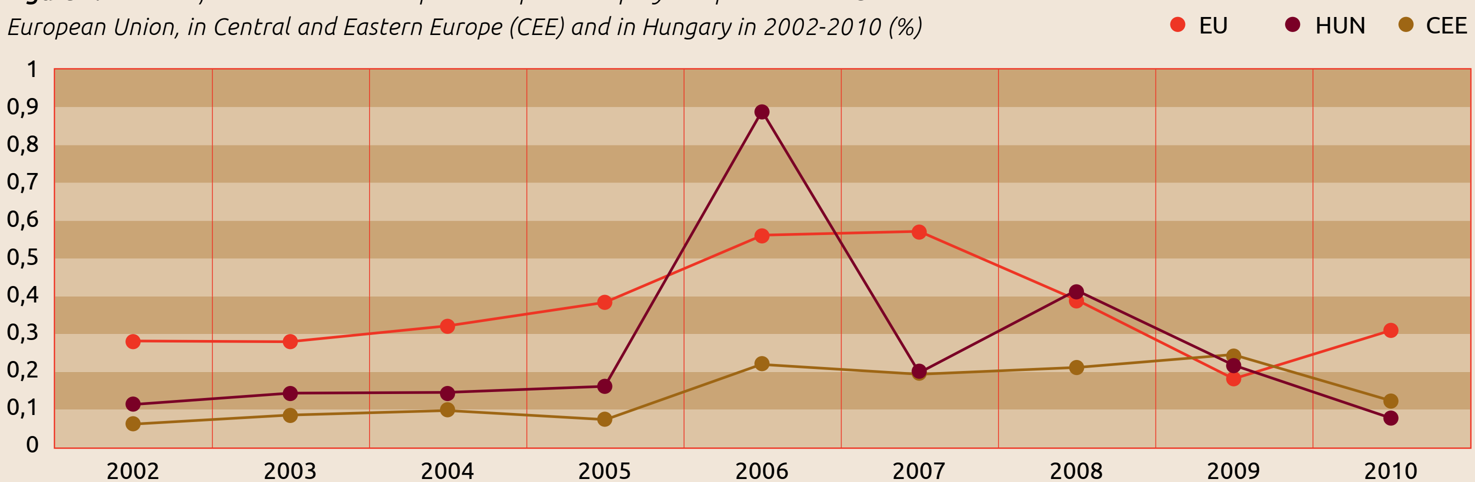
[3] Special thanks to Mrs. GOMBOS, Natalia the General Secretary of HVCA, for her valuable contribution to the updating of the database.

[4] HVCA stimulates and controls its members reporting activity to EVCA PEREP_Analytics. HVCA received the data of individual investments upon the discretion of the investors. Since all the investment and divestment data processed by EVCA PEREP_Analytics are available only on the aggregated level, the classification of the 2008-2010 investment data by investor classes are based on estimation.

theoretically available USD 8 billion for investment in Hungary, USD 3.2 billion was invested into companies based in Hungary cca. over 420 separate transactions. The survey data records more than 180 exits with a book value of approximately USD 900 million. In order to make a comparison to European data, the market share of the Hungarian venture capital and private equity market is measured by the annual rate of the value of venture capital and private equity investments into companies headquartered in Hungary as a proportion of the country's GDP. **Hungary** ranks in a **distinguished position** not only within the CEE region but also among other EU member states. The value of venture capital and private equity investments in the Hungarian market compared to the GDP, between 2002 and 2009, continuously exceeded the ratio measured throughout the region, and in addition, due to some outstanding investments ratio, the surpassed by far the EU equivalent, in 2006 and in 2008. Regarding the GDP/investment ratio the Hungarian market ranked fifth in Europe in 2006, ninth in 2007, sixth in 2008, and tenth in 2009. However, in evaluating these prestigious rankings, it has to be taken into account that individual high value buy-outs substantially influence the aggregated value of the annual investments while it has no effect on the change of the GDP. Furthermore, it is also underpinned by the size of **classical venture capital** financing in Hungarian market generally, **ranked among the last** in Europe. As capital accumulation started to develop in Hungary only after the change of political regime, **foreign capital** did necessarily **play a key role** in providing funds for the Hungarian venture capital and private equity market. The venture capital and private equity investments originating from abroad made up 6% of the foreign direct investments (FDI) in Hungary between 1990 and 2010 on average.

The proportion of companies with access to venture capital and private equity is insignificant in the Hungarian economy overall, and does not reach

***Figure 1.*** • *Value of invested venture capital and private equity compared to the GDP in the European Union, in Central and Eastern Europe (CEE) and in Hungary in 2002-2010 (%)*




***Sources:*** EVCA Central and Eastern Europe Statistics

0.2 per hundred companies with double-entry bookkeeping. However, the proportion of companies requiring access to venture capital/private equity investment far exceeds the available supply. The role of venture capital financing in the development of the economy is manifested mostly in innovation start-up companies, while on the other hand, private equity financing facilitates restructuring and regional expansion related to change of ownership in mature companies usually with significant economic strength.

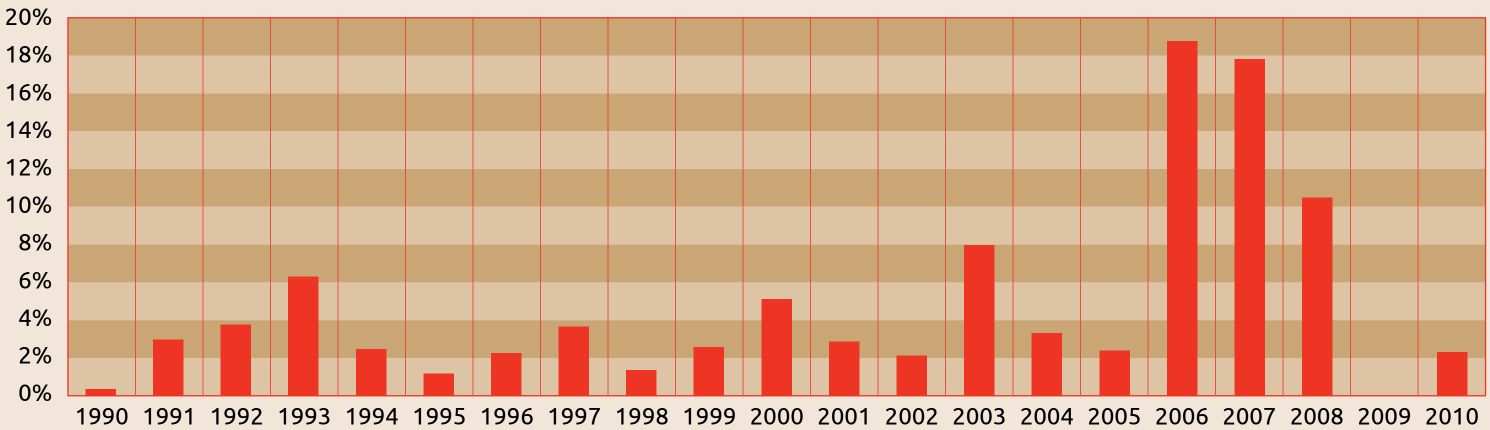
## II. Capital raised by venture capital and private equity funds

The survey shows that organizations intending to invest Venture Capital and Private Equity into Hungarian Companies invested an average of USD 360 million per year, which compounded over a 20 years period is nearly USD 8 billion, although this amount was not evenly spread during the said period.

The volume of venture capital and private equity capital raised for the Hungarian market fluctuated cyclically following the international capital market cycles and the changes of the rate of growth of the domestic economy. The Hungarian market, ranking high within the CEE region for the development of its market economy, became a favored area for foreign capital investors in the last third of the 1990s. Its position since has become particularly favorable due to Hungary's accession to the EU. From the second half of the previous decade, until the 2008 crisis, the capital allocated by investors in the region allowed investments to the Hungarian market to increase significantly.

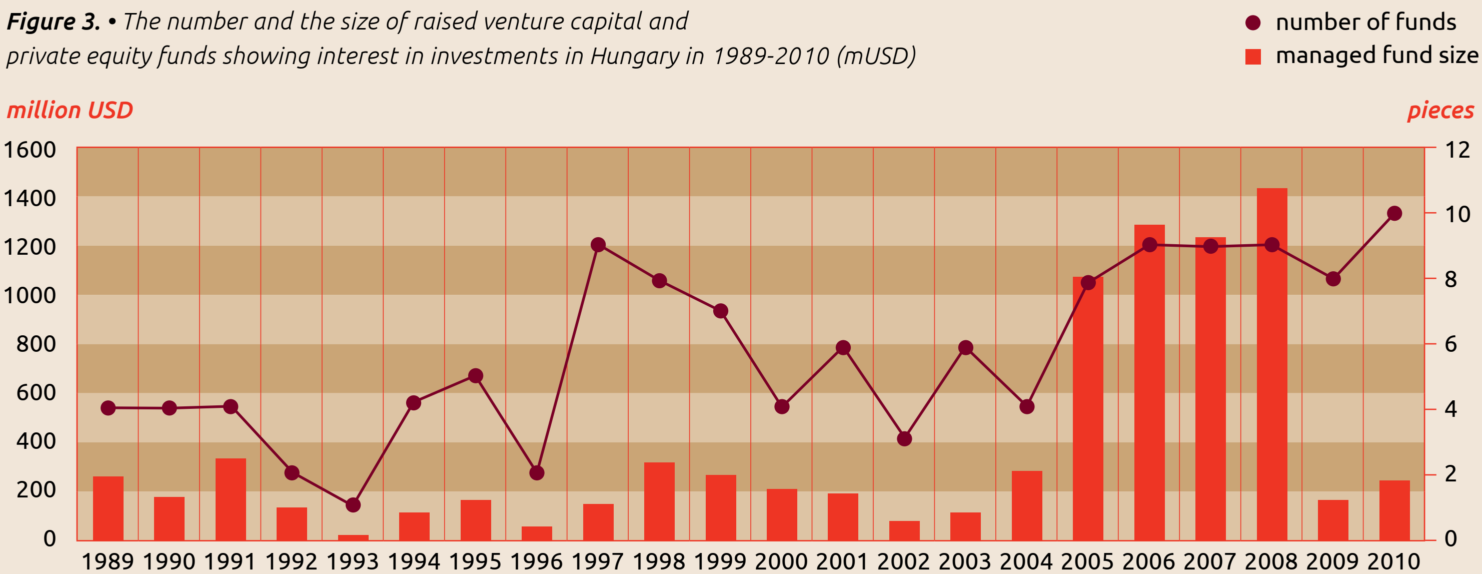
The diagram below shows the annual changes in the value of stock exchange capitalization along with the capital allocated for venture capital and private equity between 1990-2010. It accurately reflects the annual changes in the volume of the capital allocated to venture capital and private equity invest-

***Figure 2.*** *• Value of venture capital and private equity investments compared to the foreign direct investments in Hungary in 1990-2010 (%)*




***Sources:*** The National Bank of Hungary and HVCA

*Figure 3.* • *The number and the size of raised venture capital and private equity funds showing interest in investments in Hungary in 1989-2010 (mUSD)*




***Source:*** HVCA

*Remark: In the case of global funds the survey took into account the amount of the capital managed by the funds only in the volume corresponding to the actual investments as allocated capital. In the case of regional funds the survey calculated with one fourth of the capital managed by the funds interested in making investments in Hungary. In the case of organisations making investments only in Hungary the survey contained the total amount managed.*

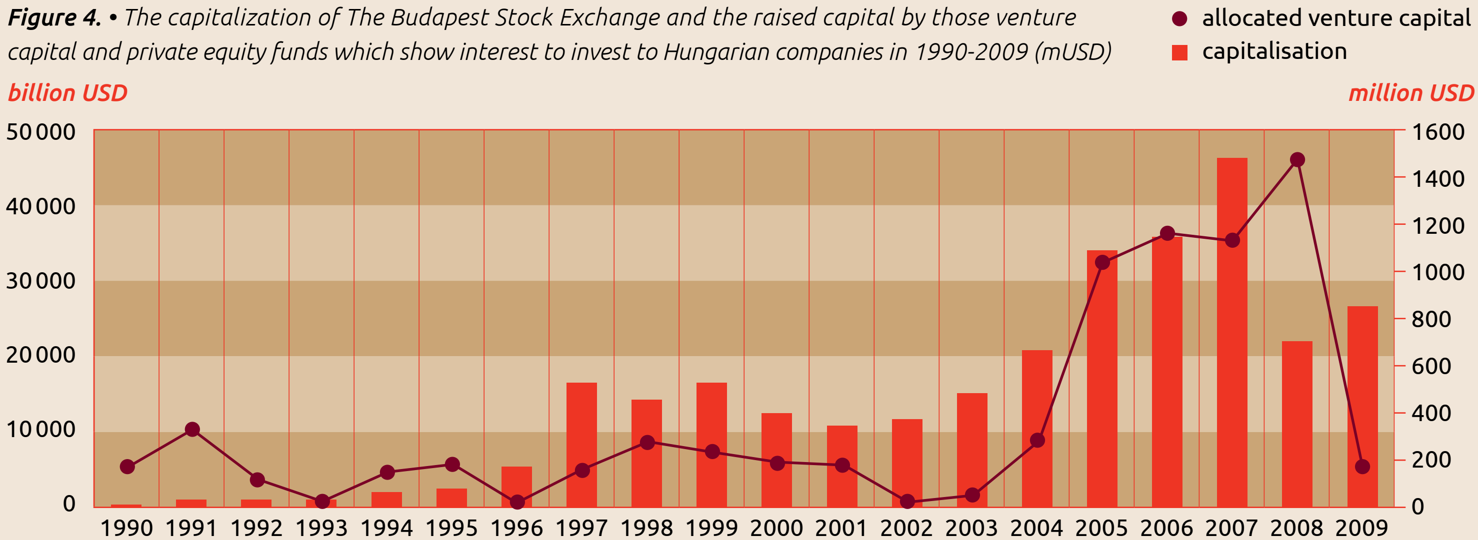
ments for the Hungarian market determined by the general capital market volume, showing its influence in stock exchange investments.

The changes in volume of capital available for investment reflect the changes in the types of funds[5] in the Hungarian market. As the capital strength of the various regionally-focused funds was considerably weaker at the beginning of the survey period, the expansion of these groups contributed to the changes of the capital allocated for investment. While the average size of the country funds, wishing to make investments **only in the Hungarian market** did not reach USD 30 million during the twenty years under review, the value of the capital allocated by the **regional** funds exceeded double that amount. The capital from **globally** operating funds allocated to the Hungarian market amounted to USD 200 million on average, considerably surpassing the former amount.

The beginning of the period under review revealed mainly those country funds in the Hungarian market that specialized in investments only in Hungary. After the change of political regime and at the start of

[5] The survey grouped investments into three categories based on the geographical focus of investors: global, regional and country funds. In the case of global funds the survey took into account the amount of the capital managed by the funds only in the volume corresponding to the actual investments as allocated capital. In the case of regional funds the survey calculated with one fourth of the capital managed, as the investors did not intend to use a higher proportion of their capital to making investments in Hungary. In the case of country funds, the survey contained the total amount managed.

*Figure 4.* • *The capitalization of The Budapest Stock Exchange and the raised capital by those venture capital and private equity funds which show interest to invest to Hungarian companies in 1990-2009 (mUSD)*



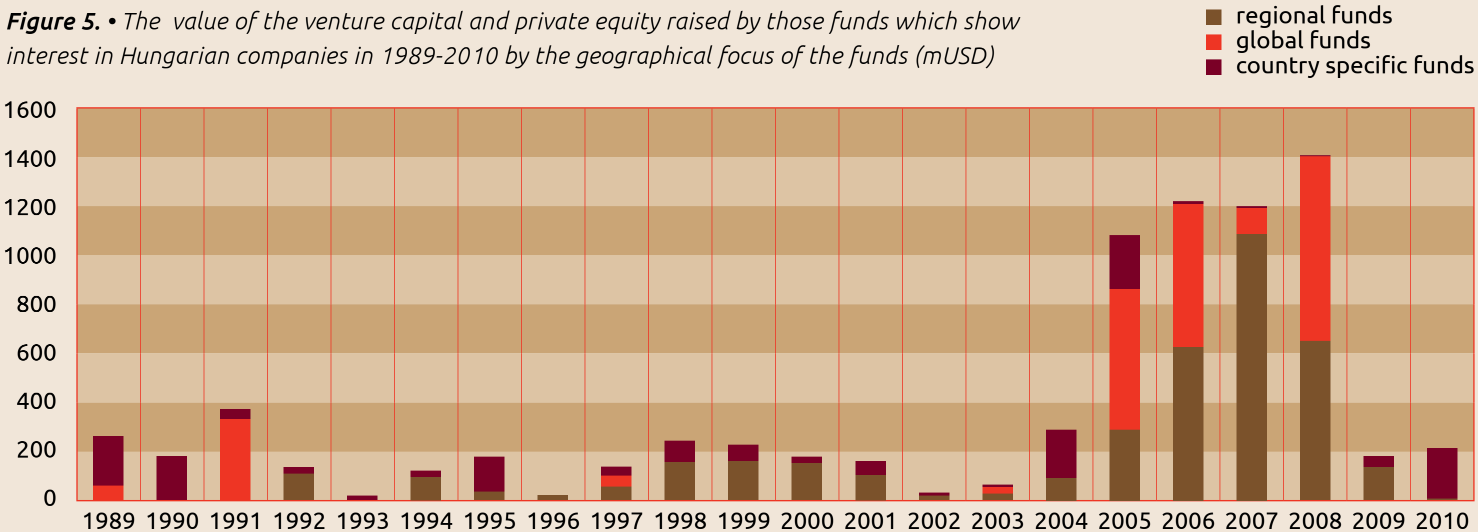

***Sources:*** Budapest Stock Exchange and HVCA

*Remark: In the case of global funds the survey took into account the amount of the capital managed by the funds only in the volume corresponding to the actual investments as allocated capital. In the case of regional funds the survey calculated with one fourth of the capital managed by the funds interested in making investments in Hungary. In the case of organizations making investments only in Hungary the survey contained the total amount managed.*

privatization the role of the multilateral (inter-governmental) funds became more important. Regional funds emerged in the Hungarian market relatively early within the region, as early as in 1992, these funds have played a key role in capital provision over time. Increased confidence in relation to the accession to the EU resulted in the further expansion of the regional funds and the brief "golden age" of the venture capital and private equity sector in the second half of the 2000s. This period also witnessed the appearance of some global funds. At the end of the last decade, the significance of the country funds increased again due to the drop in international interest caused by the crisis.

The review of the **proprietary background of the venture capital and private equity investors** highlights the significant changes in the motivation behind investments. The more intensive **government participation,** among the owners of the funds intending to make investments on the Hungarian market, reflects the motivation to build the market up and to strengthen confidence related to the elections. Over time, the decreasing significance of government participation indicates the maturity of the market and that focus is shifting toward solely profit considerations. The role of the government was substantial when the sector was first being established, and when the European community funds opened in 2009. At the same time, the level of development in the Hungarian venture capital and private equity sector, and the role the sector played in the building of the market economy, is clearly indicated by the fact that in the course of the two decades under review approximately **90%** of the capital allocated to investments overall **were raised by private sector investors.**

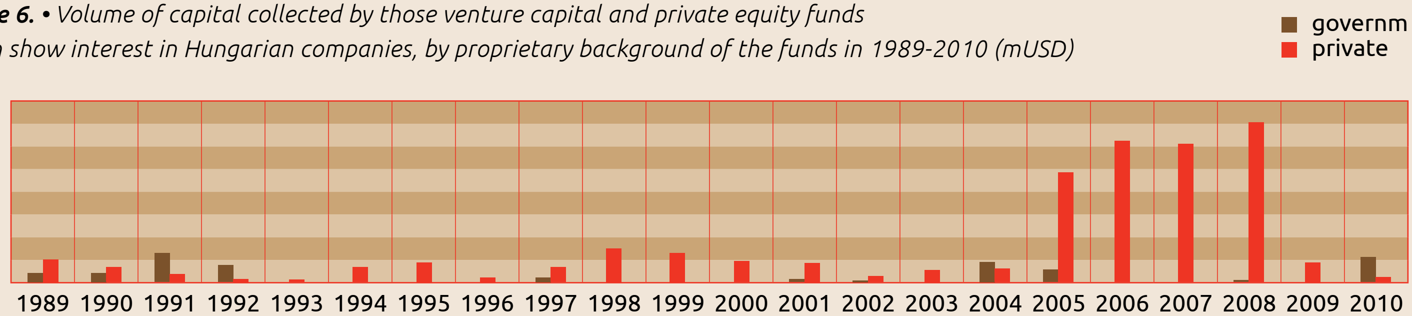
**Figure 5.** • *The value of the venture capital and private equity raised by those funds which show interest in Hungarian companies in 1989-2010 by the geographical focus of the funds (mUSD)*




***Source:*** HVCA

*Remark: In the case of global funds the survey took into account the amount of the capital managed by the funds only in the volume corresponding to the actual investments as allocated capital. In the case of regional funds the survey calculated with one fourth of the capital managed by the funds interested in making investments in Hungary. In the case of organisations making investments only in Hungary the survey contained the total amount managed.*

**Figure 6.** • *Volume of capital collected by those venture capital and private equity funds which show interest in Hungarian companies, by proprietary background of the funds in 1989-2010 (mUSD)*




***Source:*** HVCA

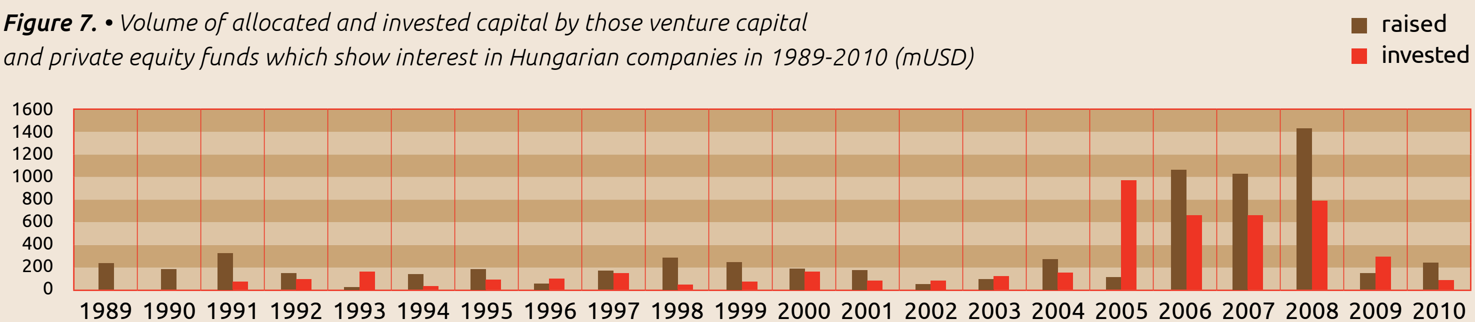
*Remark: In the case of global funds the survey took into account the amount of the capital managed by the funds only in the volume corresponding to the actual investments as allocated capital. In the case of regional funds the survey calculated with one fourth of the capital managed by the funds interested in making investments in Hungary. In the case of organizations making investments only in Hungary the survey contained the total amount managed.*

## III. Capital invested by venture capital and private equity funds

During the period under review, the 126 investment organizations included in the survey actually invested approximately 50% of their USD 8 billion capital available for investments in Hungary. During this time, USD 3.7 billion in venture capital and private equity was provided to Hungary-based companies through approximately 420 transactions The allocation of capital and the capital investments were both characterized **by four-year cycles,** while some shifts were apparent between the raising of capital and the actual investments.

After raising a substantial amount of capital following the change of political regime, investments started after a three-year delay as preparation took time, then in 1993, when fresh capital was scarce, they reached their trough. As a result of increasing capital collection once again, in 1994 (the year of the change of government), the amount of investments started to increase and in 1997 it reached an outstanding high. Despite the dynamics of the growth of capital allocation up to 1998, investments dropped sharply thereafter partly due to the uncertainty related to the change of government and partly to the Russian crisis. From 1999 and with the returning investor confidence along with the evolving IT-boom, capital investments sharply increased. As the IT-boom lost momentum they again decreased in 2001-2002 and eventually stagnated to a low level. This process turned around once again in 2003, principally due to Hungary's expected accession to the EU. The growth of investments accelerated tremendously between 2007 and 2009, increasing several-fold compared to previous years. The Hungarian market – similarly to the whole region – earned also profit from a transitory situation at the beginning of the crisis when the investment problems in Western Europe did not extend to the CEE region for some time. In 2009, however, when the crisis grew to the countries within the region, the willingness to raise funds and to make investments decreased. In addition, the crisis affected the already weakened Hungarian economy more so than it did the other economies in the region, which is reflected by the drop in investments in 2010.

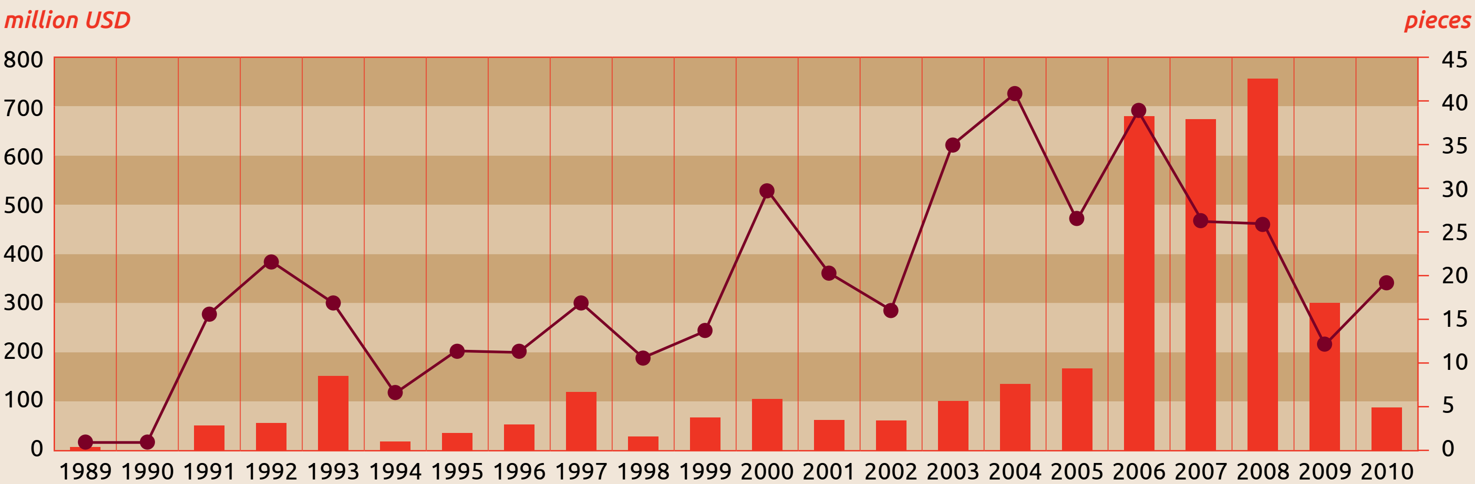
***Figure 7.*** • *Volume of allocated and invested capital by those venture capital and private equity funds which show interest in Hungarian companies in 1989-2010 (mUSD)*




***Source:*** HVCA

*Remark: In the case of global funds the survey took into account the amount of the capital managed by the funds only in the volume corresponding to the actual investments as allocated capital. In the case of regional funds the survey calculated with one fourth of the capital managed by the funds interested in making investments in Hungary. In the case of organisations making investments only in Hungary the survey contained the total amount managed.*

*__Figure 8.__ • Number and volume of venture capital and private equity investments in Hungary in 1989-2010 (pcs, mUSD)*

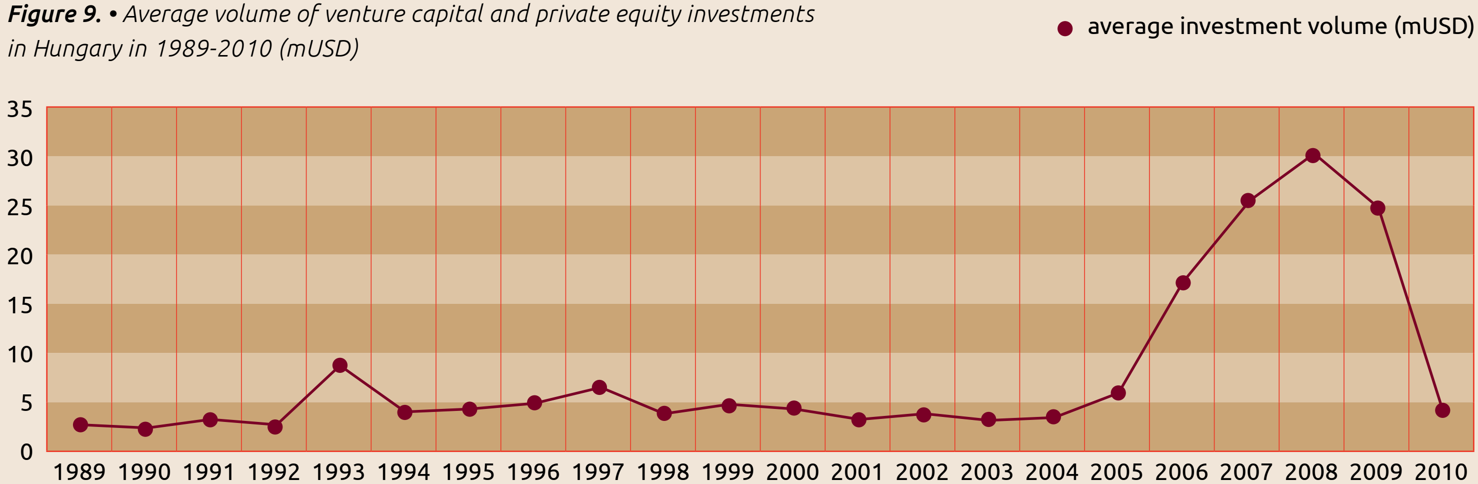



***Source:*** HVCA

The **surge** in the value of investments and in the number of investment transactions was first apparent in the **years preceding the elections.** Only the **technological bubble** at the turn of the century, the **investment boom** during the last third of the period under review here and the economic crisis have broken this upward trend. In the 1990s the highest-value investment transactions related to privatization. At the time of the IT-boom, the value of investments increased due to the accumulated effect of a growing number of smaller deals. In the second half of the last decade, generally one or two high value buy-out deals caused a significant increase in the value of investments, while the number of transactions decreased. In 2010, when the investments of the JEREMIE funds were launched, the number of investments started to grow again. However, the value of investments still remained low as high value buyouts did not materialize due to the crisis. The highest venture capital and private equity value - USD 670 million – came to the Hungarian market in 2008, while the most investment deals – 42 were made in 2004.

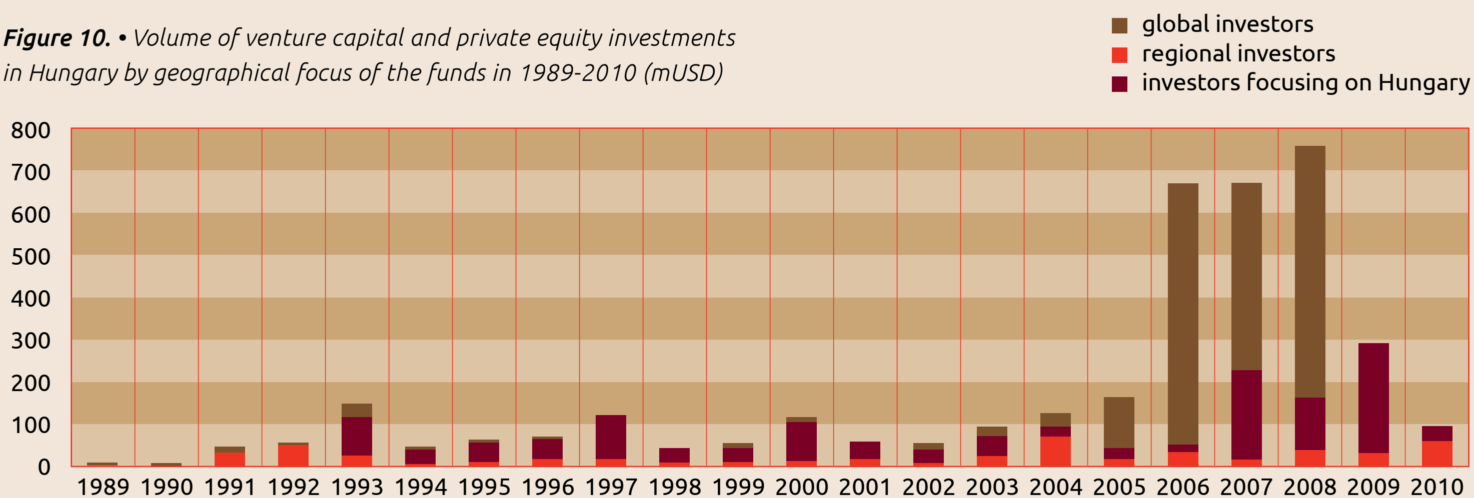
During the last two decades, among Hungary-based enterprises, an average of 19 companies received venture capital and private equity investments. The average value of venture capital and private equity invested into Hungary-based companies amounted to cca. USD 170 million per year, with an average of USD 9 million invested per transaction. However, the average investment value for the first 15 years was significantly different to the following 7; as after the accession of Hungary to the EU the average amount invested increased considerably. During the period between the change of political regime and the accession to the EU, i.e. between 1989 and 2004, the average capital value invested through the individual transactions barely reached USD 4 million per year, whereas the average investments in the years following amounted to 4.5 times that, i.e. USD 18 million.

***Figure 9.*** *• Average volume of venture capital and private equity investments in Hungary in 1989-2010 (mUSD)*




***Source:*** HVCA

***Figure 10.*** *• Volume of venture capital and private equity investments in Hungary by geographical focus of the funds in 1989-2010 (mUSD)*




***Source:*** HVCA

The changes in the average investment volumes in the individual years are also indicated by the structural changes of the funds that made the investments.

The figure accurately reflects the largest investments made by **global** funds, whose role increased massively from 2006. From 1993, **regional** investors were maintaining a determining influence on the change in investments. The significance of Hungary-only funds increased at the beginning of the period under review, also in 2004, and again then during the last three years. The weight of the deals made by investors from various geographical regions showed a significant difference. Most of the deals, approximately 270, were made by organizations that **invested only in the Hungarian market,** where they represented approximately two thirds of the total number of deals. The value of the investments of organizations, focusing only on the Hungarian market, amounted to almost half a billion US dollars during the period under review, which made up 13% of the total value of investments. The 120 transactions carried out by the funds making **regional** investments represented approximately 30% of all investment action. These organizations invested capital, totaling cca. USD 1.3 billion, into Hungary-based companies, which represents more than one third of the total investment value. The number of deals of **globally** investing funds, i.e. making investments across Europe or the world, made in the Hungarian market did not reach 30, i.e. 10% of all transactions, while the investments of these funds carried a value of approximately USD 2 billion, which made up more than half of the value of all investments made in Hungary. It is apparent, therefore, that the order of magnitude of deals made by investors with **larger geographical focus** also **differed.** The average of the investments made by organizations focusing only on the Hungarian market did not even reach USD 2 million, while that of regional funds exceeded USD 10 million, and in the case of global funds it amounted to almost USD 70 million. The average value of almost 500 transactions made by all investors in Hungary amounted to approximately USD 9 million.

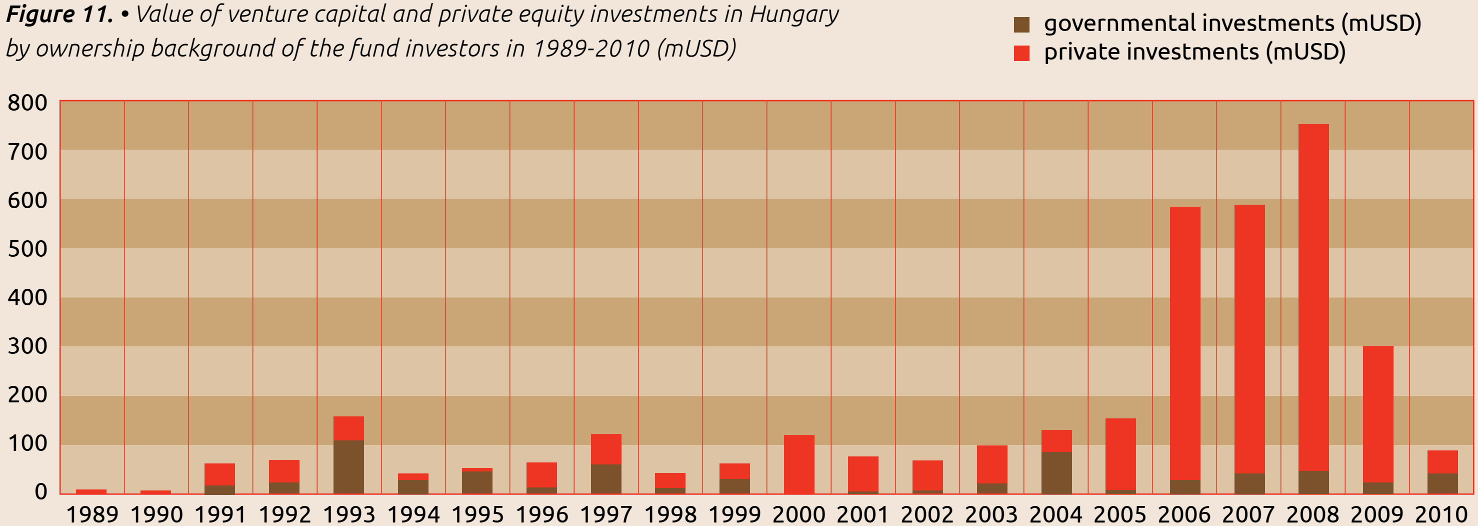
In the Hungarian venture capital market the organizations from both the **governmental** and **private sectors** fulfilled **different** but similarly important **functions.** Due to the nature of their respective activities, the average

***Table 1.***
*Number and volume of venture capital and private equity investments in Hungary in 1989-2010 by geographical focus of funds (pcs, mUSD, %)*

| | Number of investments (pcs) | Number of investments (%) | Investment value (mUSD) | Investment value (%) | Average investment value (mUSD) |
|---|---|---|---|---|---|
| **Investors focusing only on Hungary** | 268 | 64,4 | 485,5 | 13,1 | 1,8 |
| **Regional Investors** | 120 | 28,8 | 1281,7 | 34,6 | 10,7 |
| **Global Investors** | 28 | 6,7 | 1940,4 | 52,3 | 69,3 |
| **Investors total** | 416 | 100 | 3706,6 | 100 | 8,9 |

***Source:*** HVCA

***Figure 11.*** *• Value of venture capital and private equity investments in Hungary by ownership background of the fund investors in 1989-2010 (mUSD)*




***Source:*** HVCA

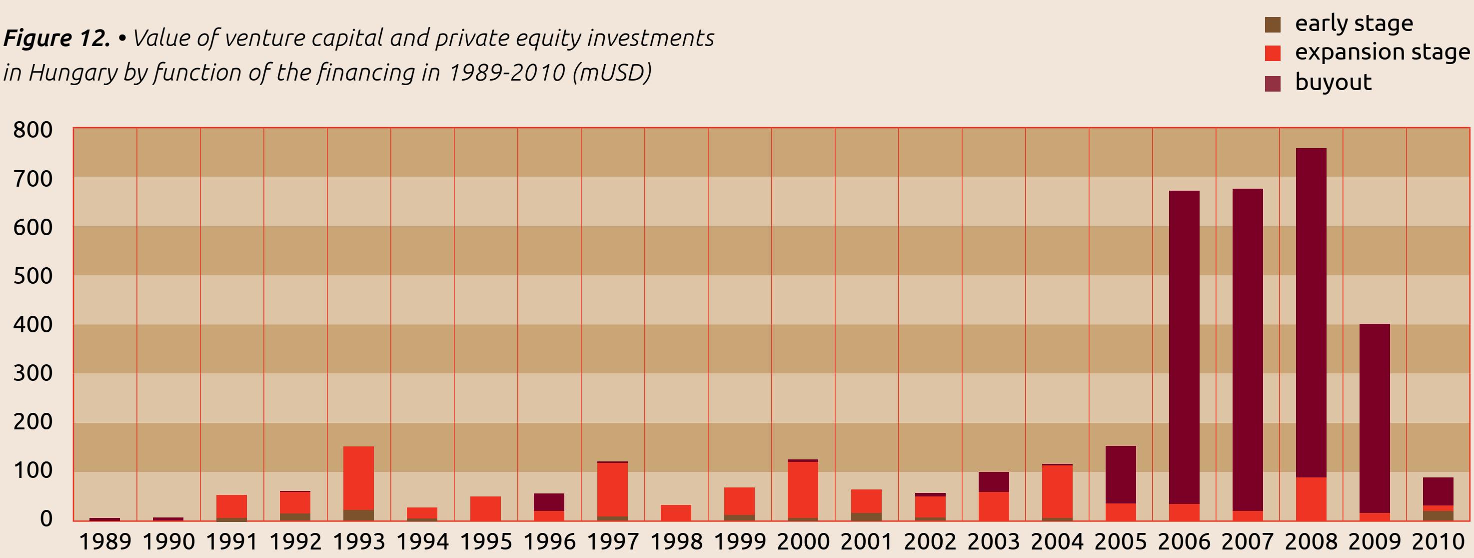
***Table 2.***

*Number, volume and average value of venture capital and private equity investments in Hungary in 1989-2010 by ownership background of the fund investors (pcs, mUSD, %)*

| | Number of investments (pcs) | Number of investments (%) | Investment value (mUSD) | Investment value (%) | Average investment value (mUSD) |
|---|---|---|---|---|---|
| **Investors with governmental background** | 218 | 52,4 | 648,7 | 17,5 | 3,0 |
| **Private sector investors** | 198 | 47,6 | 3058,0 | 82,5 | 15,4 |
| **Investors total** | 416 | 100 | 3706,7 | 100 | 8,9 |

***Source:*** HVCA

***Figure 12.*** • *Value of venture capital and private equity investments in Hungary by function of the financing in 1989-2010 (mUSD)*




***Source:*** HVCA

size of their respective investments also differed. The governmental organizations invested an average of USD 3 million per transaction, while private sector funds averaged above USD 15 million. As a result of the two types of market investor, the aggregated average invested volume was USD 9 million cca. In the course of the twenty years analyzed, funds with governmental backing financed the development of companies at the early and expansion stage of their lives on the Hungarian market; every second deal was related to these funds (i.e. 218 out of the total number of 416 transactions, which is 52% of the deals). As organizations with **government links** operated only in **classical venture capital** investments, these transactions mobilized significantly fewer funds than the buy-outs. The USD 648 million funds of organizations investing government equity on the Hungarian market represented 17.5% of the value of total investments in Hungary (USD 3706.7 million), which is low when compared to their frequency. The capital of **private sector funds** became significant mainly after the turn of the millennium. The year 2010 was an exception due to the emergence of the JEREMIE funds; the role of the government escalated to levels similar to those in the private sector, whose interest was shrinking due to the crisis and uncertainty in the economy. The private sector funds **accounted for cca. 83% of the total value of investments made,** which accounted for approximately 48% of all deals during the two decades under review. The expansion of capital from private resources reflects the development of the Hungarian venture capital and private equity market, i.e. this segment of the capital market developed with the establishment of the market economy, and became similar to other more developed markets.

The function of the venture capital and private equity investments within the economy is determined by the **phase of development** in which the financed enterprises receive the investing funds' capital. The capital received by businesses in Hungary from the venture capital and private

***Table 3.***
*Number, volume and average value of the venture capital and private equity investments in Hungary in 1989-2010 by function of the financing (pcs, mUSD, %)*

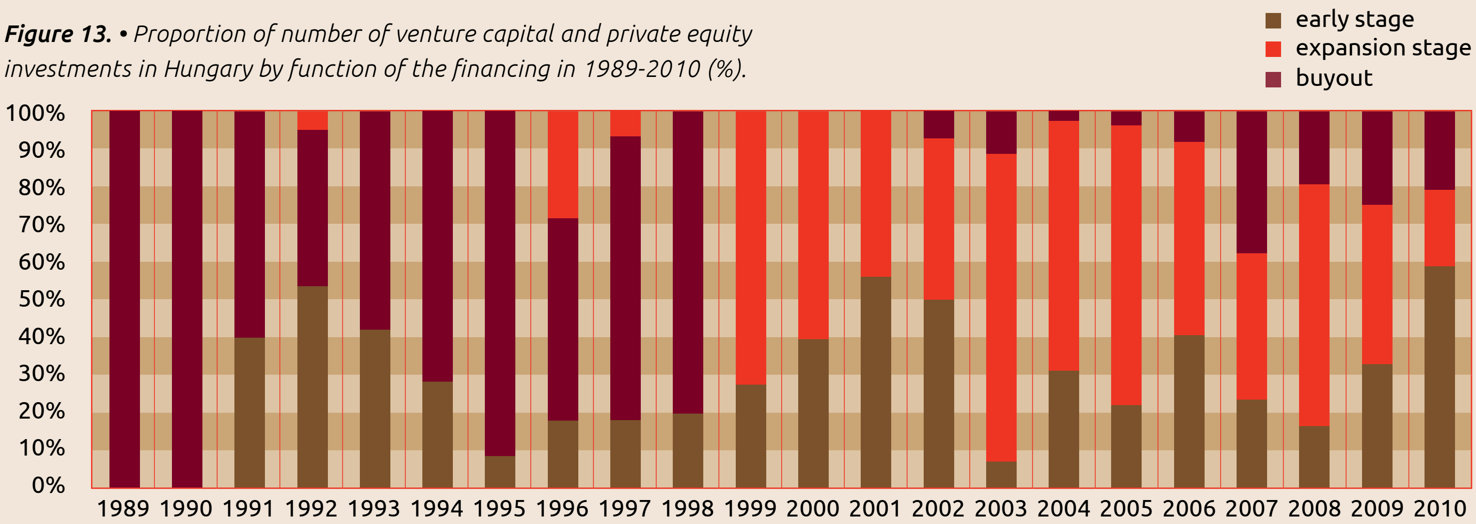
| | Number of investments (pcs) | Number of investments (%) | Investment value (mUSD) | Investment value (%) | Average investment value (mUSD) |
|---|---|---|---|---|---|
| **Early stage** | 132 | 31,7 | 147,0 | 4,0 | 1,1 |
| **Expansion stage** | 246 | 59,1 | 1037,3 | 28,0 | 4,2 |
| **Buyout stage** | 38 | 9,1 | 2521,8 | 68,0 | 66,4 |
| **Total** | 416 | 100 | 3706,1 | 100 | 8,9 |

***Source:*** HVCA

equity investors fulfilled **different functions** during the period under review. It provided capital for start-up companies and for their development at an early stage and also facilitated the expansion of companies, i.e. helped their growth and development. For mature and established companies capital was utilized to help them become international businesses, reorganize themselves or change ownership. While in relation to other European markets the proportion of capital provided at the **early phase** was relatively **low,** the proportion of financing **buyouts** to the total amount of investments became more significant than in Europe. The weight of the individual functions considerably changed during the two decades analyzed, i.e. Hungary did not see even growth among the various types of investments.

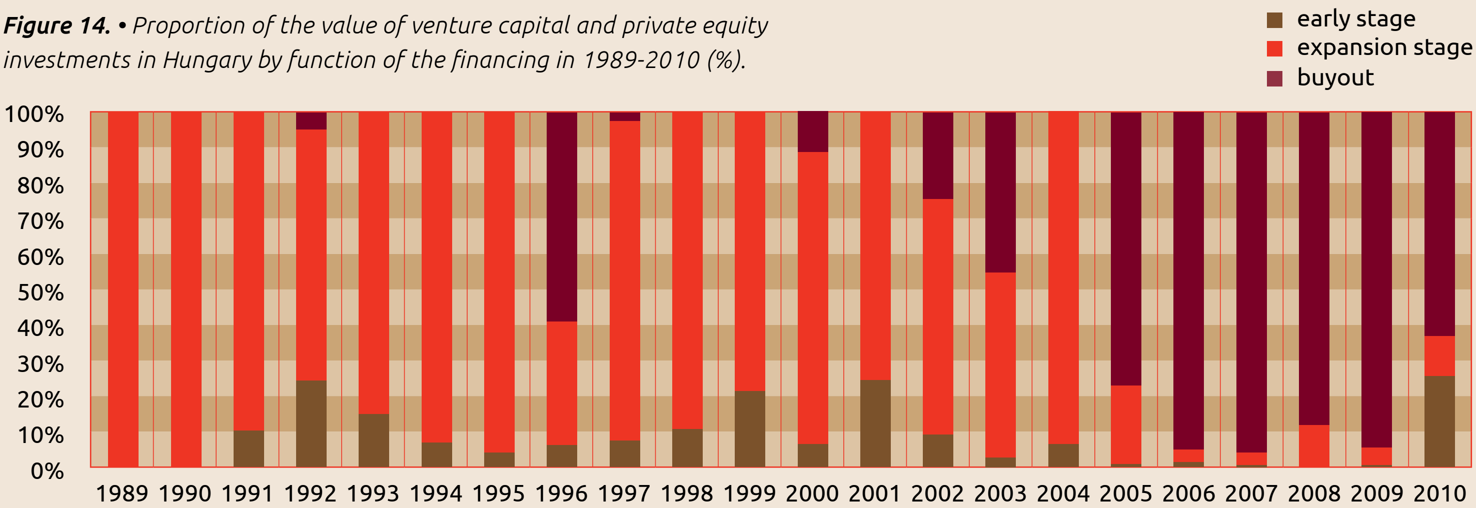
Companies in Hungary did not have equal opportunities to **receive capital investment** due to their various life-cycles. Regarding the respective life cycles of the financed Hungary-based companies – similar to their peers in the CEE region – investment in the **expansive phase** was the **most frequent.** This is also highlighted as expansion phase investments represented approximately 60% of the number of investment deals in Hungary, and approximately 30% of their value. Thus, the value of investments serving the development of businesses was insignificant compared to the capital provided to 10% of the companies for financing buy-outs, which, over the twenty years under review, represented more than two thirds of the investments, i.e. USD 2.5 billion. The proportion of companies aided through venture capital in the early phase represented almost a third of the businesses that received financing. However, investors used a proportionately low amount of capital to fulfill this function, which explains why the capital provided to **start-up** companies did not even reach 5% of the total invested capital. Start-up enterprises typically received **USD 1 million** from their investors, while those in their **expansive** phase received more than **USD 4 million on average. Buy-outs** represented a significantly higher volume than the classical venture capital investments, as the average value of these deals were higher than **USD 66 million** on the Hungarian market, still regarded as relatively low in Europe.

***Figure 13.*** *• Proportion of number of venture capital and private equity investments in Hungary by function of the financing in 1989-2010 (%).*




***Source:*** HVCA

***Figure 14.*** *• Proportion of the value of venture capital and private equity investments in Hungary by function of the financing in 1989-2010 (%).*



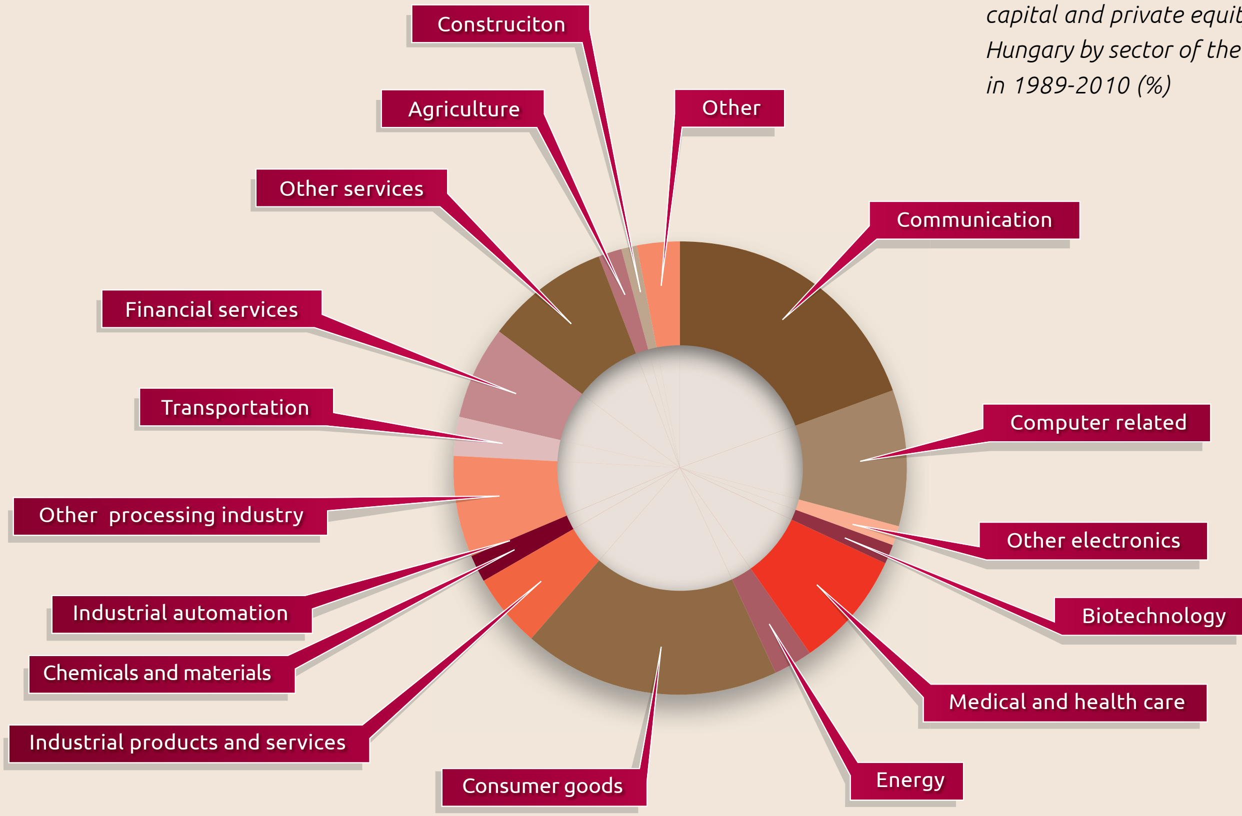

***Source:*** HVCA

Early stage investments were made predominantly in 1992, 2001 and 2010, while the weighting of investment in the **expansive** phase dominated almost continuously until 2004. From there, although these transactions continued to be **the most numerous,** the focus of investments shifted to buy-outs because of the high-value individual buy-out transactions.

The effect of the venture capital and private equity **investments** is that the sectors that received the highest amounts of venture capital and private equity experienced the strongest economic growth. The investments made over the last twenty years were strongly concentrated in **specific sectors,** both in terms of frequency and volume.

***Figure 15.***

*Proportion of the number of all venture capital and private equity investments in Hungary by sector of the investee company in 1989-2010 (%)*



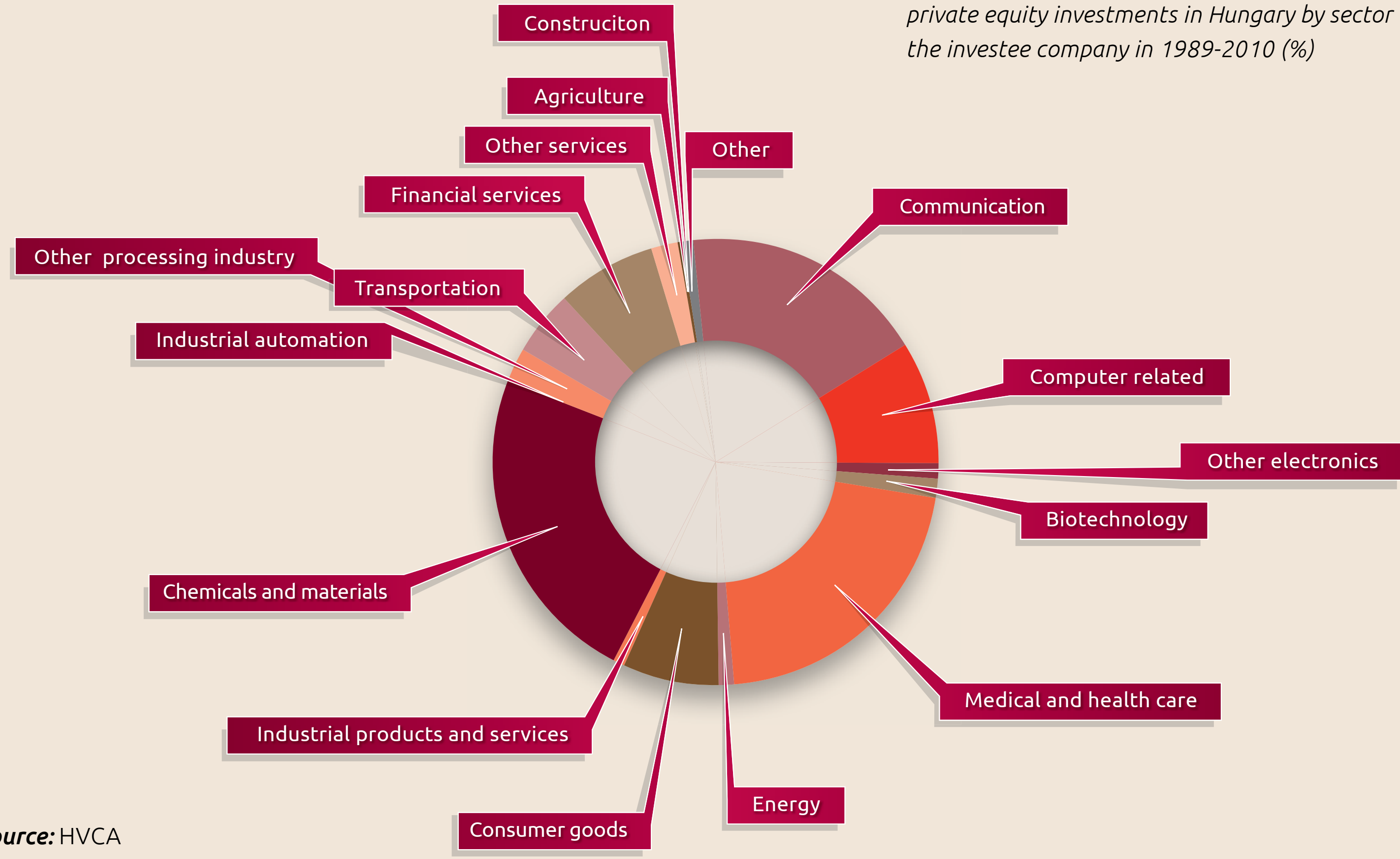

***Source:*** HVCA

In Hungary, over the course of the last two decades, **the highest number of** venture capital and private equity investments made were in the **communication** sector (19.7%) and in the sectors related to the manufacturing and services of **consumer goods** (18.3%). Approximately 40% of all investment transactions were channeled into these two areas.

With regard to the value of investments, an even higher level of concentration is apparent, as almost half of the **value of the deals** carried out in the course of the last twenty years in Hungary have been made up by investments in two distinct sectors, **chemical industry** (25.5%), and **medical/healthcare** (23.4%).

***Figure 16.***

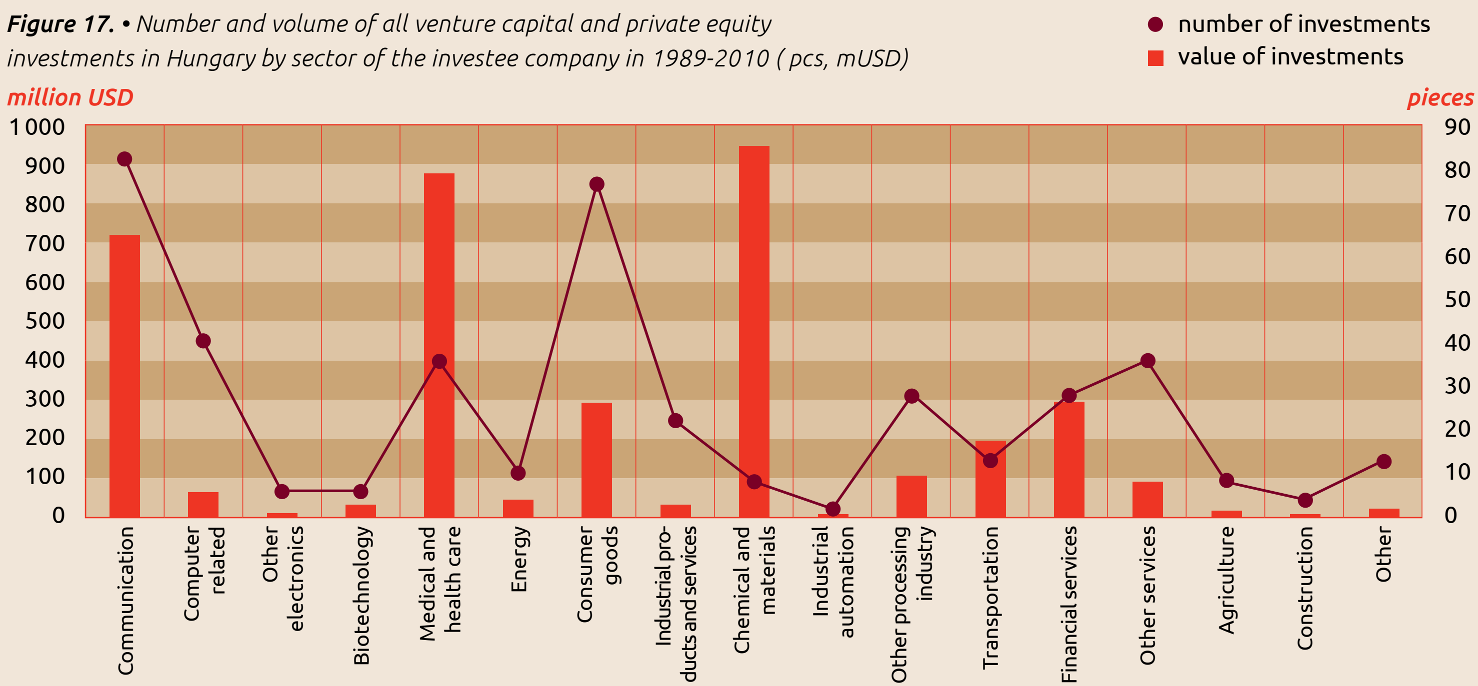
*Proportion of the value of all venture capital and private equity investments in Hungary by sector of the investee company in 1989-2010 (%)*




***Source:*** HVCA

During the two decades under review, the **chemical industry** received cca. USD 950 million in eight deals, meaning that the **average investment value** was an outstanding USD 118 million. The companies operating in the healthcare sector received investments of approximately USD 870 million in 35 transactions, thus in this specific sector the average investment reached USD 25 million. In terms of transaction value, the third highest market sector has been communication. This sector received more than USD 700 million in 82 transactions, thus the average investment size in this area was approximately USD 9 million. Hungarian companies active in consumer goods manufacturing and in the financial services sectors received cca. USD 300 million from venture capital and private equity funds. However, consumer goods manufacturers were granted more investments of the two sectors; approximately 76 enterprises received capital in this sector and were provided with investments of cca. USD 4 million per transaction. Meanwhile, approximately 30 financial services firms received higher value investments per transaction, of more than USD 10 million. The shipping and transportation sector also experienced relatively high value individual deals, where 12 companies received investments of USD 200 million, equal to USD 16.5 million per deal. The average capital investment value in buy-out transactions exceeded the average of the total investments in those sectors, while in the sectors where the enterprises received

***Figure 17.*** *• Number and volume of all venture capital and private equity investments in Hungary by sector of the investee company in 1989-2010 ( pcs, mUSD)*




***Source:*** HVCA

*Table 4.*
*Number, volume and average investment value of venture capital and private equity investments in Hungary by sector of the investee company (pcs, mUSD, %)*

| Sector | Number of investments (pcs) | Number of investments (%) | Investment value (mUSD) | Investment value (%) | Average investment value (mUSD) |
|---|---|---|---|---|---|
| Communications | 82 | 19,7 | 718,5 | 19,7 | 8,8 |
| Computer related | 40 | 9,6 | 65,8 | 9,6 | 1,6 |
| Other electronics | 6 | 1,4 | 7,7 | 1,4 | 1,3 |
| Biotechnology | 6 | 1,4 | 19,6 | 1,4 | 3,3 |
| Medical and health care | 35 | 8,4 | 868,9 | 23,4 | 24,8 |
| Energy | 11 | 2,6 | 38,5 | 1,0 | 3,5 |
| Consumer goods | 76 | 18,3 | 293,5 | 7,9 | 3,9 |
| Industrial products and services | 22 | 5,3 | 29,9 | 0,8 | 1,4 |
| Chemicals and materials | 8 | 1,9 | 946,9 | 25,5 | 118,4 |
| Industrial automation | 1 | 0,2 | 0,6 | 0,0 | 0,6 |
| Other processing industry | 29 | 7,0 | 108,5 | 2,9 | 3,7 |
| Transportation | 12 | 2,9 | 197,6 | 5,3 | 16,5 |
| Financial services | 28 | 6,7 | 289,6 | 7,8 | 10,3 |
| Other services | 36 | 8,7 | 81,1 | 2,2 | 2,3 |
| Agriculture | 8 | 1,9 | 13,0 | 0,4 | 1,7 |
| Construction | 4 | 1,0 | 1,5 | 0,1 | 0,4 |
| Other | 12 | 2,9 | 25,1 | 0,7 | 2,1 |
| Total | 416 | 100,0 | 3 706,4 | 100,0 | 8,9 |

***Source:*** HVCA

mostly venture capital for starting up or at an early phase of their life the average value of the investments was significantly lower.

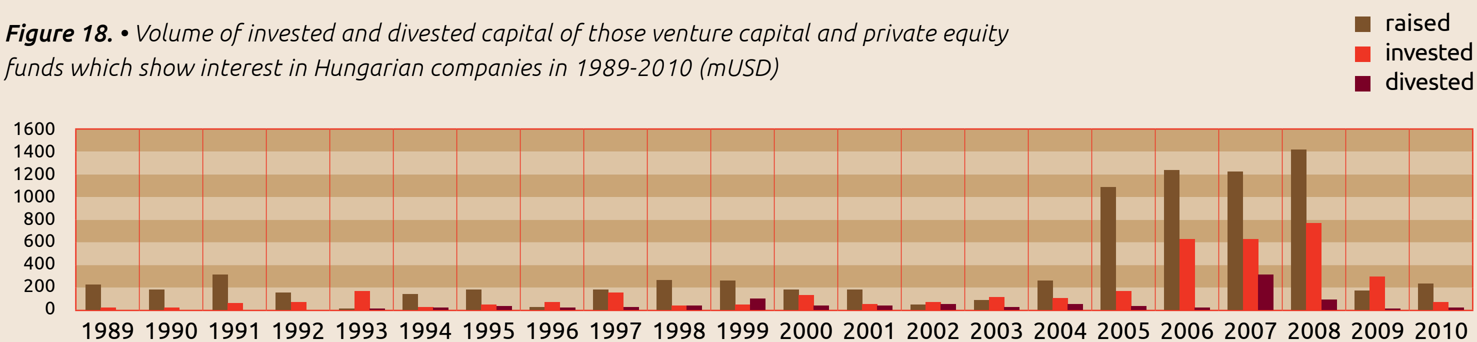
## IV. Capital divestments by venture capital and private equity funds

Over the period of this analysis, the venture capital and private equity funds investing in Hungary exited from approximately 200 investments. The value of these transactions at investment cost amounted to USD 900 million. The changes in the value of **raised, invested and divested capital** generally followed one **another with a one or two-year shift,** i.e. the increase or stop of capital allocation had a delayed effect on the changes of investments. The favorable or deteriorating investment environment also had a similar effect on delayed exits. The success of the exits, would, in turn, affect raising capital in the next cycle.

Annually, there were, on average, 10 exits by venture capital and private equity organizations investing in Hungary-based companies, and the investors sold stocks in the average of USD 50 million USD per year, calculated by the cost of investment. Exits did not take place at even intervals. In the first few years reviewed, no exit was made. Subsequently, the number of exits increased continuously, and stalled only in 2000 at the time the dotcom bubble burst. The value of divestments, in general, significantly exceeded the per year average USD 50 million in the years preceding the break out of the crises, i.e. in 1999 as well as in 2007 and in 2008.

In Hungary, on average, approximately USD 5 million of capital was divested during an exit. However, substantial differences were apparent on closer inspection of the individual **exit modes.** Similarly to the entire CEE market, the highest value exits were **trade sale** exits, averaging at USD 9 million over the period reviewed, which represented more than one third of the number of exits on the Hungarian market, and approximately two thirds in value. Not only were these exits the highest in value, but they were also the most frequent. The secondary

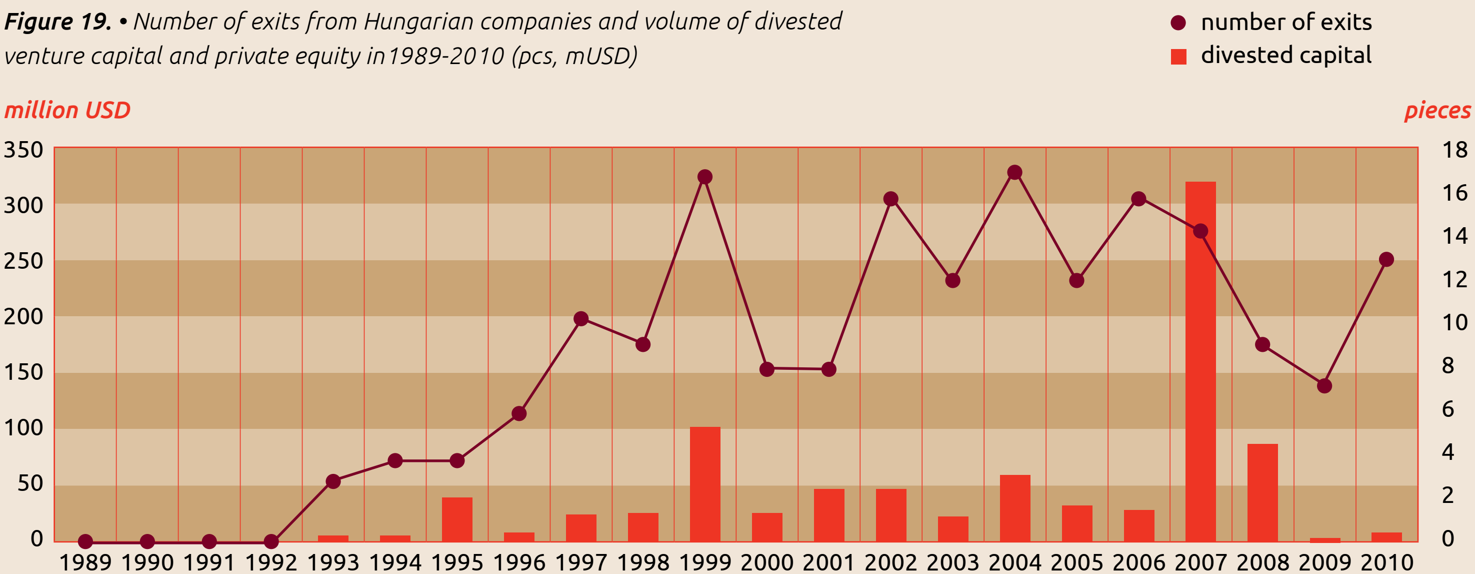
***Figure 18.*** *• Volume of invested and divested capital of those venture capital and private equity funds which show interest in Hungarian companies in 1989-2010 (mUSD)*




***Source:*** HVCA

*Remark: in the case of global funds the survey took into account the amount of the capital managed by the funds only in the volume corresponding to the actual investments as allocated capital. In the case of regional funds the survey calculated with one fourth of the capital handled by the funds interested in making investments in Hungary. In the case of organizations making investments only in Hungary the survey contained the total amount managed.*

***Figure 19.*** *• Number of exits from Hungarian companies and volume of divested venture capital and private equity in 1989-2010 (pcs, mUSD)*




***Source:*** HVCA

sales were made predominantly by private equity investors, where funds sold their shares to **each other,** reaching a similar average exit value (USD 8.5 million). However, the latter transactions that mostly involved the borrowing of loans occurred a lot less frequently, than trade sales, until the latter half of the last decade. Consequently, secondary sales made up only 5% of the exits, and cca. 9% of the total value of exits. The value of **exits by public offering** represented a similar level, reaching USD 5 million on average, occurring in approximately 10% of the exits. In one fifth of the deals, registered in this analysis, were equity shares **bought back** by the **owner-managers** of the concerned **companies,** this type of exit was typically done by government backed organizations. This particular mode of exit only represented approximately 5%. of the total value of divestments due to the lower individual value of the deals, not even reaching USD 1 million.

The proportion of individual types of exit mode varied significantly over the period reviewed, except the **trade sales,** which played a **dominant role almost throughout.** Public offerings were most prevalent in 1999, exits through the repayment of loans in 2004, secondary sales to other private equity funds and sales to financial organizations both in 2008. The roles of MBOs, being the sale of shares to the managers of the concerned companies, were most common in 2007-2008.

## V. Expected outlooks

Over the period surveyed and prior to the 2008 crisis, Hungary's venture capital and private equity industry grew to become one of the leaders of the CEE region. This capital investment sector with regard to the industry players, operation mechanism, function and efficiency, has

*Table 5.*

*Number, volume and average value of venture capital and private equity divestments in Hungary by the exit routes in 1993-2010 (pcs, mUSD, %)*

| Exit routes | Number of transactions (pcs) | Number of transactions (%) | Exit value (mUSD) | Exit value (%) | Average exit value (mUSD) |
|---|---|---|---|---|---|
| Divestment by trade sale | 63 | 34,0 | 569,4 | 63,4 | 9,0 |
| Divestment by public offering | 17 | 9,2 | 80,0 | 8,9 | 4,7 |
| Divestment by write-off | 13 | 7,0 | 27,8 | 3,1 | 2,1 |
| Repayment of the loan | 5 | 2,7 | 21,9 | 2,4 | 4,3 |
| Sale to other private equity house | 9 | 4,9 | 76,1 | 8,5 | 8,5 |
| Sale to financial investors | 4 | 2,2 | 27,5 | 3,0 | 6,9 |
| Sale to management (MBO) | 36 | 19,4 | 43,4 | 4,8 | 1,2 |
| Divestment by other means | 9 | 4,9 | 6,0 | 0,7 | 0,7 |
| Unknown | 29 | 15,7 | 46,5 | 5,2 | 1,6 |
| Total divestment | 185 | 100,0 | 898,7 | 100,0 | 4,9 |

***Source:*** HVCA

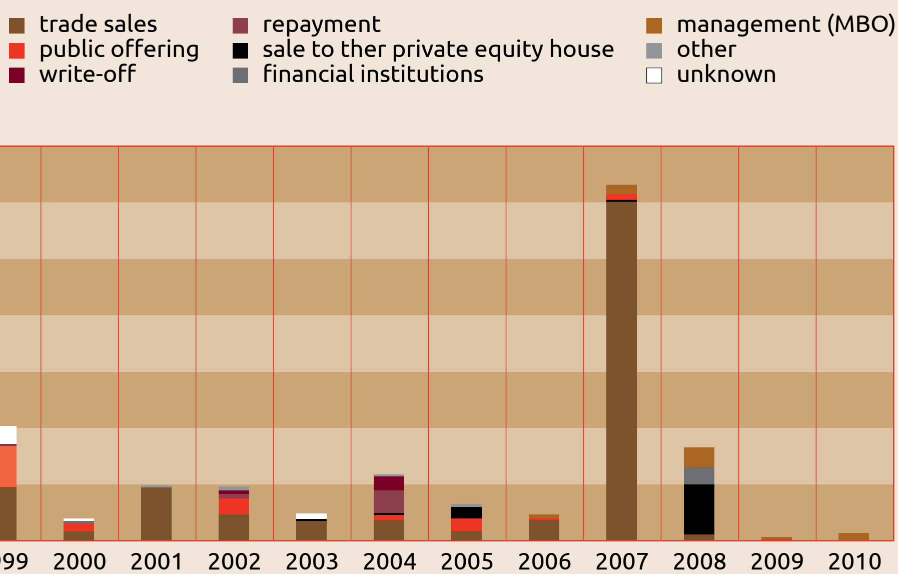
grown to be comparable to the European venture capital and private equity sector. The similarity has manifested in the legal and regulatory environment, with the availability and experience of the investors, as well as the type and structures used in transactions.

In the last twenty years, opportunities for **companies in Hungary to access venture capital and private equity have explicitly improved.** The capital flow in the funds of the CEE region facilitated the growth of private equity investments. The positive effect of the accession to the EU was expected to assert confidence in the longer term, too. It was projected that the JEREMIE funds, set up by using EU resources, would boost classical venture capital investments in Hungary. This may go on to increase the strategic commitment of venture capital investments into technological and knowledge intensive companies. The high-amount of buy-outs were attributed to the developed market, which at the same time also indicated the availability of loans necessary for the transactions, leading to the possibility of structuring deals that are considered normal in developed capital markets. The higher number of exits along with the increased liquidity of the market allowed for new investments.

As a result of the financial and economic **crisis,** the last third of the last decade witnessed a **strong recession** in the venture capital and private equity industry across the world. The decrease in the number of deals reduced the proportion of loans available within the financing structure of investments. The ever more difficult exits from the portfolio companies indicated the **weakening of the sector's position.** In addition, the rate of new investments significantly decreased along with investments considerably decreasing more generally, as the funds were forced to finance the companies already included in the portfolio far longer than they had intended.

As a result of the crisis, the volume of fresh capital raised all over the world by venture capital and private equity funds dropped enormously. Furthermore, the type of funds favored by investors also changed, i.e. instead of the buy-out funds executing mega-transactions, the funds invest into **companies in difficult situations** and plan **smaller size buy-outs.** In spite of the significant amount of uninvested capital accumulated in recent years (dry powder), in CEE the crisis was also very severe. While in the years preceding the crisis, the region became one of the preferred targets for investors, with the increase of risk and the slowing pace of growth within the region, along with the more expensive loans, interest in the region has dropped and global investors that had recently settled in the region were driven away, and

***Figure 20.*** *• Volume of venture capital and private equity divestments in Hungary by exit routes in 1993-2010 (m USD)*




***Source:*** HVCA

made it more difficult to set up new, regional venture capital and private equity funds.

The outlook for the venture capital and private equity market in the CEE region will be determined by investor interest in **emerging markets.** There are positive expectations within the region as the **rates of growth** of all significant economies **in the CEE** are expected to perform **above the average of the Eurozone** in 2011-2012. There are already indications that buy-outs will return to the regional market as, already in the first half of 2011, a number of high-value investment deals were executed or are in the negotiation phase. Primarily, consolidation of large companies and privatization deals will form the majority of deals in the region. In addition to the high number of buy-outs, classical venture capital financing of early stage companies is likely to continue due to the investment potential of the JEREMIE funds receiving EU resources and targeting smaller transactions, start-ups and innovation companies.

The prospects of the Hungarian venture capital and private equity market have been affected by the **aftermath of the world economy recession** and the position of the Hungarian market within the CEE region. In the eyes of potential investors the smaller size of the country, its high-level of indebtedness, the exhaustion of the privatization opportunities, the slow increase of domestic demand, the low liquidity of the stock exchange and the uncertainties felt in economic policies are all unfavorable factors. Nonetheless, the boost in the export markets and the acceleration of economic growth may give momentum to Hungarian venture capital and private equity investments.

Judit Karsai Dr.

# The 2010 results of the venture capital and private equity industry in Hungary

# The 2010 results of the venture capital and private equity industry in Hungary

Dr. Judit Karsai[1]

2010 was a year when the venture capital and private equity sector in Central and Eastern Europe came to a halt due to the economic crisis. While in the first half of the year the fund managers in the region were still busy making their portfolio companies successful together with some lower-value investments, in the second half of the year significant-value exits took place. The first half of 2011 showed the initial signs of prosperity, as the value of the investments made in the region in the first six months reached the total sum of all previous year's investments. As a result of the successful exits the fund managers are now preparing for the market entry of their new funds.

Within the region, the year 2010 development of the Hungarian venture capital and private equity market was characterized by two conflicting tendencies. The high-amount buy-outs determining the value of annual

***Table 1.***

*Annual value, number and average size of venture capital and private equity investments received by Hungarian companies in 2002-2010 (in mEUR and in pcs)*

| Year of the investment | Invested capital (m €) | Number of investment transactions (pcs) | Average investment value (m €) |
|---|---|---|---|
| **2002** | 127 | 29 | 4,4 |
| **2003** | 117 | 32 | 3,7 |
| **2004** | 108 | 41 | 2,6 |
| **2005** | 131 | 26 | 5,0 |
| **2006** | 535 | 39 | 13,7 |
| **2007** | 491 | 26 | 18,9 |
| **2008** | 477 | 25 | 19,0 |
| **2009** | 214 | 12 | 17,8 |
| **2010** | 65 | 19 | 3,4 |

***Sources:*** 2002-2006: HVCA database; 2007-2010: PEREP_Analytics

[1] KARSAI, Judit is a senior research fellow at the Institute of Economics, Hungarian Academy of Sciences, and the chairperson of the Statistical Committee of the Hungarian Venture Capital Association.

investments have practically stopped on the Hungarian market that had to face difficulties due to the crisis and the economic and political uncertainties, while the financing of start-up and early-stage companies started to boom related to the launch of the Jeremie-program. As a result of the two effects different in nature the value of venture capital invested into enterprises in Hungary in 2010 dropped to close to one third of the value of the previous year, while the number of investments increased by more than its half, thus the average value of investments fell back to an order of magnitude that characterized the beginning of the decade.

According to the data of EVCA PEREP_Analytics, the value of the venture capital and private equity invested into companies in Hungary dropped to Euro 65 million in 2010 from the Euro 214 million measured in 2009. The number of investment deals, after a steady decrease for years, dropped to zero in 2010, and the number of investments increased to 19 from the 12 transactions registered in 2009. Out of these in 14 cases it was the first time that the concerned portfolio company received capital from its investor. The average value of investments from the year 2009 Euro 18 million, regarded as relatively high even on the regional level, decreased to Euro 3.4 million in 2010.

## Dominance of innovation

The value and number of classical venture capital investments ensured for the start-up, early stage development and growth of companies was very low in 2009 among Hungarian enterprises, similarly to previous years. This is why it is noted as an important change that in 2010 close to 40% of the value of investments and 80% of their number fulfilled traditional venture capital function in the Hungarian companies. The boom of investments can primarily be attributed to those eight new Jeremie funds set up in the beginning of 2010, which were established through the raising of funds from private-sector investors in addition to community resources. These venture capital funds, after reviewing several hundreds of investment proposals, selected their portfolio companies in a wide scope. Thus,

***Table 2.***

*The investment value and the number of the private equity and venture capital investments in Hungary in 2010, by the life cycle of the investee companies (in mEUR and pcs)*

| Life cycle | Investment value (million €) | Volume of raised capital (%) | Number of transactions (pcs) | Number of transactions (%) |
|---|---|---|---|---|
| **Early stage** | 18 | 28 | 11 | 58 |
| **Expansion** | 7 | 11 | 4 | 21 |
| **Turnaround** | 0 | 0 | 0 | 0 |
| **Replacement** | 0 | 0 | 0 | 0 |
| **Buyout** | 40 | 61 | 4 | 21 |
| **Total** | **65** | **100** | **19** | **100** |

***Source:*** PEREP_Analytics

*Table 3.*
*Value and number of venture capital and private equity investments in Hungary in 2010 by the sector of the investee companies (in mEUR and pcs)*

| Sector | Investment volume (million €) | Investment volume (%) | Number of transactions (pcs) | Number of companies (pcs) |
|---|---|---|---|---|
| **Agriculture** | 0 | 0 | 0 | 0 |
| **Business and industrial products** | 0,2 | 0,3 | 1 | 1 |
| **Business and industrial services** | 0,6 | 0,9 | 1 | 1 |
| **Chemicals and materials** | 3,4 | 5,2 | 2 | 1 |
| **Communications** | 14,8 | 22,9 | 3 | 2 |
| **Computers and consumer electronics** | 2,0 | 3,0 | 2 | 2 |
| **Construction** | 0 | 0 | 0 | 0 |
| **Consumer goods and retail** | 0,2 | 0,3 | 1 | 1 |
| **Consumer services** | 0 | 0 | 0 | 0 |
| **Energy and environment** | 0 | 0 | 0 | 0 |
| **Financial services** | 36,1 | 55,5 | 3 | 3 |
| **Life-sciences** | 4,2 | 6,5 | 4 | 4 |
| **Real estate** | 0 | 0 | 0 | 0 |
| **Transportation** | 3,5 | 5,4 | 2 | 2 |
| **Total investments** | **65,0** | **100,0** | **19** | **17** |
| **Subtotal high-tech** | 17,6 | 27,1 | 5 | 4 |

***Source:*** PEREP_Analytics

among others, they financed a wide variety of domestic companies in start-up or early stage with promising growth from biotechnological development through medical instrument manufacturing, information technology and telecom applications, direct and telemarketing, as well as asset management, industrial automation and warehousing.

The formerly determining role of buy-outs in 2010 reduced among the investments concerning enterprises in Hungary, similarly to the whole region. 2009 buy-outs the buy-outs represented 95% of the value of venture capital and private equity investments in Hungary, in 2010 their value decreased to 62%. The average value of buy-outs in Hungary amounted to Euro 10 million in 2010, and in the case of three out of the four registered deals the equity ratio of the transaction value did not reach Euro 15 million, while one transaction was made in the lower part of the range of Euro 15 and 150 million. In 2010 financial services dominated the deals made public in Hungary, such as, among others, the in-

*Table 4.*
*The volume and the number of divestments by exit routes in Hungary in 2010 (in mEUR and in pcs)*

| Exit routes | Exit value (million €) | Exit value (%) | Number of transactions (pcs) | Number of companies (pcs) |
|---|---|---|---|---|
| Divestment by Trade Sale | 0 | 0 | 0 | 0 |
| Divestment by Public Offering | 0 | 0 | 0 | 0 |
| Divestment by Write-Off | 1,3 | 16,4 | 1 | 1 |
| Repayment of Silent Partnership | 0 | 0 | 0 | 0 |
| Repayment of Principal Loans | 0,1 | 1,4 | 2 | 2 |
| Sale to Another PE Player | 0 | 0 | 0 | 0 |
| Sale to Financial Institutions | 0 | 0 | 0 | 0 |
| Sale to Management (MBO) | 6,7 | 82,2 | 10 | 8 |
| Divestments by other means | 0 | 0 | 0 | 0 |
| **Total divestments** | **8,1** | **100,0** | **13** | **11** |

***Source:*** PEREP_Analytics
*Remark: The exit values in the above table are shown on cost prices*

vestment of Enterprise Investors into Netrisk First Online Insurance Broker Ltd., and the investment of SBI European Fund into CIG Pannónia Life Insurance Ltd.

In 2010, out of the sectors financed by venture capital and private equity investors in Hungary, the financial services sector received the highest-value investment of more than Euro 36 million, as buy-out deals took place mainly in this area. Investors supported the development of communication companies by close to Euro 15 million, which was the second highest amount. Based on the number of investments, this has been for years one of the most popular sectors within the investments made in Hungary, just like in the whole region, although in 2010 the transactions carried out in the field of life sciences slightly overtook deals targeting this sector.

## Increasing number of exits

The increase in the number of exits in 2010 indicated that the effect of the crisis mitigated in Central and Eastern Europe, and within that on the Hungarian market. Sales were made in the region at a relatively high price, and thus contributed to creating confidence necessary for setting up new funds by the investors.

The number and value of exits from Hungarian companies registered in 2009 – compared to an extremely low base – almost doubled in 2010. Exit paths that used to be the most important earlier, such as the trade sale of companies to professional investors and secondary buyouts of private equity funds among themselves, were not included among the registered domestic exits in 2010, unlike in the other parts of the region.

Initial public offering (IPO), the form of exit most preferred by investors, did not occur either on the Hungarian market in 2010. It is true, though, that CIG Pannónia Ltd., shares of which are now owned by ELAN SBI European Fund, was introduced to the BSE, but this only created a potential opportunity for the investor to exit later.

Out of the registered exit transactions, in most exit deals, and in the highest value, the former owner managers of the concerned domestic portfolio companies repurchased shares of their companies. This exit path represented close to 80% of both the value and number of the exits registered in Hungary in 2010.

## Slowly increasing resources

In the venture capital and private equity sector, the effects of the economic crisis first manifest themselves in the area of investments, then of ex-

***Table 5.***
*List of Jeremy funds set up in Hungary in 2010 (in bn.HUF)*

| Fund manager | Fund name | Fund size (bn. HUF) | State resources (bn. HUF) | Private resources (bn. HUF) |
|---|---|---|---|---|
| **Biggeorge's-NV Equity Venture Fund Management Private Limited Company** | Biggeorge's Venture Capital Fund | 4,0 | 2,8 | 1,2 |
| **Central- Fund Venture Capital Fund Management Ltd.** | CenTech New Hungary Venture Capital Fund | 5,0 | 3,5 | 1,5 |
| **DBH Investment Ltd.** | DBH Venture Capital Fund | 5,0 | 3,5 | 1,5 |
| **Euroventures Capital (Etalon Capital) Venture Capital Fund Management Ltd.** | Euroventures IV Venture Capital Fund* | 4,0 | 4,0 | 0 |
| **Finext Startup Venture Capital Fund Management Ltd.** | Finext Sartup Venture Capital Fund | 7,4 | 5,0 | 2,4 |
| **Morando Venture Capital Fund Management Ltd** | Morando Venture Capital Fund | 6,5 | 4,5 | 2,0 |
| **PortfoLion Venture Capital Fund Management Co.** | OTP Venture Capital Fund I | 6,8 | 3,8 | 3,0 |
| **Primus Capital Venture Capital Fund Management Ltd.** | Primus III Venture Capital Fund | 6,2 | 4,3 | 1,9 |

***Source:*** HVCA researches

*Remark: The fund and the private investors contract on the level of the individual investments, they do not have a general contract on the fund level.*

its, and can be felt for the longest in raising new funds. Compared to the pre-crisis period, the size of funds has reduced, and it also takes longer to set them up. In line with that, also the fund managers in Central and Eastern Europe carefully express intention to raise new funds.

As the crisis made it difficult to set up even private sector venture capital and private equity funds in the region, the eight Jeremie funds set up in 2010 ensured favorable conditions for financing innovative Hungarian firms with venture capital in the early phase of their lives.

## Positive outlooks

The outlook of the private equity markets in the Central Eastern European region is mostly determined by the interest of investors in the emerging markets. The positive expectations are also underpinned by the fact that the growth ratio of all important economies of the region is expected to be higher in 2011-2012 than the average of the Euro zone. In the first half of 2011 the fact that a number of high-value investment deals executed or negotiated in the CEE region indicates that buy-outs have returned to the region. The regional pipeline mainly consists of the consolidation of large companies and privatization deals. The venture capital and private equity market has also started to boost in Hungary. It is also indicated by the significant buy-outs concerning two Hungarian companies in the first quarter of 2011. Mid Europa Partners obtained 49.05% shares in Waberer's, involved in road freight transportation, and Advent International purchased the shares of the Permira global fund held in the Budapest based Provimi Pet Food, a pet food manufacturer for Euro 188 million. In addition to high-amount buy-outs, it is also likely that the traditional venture capital financing of companies in early phase will also dynamically continue, as the Jeremie funds set up in 2010 plan a number of smaller-amount capital investments in the near future.

The intensifying of the market is also anticipated in the area of exits. Among the exits announced at the beginning of 2011 the sale of the dialysis unit of Euromedic to Fresenius Medical Care for Euro 485 million deserves particular attention. The deal also involved the partial exit of the three major global private capital funds - BAML Capital Partners, Ares Life Sciences and Montagu Private Equity - owning Euromedic. It was also announced in the very beginning of 2011 that Wanhua Industrial Group took over control over BorsodChem, owned by Permira and Vienna Capital Partners since 2006, in a transaction of the total amount of Euro 1.2 billion. Wanhua Industrial Group already participated in the restructuring of BorsodChem back in 2010.

A Decade of LBOs in Hungary

Recent study shows Hungary having a competitive PE/VC investor environment with room to develop in critical areas

Allen & Overy in Hungary

Enterprise Investors Invests in Hungarian Success Story

Is there life under 5 million EUR?

# A Decade of LBOs in Hungary

Not so long ago it wasn't possible to execute a leveraged buyout in Hungary; quite simply leverage wasn't really available for such transactions on terms and conditions which made sense and the tax and security structures for executing LBOs were largely untested.

One of the first sizeable buyouts to complete in Hungary, and perhaps even the CEE region, was our acquisition in 2003 together with GMT Communications Partners of fixed line telecom operator Vivendi Telecom Hungary (subsequently renamed Invitel). Since then Hungary has reliably delivered one large private equity deal in almost every one of the subsequent years. In so doing it has punched well above its weight in terms of the value of leveraged finance transactions completed as a share of total CEE deals.

***Table 1.***
*Major Hungarian LBOs*

| Target | Year | Value | Acquirer |
|---|---|---|---|
| **Vivendi Telecom Hungary** | 2003 | EUR 325m | Mid Europa / GMT Communications |
| **Fibernet** | 2004 | USD 72m | Warburg Pincus |
| **Euromedic** | 2005 | EUR 120m | Warburg Pincus / GE Healthcare |
| **Borsodchem** | 2006 | EUR 1.1bn | Permira / VCP |
| **Euromedic** | 2008 | EUR 860m | Merrill Lynch / Ares Life Sciences / Montagu / Management |
| **Invitel** | 2009 | EUR 675m | Mid Europa |
| **Provimi Pet Foods** | 2011 | EUR 188m | Advent |

The Vivendi Telecom deal was negotiated throughout the course of 2002 as its parent Vivendi Universal sought to pay down debt following the bursting of the TMT bubble. In what was still a very difficult financing market this deal was made possible by paying down and rolling over an existing bank facility led by BNP Paribas, CIBC, Dexia and the EBRD. Subsequently Invitel was refinanced twice through the European High Yield markets returning almost three times the original amount invested before its sale in 2007 to HTCC, the local subsidiary of private equity owned Danish telecom operator TDC.

In 2004 Warburg Pincus then acquired CATV operator Fibernet from Argus Capital Partners in what was one of the first secondary transactions to take place in the CEE region with financing from Raiffeisen Bank. Fibernet expanded in Hungary and abroad via acquisitions which were supported by its lenders through several refinancings. Ultimately the group was broken up with the Hungarian operation being acquired by Invitel in 2010 as part of the ongoing consolidation of the country's telecoms sector.

Warburg Pincus was active on the market again the next year with its acquisition of Euromedic, a Hungary based European diagnostic imaging and dialysis services provider, which was supported with financing from ING and UniCredit. The Company grew rapidly through acquisitions supported by its lenders and was sold in 2008 in a deal that reportedly returned its investors three times their investment.

In 2006 Permira acquired chemicals producer Borsodchem in one of the few EUR 1bn+ deals to have taken place in CEE as well as one of the first significant public-to-private transactions and an example of the increasing interest of the large European PE firms in the region. The €1.15bn financing was arranged by HSBC, Lehman Brothers, Royal Bank of Scotland and UniCredit. Ultimately the economic downturn caused the financial performance of the Company to suffer but the deal was successfully restructured which resulted in Wanhua of China taking full control in 2011.

In October 2008, Euromedic traded again in what was then effectively a €860m tertiary buy-out by Merrill Lynch Global Private Equity and Ares Life Sciences with €428m of senior debt facilities arranged by Bank of Ireland, ING and UniCredit. This was one of the last large buyouts to close before markets shut down following the Lehman Brothers bankruptcy.

Invitel, now transformed through the merger with HTCC and the acquisitions of Memorex Austria and Tele2 Hungary, traded again in 2009. The Company had funded its acquisitions through debt facilities and entered the financial crisis significantly over extended as valuations fell and the availability of financing shut down. Mid Europa was able to acquire control of the Company through a complex series of transactions involving an acquisition of shares from TDC, the rollover of existing bank facilities and a series of tenders for the publicly traded debt at a discount to par. The Company was then refinanced through the European High Yield markets in one of the first senior secured bonds by a CEE issuer.

More recently in March 2011 Advent International announced that it had agreed to acquire Provimi Pet Food, a leading European manufacturer of pet food headquartered in Hungary from Provimi Group, a leader in animal nutrition owned by Permira, for an Enterprise Value of €188 million. The acquisition debt is arranged by Erste Group Bank, Raiffeisen Bank International and UniCredit. The deal is an interesting example of how the European PE groups can be both a competitor to the local industry as well as a provider of local and regional deal flow as they spin-off non-core divisions of much larger businesses.

As 2011 draws slowly to a close the economic outlook once again remains uncertain and deal activity is subdued after a wave of activity that kicked off in the fall of 2010 and drew to a close in Q2 2011. On the basis of the track record of the last 10 years there are nonetheless good reasons for optimism that Hungary will continue to remain a key source of mid to large sized deals for the CEE LBO industry. Certainly we at Mid Europa fully intend to remain at the heart of that industry and remain open for business and in active pursuit of the next large Hungarian LBO.

Mid Europa Partners is a leading independent private equity investment firm focused on Central and Eastern Europe, with approximately €3.2 billion of funds raised and managed since inception.

MID EUROPA PARTNERS

**Craig Butcher**
Senior Partner

# Recent study shows Hungary having a competitive PE/VC investor environment with room to develop in critical areas

Hungary ranked strong within 80 countries examined as part of a study sponsored by Ernst & Young to identify a country's attractiveness for venture capital and private equity investments.

Ernst & Young sponsored a comprehensive international study[1] to analyze the factors that make a country attractive for venture capital (VC) and private equity investors (PE) and to measure this attractiveness based on a composite index reflecting the selected macro-economic factors. The resulting Global Venture Capital and Private Equity Country Attractiveness Index is based on selected criteria of the institutional investors' international VC and PE allocation. The study measured 80 countries on five continents, out of this 18 are from Eastern Europe. Hungary ranked 40th, exactly in the middle of the surveyed cluster of countries. Mostly Western European and other OECD countries ranked before Hungary, and mainly other Eastern European and developing countries ranked behind. Based on the index, the United State provide the most attractive environment for VC and PE, followed by the UK and Canada. What makes Hungary and the rest of Eastern Europe attractive are mainly the tax environment (12) and the deal opportunities (30) where this region mainly lags behind is the economic activity (58), the depth of capital markets (49) and the human-social environment (51).

***Table 1.***
*Table provides the ranking for Hungary, comparing 2011 to 2007 (date of previous survey)*

| | 2007 | 2011 | | |
|---|---|---|---|---|
| | Rank | Value | Rank | |
| **VCPE Ranking** | 43 | 52,0 | 40 | ▲ |
| **Economic Activity** | 49 | 68,1 | 58 | ▼ |
| **Depthof Capital Market** | 46 | 36,2 | 49 | ▼ |
| **Taxation** | 16 | 108,7 | 12 | ▲ |
| **Inv. Prot. / Corp. Gov.** | 35 | 66,4 | 38 | ▼ |
| **Human / Social Env.** | 53 | 49,2 | 51 | ▲ |
| **Enterpr. Cult. / Deal Opp.** | 32 | 56,7 | 30 | ▲ |

According to the result of the survey, from the Central-Eastern European region Poland (36), the Czech Republic (37) are the countries that are more attractive for VC and PE from a macro-economic pro-

[1] The second edition of the Global Venture Capital and Private Equity Country Attractiveness Index presented by IESE Business School in cooperation with EMLYON Business School (sponsored by Ernst & Young) in 2011 seeks to measure the attractiveness of countries for investors in venture capital (VC) and private equity (PE) limited partnerships.

***Table 2.***
*Hungary's improvement (compared to countries in the region)*

| | 2007 | 2011 | | |
|---|---|---|---|---|
| | Rank | Value | Rank | |
| **Poland** | 35 | 57,4 | 36 | ▼ |
| **Czeck Republic** | 34 | 55,0 | 37 | ▼ |
| **Turkey** | 31 | 52,8 | 39 | ▼ |
| **Hungary** | 43 | 52,0 | 40 | ▲ |
| **Slovenia** | 45 | 46,8 | 45 | ▶ |
| **Estonia** | 41 | 44,8 | 49 | ▼ |
| **Bulgaria** | 50 | 44,1 | 51 | ▼ |
| **Croatia** | 55 | 43,4 | 52 | ▲ |
| **Romania** | 47 | 41,0 | 60 | ▼ |

spective than Hungary. Hungary ranks before Slovenia (45), Bulgaria (51), Croatia (52) and Romania (60), based on this measure. Interestingly, Hungary and Croatia are the only countries in the region that improved their ranking between 2007 and 2011. This is mainly due to the improving tax environment. The decisive factors that render a country attractive and the determinants of vibrant VC and PE markets have been extensively studied. As a result, six key drivers for the attractiveness of a country from a VC and PE perspective have been identified, listed in order of importance:

1. depth of the capital market
2. entrepreneurial culture and deal opportunities
3. economic activity,
4. investor protection and corporate governance
5. human and social environment, and
6. taxation.

The combination of all these factors need to be improved in parallel to increase VC and PE attractiveness of countries and regions. The Global Venture Capital and Private Equity Country Attractiveness Index cover all the six key drivers and for a country to receive a high index rank, it needs to achieve a high score on all of the individual criteria. Below are the six key drivers discussed in more detailed, with reference to Hungary noting the critical; areas for improvement.

## 1. Importance of the depth of the capital market

There are major differences between bank-centered and stock market-centered capital markets. Well-developed stock markets, which allow investors to exit via IPOs, are crucial for the establishment of vibrant VC/PE markets. In general, bank-centered capital markets show less ability to produce an efficient infrastructure that supports VC/PE deal-making. It is not merely the strong stock market that is missing in bank-centered capital markets; it is also the secondary institutions, including the bankers' conservative approach to lending and investing, and the social and financial incentives that reward entrepreneurs less richly (and penalize failure more severely), that compromise entrepreneurial activity. IPO activity is the main force behind cyclical swings because it directly reflects the returns to the VC/PE funds. Risk capital flourishes in countries with deep and liquid stock markets. Likewise, the capitalization of stock markets or the number of listed companies as a measure for stock market has a significant impact on VC and PE investments. Alongside the disadvantages of bank-centered capital markets, low availability of debt financing is an obstacle for start-ups in many countries. Entrepreneurs need to find backers – whether banks or VC/PE funds – who are willing to bear risk.

Hungary lacks size, liquidity and general market activity in the stock market-centered capital markets. Government intervention is required in the form of refreshing the Capital Markets legislation to encourage the growth and participation in the Hungarian capital markets.

## 2. Importance of entrepreneurial culture and deal opportunities

The expectation about access to viable investments is probably the most important factor for investors' international risk capital allocations. Especially for the early stage segment the number of potential investments is related to the research output in an economy. Both industrial and academic research and development (R&D) expenditure significantly correlates with VC activity. The number of both R&D employees and patents, as an approximation of the human capital endowment, has a positive and highly significant influence on VC activity. Furthermore, start-up activity interacts with the R&D capital stock, technological opportunities and the number of patents. Without sufficient R&D activity it will be impossible for established businesses to create or maintain market positions with strong products and brands, which, once established, attract private equity investors. Despite the innovative output of a society, bureaucracy in the form of excessive rules and procedural requirements, multiple institutions from which approvals are needed and cumbersome documentation requirements, may severely constrain entrepreneurial activity. The time and money required to meet such administrative burdens may discourage new venture creations. Hungary ranks well and within the second quartile for innovation, corporate R&D and scientific and technical research, however, there is room to improve in simplifying the rules and regulations around starting and running a business.

## 3. Importance of economic activity

Intuitively, the state of a country's economy affects its VC/PE market activity. An economy's size and employment levels are also proxies for prosperity, the number of its local corporations and entrepreneurial activity, and hence, also for expected VC and PE deal flow. Capitalizing on economic growth requires investments and provides a rationale for institutional investors to enter into certain countries. VC/PE activity is cyclical and significantly related to GDP growth. Economic prosperity and development facilitates entrepreneurship, as it provides a greater accumulation of capital for investments. The ease of start-ups is expected to be related to societal wealth, not solely due to the availability of start-up financing, but also to higher income among potential customers in the domestic market. Hungary unfortunately did not feature well within the 80 countries surveyed in this category, with medium-term real GDP growth pulling the country down, ranking it 74th from the survey population.

## 4. Importance of investor protection and corporate governance

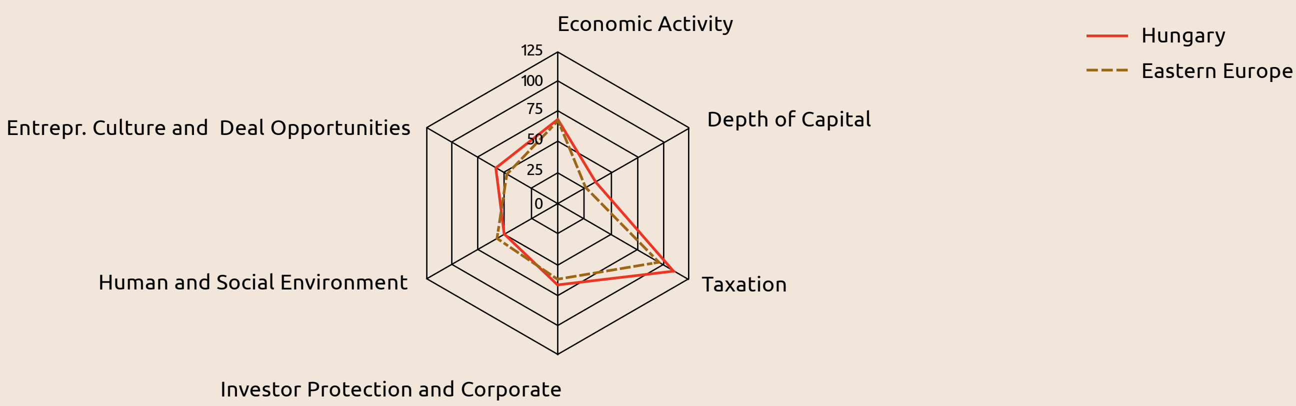
Legal structures and the protection of property rights strongly influence the attractiveness of a national VC/PE market. Legal environment determines the size and extent of a country's capital market and local companies' ability to receive outside financing. The quality of a country's legal system is more closely related to facilitating VC/PE backed exits than the size of a country's stock market. The cross-country differences in legality, including legal origin and accounting standards have a significant impact on the governance of investments in the VC/PE industry. Fairness and property rights protection largely determine the growth and emergence of new enterprises. Weak property rights limit the reinvestment of profits in start-up companies. Hungary ranks well in terms of security of property rights (28th) but has room to develop in the quality of its legal enforcement (40th) and can improve in its approach to corporate governance matters (48th). All measures deteriorating since the 2007 survey.

## 5. Importance of human and social environment

Cultures shape both individual orientation and environmental conditions, which may lead to different levels of entrepreneurial activity. In order to foster a growing risk capital industry, the research culture with respect to universities and national laboratories plays an important role. Rigid labor market policies negatively affect the evolution of a VC/PE market. It is especially important for start-up and medium-size corporations to respond quickly to changing market conditions. Labor market restrictions influence VC/PE activity, though not to the same extent as the stock market. The highest barriers and costs are associated with corruption, crime, a larger unofficial economy and bureaucratic delay. It should be noted that this argument is probably of particular importance in some emerging countries with perceived higher levels of corruption. The survey shows that Hungary ranks in the second quartile for education and human capital (33rd, an improvement of the 2007 results where it ranked 42nd) together with attitude to bribing and corruption issues (38th), while very poorly in respect of labor market rigidities (76th).

## 6. Importance of taxation

Tax regimes matter for business entry and exit, direct and indirect taxes affect entrepreneurial activity. Taxation incentives drive the advantages to becoming an entrepreneur. Hungary provides for an attractive taxation system for both corporations and individuals. This is backed by the Hungarian Government being committed to maintaining the competitiveness of the country by having a stable tax environment. The corporation tax rate is 10% up to EUR 1.8million tax base, whilst it is 19% above. Full participation exemption is available, dividend income is tax exempt, capital gains are also fully exempt if the availability criteria are met. The benefits are limited if controlled foreign corporations are involved in a transaction. 50% of royalty income is also exempt which attracts a great level of IP transactions. Various tax credits and R&D incentives are available for all corporations. Hungary has a wide range of double tax treaties. There are no withholding taxes levied on any payments from Hungary to any countries. Hungary introduced a flat 16% personal income tax rate as of 2011 and gradually decreases the amount and rate of employment related contributions. All these steps from the Hungarian government has allowed Hungary to be ranked in the top quartile at number 12 of the population surveyed. This is an improvement on the 2007 ranking, where it was ranked 16th. See chart above, showing the key factors for Hungary, 100 being United States ranked top of the 80 countries surveyed.



Another recent study prepared by Ernst & Young[2] clearly demonstrates that PE investment has long reaching benefits.

In addition to constantly delivering solid returns to its shareholders, it has proven to be a contributor to the growth of the GDP and the economy at large. It has shown to have accelerated growth through responsible investments, choosing the right markets to grow revenue organically and in the execution of strategic and operational improvement in its portfolio companies. All of these factors have resulted in returns that have outperformed public markets and allowed productivity, employment and EBITDA growth.

It is a fair conclusion, based on the findings of both studies that PE and VC have shown to contribute to the development and growth of an economy; however there are certain factors that the economy must possess to make itself attractive to these types of investors.



**Balázs Tüske**
Partner, Ernst & Young
Tranzakciós Tanácsadási Szolgáltatások

[2] Return to warmer waters – How do private equity investors create value? A study of 2010 European exists

# Allen & Overy in Hungary

Allen & Overy opened its Budapest office in 1993, so just like the HVCA, we will be celebrating our 20th anniversary shortly. With offices in Bratislava, Bucharest, Prague and Warsaw, Allen & Overy remains one of the most important players in the legal market in Central and Eastern Europe. The CEE region is a key market for us and, unlike many other law firms, we remain committed to maintaining a long-term presence, as evidenced by the location of our regional leveraged finance team in Budapest.

The M&A landscape in Hungary has evolved over the last 20 years from the privatization era to the emergence of local, regional and international private equity houses and leveraged finance in the market to the re-appearance of trade buyers and rising interest from investors in Asia.

In the 1990s and early 2000s in Hungary (and indeed across Central and Eastern Europe) the privatization of state-owned enterprises such as banks was the dominant source of work. Investor appetite was high with the belief that the many inefficiencies inherent in state-owned enterprises could be stripped out of the businesses. Different approaches were taken with companies such as MOL, TVK, and FHB mortgage bank, choosing to go public in high profile IPOs. Others such as Postabank were seen as ideal targets for other regional private banks. Allen & Overy were the law firm of choice to act on these and many other privatizations.

The private equity boom of the early to mid 2000s around the world was repeated in Hungary, even attracting the bulge bracket investors from the US and UK. Deals such as Fibernet and Euromedic were well received by investors and bankers alike and have kept those involved (including Allen & Overy) busy for a number of years. Whilst the number of private equity led transactions has slowed in the last 2 or 3 years, transactions such as Provimi pet foods have completed. On the whole, despite the emergence of some very aggressive structures in Western Europe, most leveraged financing structures in Hungary remained within sensible limits.

Despite the global crisis, M&A has continued and we have started to see the return of trade buyers and greater investment interest from Asia. In early 2011, Allen & Overy completed the acquisition of certain cable TV assets from Fibernet by Liberty Global International and assisted Wanhua, the Chinese industrial company, in acquiring BorsodChem from Permira. Chinese and Indian investors are known to be looking at other assets in Hungary and across the CEE which may provide ideal opportunities for private equity funds looking to exit.

With the continuing difficulties in the financial world, the future for M&A in Hungary remains uncertain. Many market participants comment on a lack of decent businesses or a lack of willing sellers or management for private equity investment which would suggest that the prospects for new primary transactions are relatively low. However, with many PE funds still holding significant amounts of cash in their funds and with interest from trade buyers increasing, we may see more exits from existing deals. Either we trust that Allen & Overy will continue to be the leading player in the market in Hungary and across the region.

ALLEN & OVERY

Allen & Overy is an international legal practice with approximately 4 750 staff, including some 480 partners, working in 39 offices worldwide. Our Budapest office consists of 25 lawyers including two resident partners.

**James Graham**
Partner, Head of Central European English law banking and finance group

# Enterprise Investors Invests in Hungarian Success Story

Enterprise Investors (EI) is the oldest and one of the largest firms managing private equity and venture capital funds in Central and Eastern Europe. The firm has been investing in the CEE region for over 21 years, since it was established in 1990. As a result, EI has acquired deep experience in the markets of the entire region through having completed investments in over 120 companies. EI's operations started in Warsaw, which continues to comprise the majority of its investment team, but over the past years the company has also successfully established offices in Bucharest, Bratislava, Prague, and Budapest. Given the increasing importance of regional expansion, EI's physical presence in the five largest markets in the region is of huge benefit to its portfolio companies.

EI puts great emphasis on building close partnerships with the founders and owners of companies it plans to invest in. As a consequence, those individuals often take part in the management of the company post-investment as co-owners and/or members of the management board. EI's business philosophy centers on the idea that the founders have profound knowledge of their company and can therefore greatly facilitate further development.

## Netrisk.hu: A Hungarian Success Story

As its first investment in Hungary, (in 2010) EI acquired an 80 per cent stake (governing majority) for EUR 23 million in Netrisk.hu, Hungary's leading online insurance broker, in what has been the largest investment in the country's online sector so far. EI's main objectives are to further extend the product range and to expand Netrisk.hu in the CEE region.

EI considers Netrisk.hu an attractive investment primarily because it sees great potential in retail online services. Moreover, the e-commerce market in Hungary is developing in all segments of the market (auctions, price comparison for goods, price comparison for insurance/ financial products, classifieds for real estate/cars/jobs etc.), with each being led by one strong player. Netrisk.hu is the leading online insurance broker and the number two player on Hungary's e-commerce market overall. The company has a highly successful business model that generates income on both newly generated and prior contracts and is based on a service that is free of charge, simple to use, and continuously available.

Netrisk.hu is led by a new, expanded management that was formed as the first step in EI's strategy to develop the enterprise further. Thanks to the team's efforts, Netrisk.hu grew by over 80 per cent between June 2010 and June 2011 in terms of visitor numbers, and the number of active contracts increased by over 40 per cent in the six months up to June 2011. As a result, 20 per cent of Hungary's car owners now hold compulsory and/or private car insurance purchased through Netrisk.hu.

Since investing in Netrisk.hu, EI has also overseen initial extension of the product range as well as the beginnings of its regional expansion, with Netrisk.hu now providing services in Romania too (under the name asigura.ro). The company plans to enter further key foreign markets, starting with two new markets in 2012.

In line with EI's investment program involving company founders, a key part of the Netrisk transaction was to keep the founder of the company involved post-investment. The founder of Netrisk.hu sits on the board of directors, thus taking part in the management of the company as a continuing co-owner.

EI generally looks for companies with strong, organic growth and with exceptional brand value and/or market position. EI looks forward to further building its portfolio of successful enterprises, both in Hungary and in other countries of the CEE region.

Enterprise Investors

Enterprise Investors is the leading firm managing private equity and venture capital funds in Central and Eastern Europe. Since inception EI has raised 7 funds with combined capital in excess of EUR 1.7 billion. Private equity and venture capital funds managed by Enterprise Investors have invested more than EUR 1.4 billion in 122 companies in Poland and the CEE region, and have exited 93 investments with proceeds of EUR 1.6 billion.

**Thomas Tuske**
Country Director

# Is there life under 5 million EUR?

Over the past 10 years until the break-out of the present crisis, the average volume of equity involved transactions in the Hungarian market was continuously growing, market actors (investors, legal advisors, consultants) got used to bigger deals. And what is the situation with smaller projects of less than 5 million EUR? Is there or will there be any need for such volume of financing? Is there any elaborated response, solution in the venture and private equity market for this need? Why will it be interesting for investors? How should we prepare ourselves in the forthcoming years regarding smaller projects? In my opinion, we need to consider financing claims under 5 million EUR, too.

In order to defend my statement, let us have a look at potential answers for the questions listed above...

## Is there or will there be any need for smaller volume of financing?

In the past few years, there have been numerous solutions for Hungarian companies to finance their projects (and it is also true for the whole CEE region). Only a quick phone call to the account manager at the bank and the credit line just got doubled. From 2004 on, EU subsidies flooded Hungarian enterprises, several thousands of billions of HUF was available for their growth and development projects. Then the crisis has rearranged the rules of the financing market, bank loans have almost disappeared and although everyone would like to believe that it will be a real option again to turn to the banks for financing projects, in reality it is still not likely. Few weeks ago bank directors were questioned in a survey: is there any change planned in the corporate lending policy of the banks? Responders showed more openness in the field of lending as opposed to previous polls, 80% of them would already like to open financing solutions for the operation of enterprises, but only 30% expect more activity regarding project financing. In addition, there are some who dare to say that there will be more restrictions foreseen in corporate lending. Banks' reluctance in this field affects mostly the SME sector. Therefore I do not recommend enterprises to count on exclusively their banks when it comes to external financing.

What is the situation currently with EU subsidies? The EU wanted us to catch up by 2013, as a recently joined member state, but from 2014 there could be a new world order in this respect, as well. Although the planning process of the new budgetary period of 2014-2020 is not yet finished, restructuring is surely coming. Chances are good that the role of non-refundable subsidies will be reduced and refundable sources will step on the stage, which will manifest in the form of loans or equity. Subsidy will cease to be an automatic solution, companies surely need to look for new channels. Unfortunately, on the other hand, companies' own financial resources are also decreasing, so the importance of borrowed capital will be multiplied!

What can be expected is that the number of enterprises will increase year by year who look for the opportunity for growth, expansion and development in venture and private equity (and in other similar instruments). Thus, the biggest growth will be experienced in the volume under 5 million EUR, since EU or bank fundings will gradually disappear from exactly this segment. So the market has to be ready for it.

## Has the market any solution for this? Why will it be interesting for investors?

First of all, the main question is whether there is any fund which looks for such projects. There are many reasons why I would answer this question with a definite yes. In the budget of the EU the so-called innovative financial means (e.g. JEREMIE programme) are to be put to the forefront. In addition, it is also declared in the parliamentary proposal that there will be more resources allocated to venture capital type of instruments. One way to do this is that these financial instruments will be allocated to the funds already present at the market (moreover, in the proposal cross border funds are mentioned!).

Regulations might also face some changes. Not so long ago (in August 2011) the EVCA (European Private Equity and Venture Capital Association) sent its comments and reflections regarding the consultation on "New European regime for Venture Capital" to the European Commission. The Commission's intention is to favor SMEs, thus if their goals can be realized, there will be a more advantageous environment, for example for the so-called small funds. This is to be one of the declared aims of the consultation in progress.

In fact, if there will be a more advantageous environment for the small funds and – in addition – these funds could receive EU co-financing and guarantee schemes, then the previously difficult fundraising would become a more realistic option when it comes to financing smaller projects.

Let us not forget: investors and funds know very well that the biggest yields in history have always been realized during the recovery from a recession. Therefore there will be projects at a "good price" in the forthcoming years! Of course, a certain shift from traditional solutions will be necessary: strategic partners can come to the forefront among financing institutions, but for example there are more and more examples for syndication, too, where funds invest together in smaller projects as a "club". It serves not only risk-sharing purposes, but also to benefit from the partners' know-how or to utilize the synergies between the portfolio companies of the funds to create an even higher added value.

This should also be discovered by state development policy-makers and they should also listen to the needs of the capital sector, especially if there is or will be any imbalance between the demand of enterprises and the resources ensured by the market.

## What should we expect?

If we accept that demand will significantly increase (both in Hungary and in the neighboring countries), then we have to be prepared for this growth.

If we have any claims towards the state, we need to make it transparent, we need to articulate it! Development policy makers and legislators have to recognize, too, the tendencies and to shape the environment accordingly.

Consultants, legal advisors also need to adapt their activities to smaller transactions; they need to set up standards, processes and tools for such projects. Consultancy fees, which are usual for a mid-market deal, cannot be applied for these projects. I would add that with nominally smaller fees it is not impossible to make profit, either.

We should also learn from the experiences of the JEREMIE programme, learn how to validate efficiently a business model, how to simplify due diligence, what kind of defects the enterprises' concepts have, what worked and what did not work.

In addition, the whole industry should offer a helping hand to (partly) government controlled VC funds. They are preparing for hundreds of deals; certainly they would welcome the experience, while enterprises need to be educated, educated, and educated. Financing of smaller projects will only be viable, if enterprises understand what kind of business private equity is interested in, what motivations drive investors, if companies are not surprised by the rules of the market, if transparency is increasing, if they understand that beside introducing their products or services to the Hungarian market, they should develop an internationalization strategy at the same time! In other words: if good projects are available and the transaction itself can be smooth. In this way, projects of smaller volume might be interesting, as well.

Enterprises need to take advantage of the circumstances: they need to search for gaps on the market confused by the crisis. Media needs to be involved in the 'education' process, myths need to be pulled down ('any idea can get a few million dollars'); in order to achieve this, we need conferences, workshops, which are conducted and led by the sector. If there will be no solutions, quick processes reflecting the upcoming needs, then the consultants, funds will waste a lot of time and energy in vain and in extreme cases undesirable actors and solutions will show up – malfunctions of the market, demolishing the entire industry built up in the last 20 years. But the most important is that the market would miss a great chance by dismissing the smaller transactions, not to mention that unrealized developments, wasted technologies and not created new workplaces have a negative effect on current investments, too.

Personally I am confident that more and more players are ready to conduct the necessary changes and more and more agree that there is life under EUR 5 million, too!

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**DEFINITIONS**

**Syndication:** A group of venture capitalists jointly investing in an investee company.

**Due diligence:** For private equity professionals, due diligence can apply either narrowly to the process of verifying the data presented in a business plan/sales memorandum, or broadly to complete the investigation and analytical process that precedes a commitment to invest. The purpose is to determine the attractiveness, risks and issues regarding a transaction with a potential investee company. Due diligence should enable fund managers to realise an effective decision process and optimise the deal terms.

**Jeremie:** The JEREMIE initiative developed in cooperation with the European Commission, offers EU Member States, through their national or regional Managing Authorities, the opportunity to use part of their EU Structural Funds to finance small and medium-sized enterprises (SMEs) by means of equity, loans or guarantees, through a revolving Holding Fund acting as an umbrella fund. In Hungary, financial resources are invested via 8 local VC funds; SME's must be younger than five years and can receive up to 1.5 mio EUR venture capital through these JEREMIE funds.

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# Definitions

## VENTURE CAPITAL

Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch, early development, or expansion of a business.

## PRIVATE EQUITY

Private equity provides equity capital to enterprises not quoted on a stock market. Private equity refers mainly to management buyouts, management buyins, replacement capital and venture purchase of quoted shares.

## MEZZANINE CAPITAL

Mezzanine capital is a long-term, non-amortizing, second secured, subordinated debt. instrument.

## SEED CAPITAL

Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.

## START UP

Financing provided to companies for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their product commercially.

## EXPANSION

Financing provided for the growth and expansion of an operating company, which may or may not be breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital.

## BUY-OUT

A transaction which tends to acquire a firm or division from its current owner (seller). Types of buy-out: MBO– management buyout, MBI – management buy-in, IBO – Institutional buyout, LBO – leverage buyout.

## REPLACEMENT CAPITAL

Minority stake purchase of existing shares in a company from another private equity investment organisation or from another shareholder or shareholders.

## SALE TO TRADE BUYERS

The sale of company shares to industrial investors.

## SECONDARY PURCHASE/REPLACEMENT CAPITAL

Purchase of existing shares in a company from another private equity investment organisation or from another shareholder or shareholders.

## DIVESTMENT ON FLOTATION (IPO)

An IPO (initial public offering, which is the sale or distribution of a company's shares to the public for the first time by listing the company on the stock exchange) is one way in which a private equity firm can sell its shares and exit an investment.

## DIVESTMENT BY WRITE-OFF

The write-down of a portfolio company's value to zero or a symbolic amount (sales for a nominal amount). The value of the investment is eliminated and the return to investors is zero or negative.

# Contact

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The Hungarian Venture Capital and Private Equity Association (HVCA) represents virtually every major source of funds and expertise of private Equity in Hungary and is dedicated to promoting the venture capital and private equity industry for the benefit of funds, entrepreneurs, private Equity professionals and the economy as a whole. The Association aims to promote the development of the industry, and to create a set of rigorous professional and ethical standards for its member companies to follow. The members involve all the important investors or advisors in the sector dealing with non-quoted companies.

The Association provides a regular forum for the exchange of ideas among members, high-level discussions on the topical issues of venture capital and private equity industry and the future trends. As the most and only important representative of the industry it is in constant discussion with the financial and legislator institutions of the Hungarian State and with other professional organisations.

Hungarian Venture Capital and Private Equity Association

# Jubilee 20 Years Yearbook

2011