EXPERT Q&A

With strong growth rates and limited competition, Central and Eastern Europe is a land of promise for lenders, say Marcin Leja, partner and CEO; Magdalena Śniegocka, principal; and Radoslav Tausinger, partner at CVI

The best SME lending opportunities in CEE

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Q SMEs are the growth driver of Central and Eastern European economies. Does accelerating GDP growth imply better credit strength among those companies?

Marcin Leja: The role of SMEs in the economies of CEE countries is much more significant than it is in Western Europe. In Poland, for example, European Commission data shows that more than 99 percent of companies are SMEs and they account for over half (53 percent) of the overall value added to the economy.

When it comes to how the segment has performed in recent years, cumulative growth in SME employment between 2019 and 2023 was 6.3 percent in Poland, compared with minus 9.6 percent in Germany and 0.4 percent for the EU 27. Similarly, the cumulative growth in the value added by SMEs over the same period was astonishing, 29.6 percent in Poland compared with only 10.6 percent in Germany and 16 percent for the EU 27. This stellar performance of SMEs in Poland underpinned the 6 percent GDP over the same period, versus only 2.7 percent for Germany and 3.1 percent for the EU 27.

This strong macro performance translates of course into credit performance, and we can see that in our portfolio. Despite all the turmoil from covid, war in Ukraine, inflation and resulting rate increases, the credit quality of our portfolio measured by credit losses did not change materially and has in fact improved over recent years.

Our long-term credit loss rate is below 0.5 percent. When you compare that with high double-digit returns in the portfolio, it is clear that working with SMEs makes a lot of sense. In general, SMEs are more agile in a constantly changing environment, and better able to adapt to changes in areas like technology or supply chains. They operate with much lower financial leverage – usually three to four times net debt to EBITDA maximum – and their smaller size also means they have much lower operational leverage that allows for further flexibility.

What is also important is that they are usually owner- or founder-managed, and those individuals are, by definition, more motivated to increase the performance and value of their companies. That all comes on top of the fact that SMEs in CEE operate in fast-growing economies, so, yes, in fact accelerating GDP growth implies better credit strength for SMEs.

Q What financing options are available to SMEs in the region, and how does the value proposition of private debt compare with the alternatives?

ML: Access to financing is one of the biggest barriers to growth for SMEs anywhere. In the case of Poland, more than 70 percent of SME capex is financed by companies' own equity or, in other words, retained profits, and the same is true in the rest of Central Europe. Generally, we see banks withdrawing from financing SMEs, largely driven by regulatory requirements.

In the absence of bank financing, and given limited other options such as public markets or private equity, private debt becomes one of few choices available to SMEs.

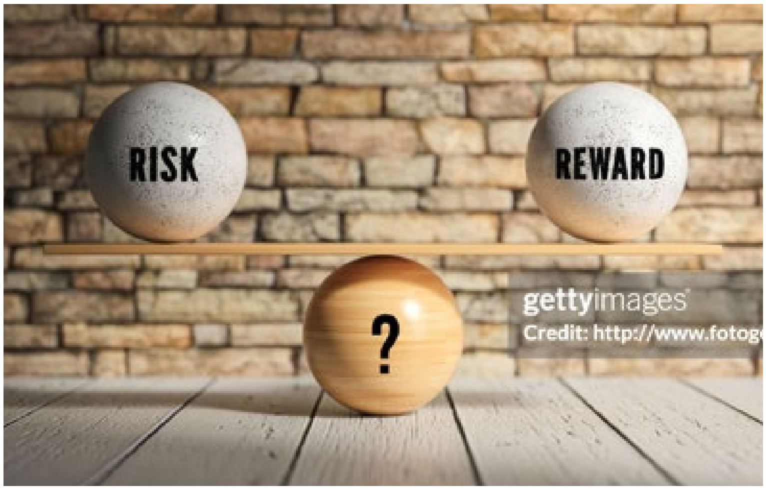
In contrast with Western Europe, where private debt needs to offer a lot of flexibility to compete, in CEE a sheer lack of availability of financing makes it interesting for companies. High demand combined with low competition means CEE private debt does not know concepts such as cov-lite structures, EBITDA add-backs or similar features, and instead resembles much more traditional bank financing in terms of underwriting standards, collateral packages and covenants.

That does not mean it offers absolutely no flexibility. In the case of CVI, we get more than 40 percent of our business from repeat borrowers. They need financing, they execute their growth plans and then they come back to us with new ideas. That proves our private debt offering meets their needs.

Q What opportunities are there in the sponsorless market for private credit managers? What does it take for managers to thrive doing those deals?

Radoslav Tausinger: We do some sponsored transactions but the vast majority of our business is sponsorless lending, and that is because the private equity market in Central Europe is relatively small and does not offer enough opportunities for private debt. Private equity also tends to focus on smaller investments in CEE, creating less room for the kind of unitranche deals that are becoming market standard in Western Europe and the US. The same standards do not really apply.

For sponsorless transactions, there are plenty of opportunities because, besides the banks, there are not many alternatives. There is some kind of bond market for large companies, but



Q How do the returns being generated compare with the risks taken?

Magdalena Śniegocka: There are a number of factors that make this overall investment proposition very attractive. From a risk-adjusted returns perspective, we feel we can deliver significant alpha compared with what is achievable for similar structures in Western Europe.

For example, in our previous direct lending fund that started investing in 2021, we deployed capital across 44 companies. That fund is fully invested, with five investments already repaid. We expect circa 14-15 percent IRR in euros on an unlevered basis for a predominantly senior secured strategy. Current average leverage is at 3.3x net debt of EBITDA and the current average loan-to-value stands at 43 percent.

We have no credit losses to date on the portfolio. The security packages are very robust, with no cov-lite deals in the portfolio. We estimate that our returns generate at least a 200 to 300 basis point premium compared with unitranche returns in Western Europe, but the portfolio displays more senior-like features than unitranche.

there are not many options for companies that need growth capital and those looking to make add-on acquisitions.

So sponsorless is the natural target market for firms like us, but that does require managers to understand and know the market much better. You need a large local team to develop direct relationships with entrepreneurs and intermediaries.

Further, underwriting skills are also different. In the sponsored market, private debt investors are basically price takers, but in the sponsorless market very often even the advisers to the company may have little insight on the company so you need to perform your own due diligence on various areas and prepare adequate structuring.

Monitoring is also different. In sponsorless transactions, it is the private debt fund manager carrying out the primary independent review of a company's performance as it is typically the only institutional investor. This leads to a more active role in discussing developments with the management team and, in case of underperformance, more involvement in implementing corrective measures.

Also, given current ESG requirements, in sponsorless transactions it is the private debt provider that brings all the ESG governance and reporting, which is done by private equity in a sponsored deal.

Q How is the market opportunity growing for private credit? What does the competitive landscape look like?

RT: Overall, we believe private debt has the potential to grow tenfold in this region over the next decade. When looking at debt levels compared with GDP, Poland is at around 100 percent while Western European countries are at two or three times that. While some of that difference is covered by banks, a significant proportion needs to come from alternative sources and private debt is well-positioned to fill the gap.

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>
> **MARCIN LEJA**

We are seeing increasing signs of private debt growing in Central Europe, including Western European GPs investing in the region. Our co-investment with Kartesia in car dealership management system business Omnetic is a nice example, but basically all of the larger GPs have now made at least one investment in CEE.

When it comes to the competitive landscape, investment sizes of above €25 million are well covered by pan-European players, with competitive processes almost always run by professional advisers and attracting a lot of interest. The other segment that is quite competitive is below €5 million, where various solutions are available including crowdfunding, private placement bonds or direct investments from high-net-worth families or family offices. In private debt, that segment is covered by single country funds, and there are many new players joining.

However, the bracket between €5 million and €25 million is not so well addressed, with only CVI and one other fund active. We think there is space in the market for others. As GDP grows and the region keeps catching up with Western Europe, the market should grow in coming years. Currently, lower competition for us results from very high entry barriers such as set-up costs, finding adequate people and building the network for origination.

Q Finally, why should the region be of interest to private credit LPs?

MŚ: We have been active in Central European private debt for more than 12 years and over that time we have had the chance to build a successful platform. We now believe the market has significant potential to continue generating attractive risk-adjusted returns, achieving 14-16 percent IRR in euros, unlevered, for a predominantly senior secured portfolio.

It also offers access to a high-potential market with solid fundamentals where we see a strong pipeline of companies in need of capital to cover the funding gap and that allows us to be highly selective. We currently have a conversion rate of doing about 5 percent of the deals we look at.

We also see limited GP competition here compared with the crowded US and Western European markets, and we enjoy negotiating power that leads to strong pricing and robust documentation. We are also able to deploy capital quickly – we execute between 40 and 60 deals a year, which, according to Debtwire rankings, puts us consistently in the top three direct lenders across Europe.

Looking forward, we see opportunities for the LPs to diversify their existing portfolio, with access to strong growth markets in the EU, providing growth finance to companies with strong cash-flow profiles, and less concentration per deal. Our smaller ticket sizes mean we can conduct smarter credit risk management. In our last fund, we invested in 44 projects across different industries and countries, whereas similar GPs in Western Europe might only do 10 to 15 deals per fund. ■