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Why is the Central European construction sector so interesting?

A private equity perspective.

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Construction sector in CE – a private equity perspective

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Our recent sector credentials

Krokus Private Equity

Commercial and Financial Due Diligence of a construction materials producer in Poland

2008 **Poland**

Enterprise Investors

Buy-side advisory on the contemplated acquisition of water and infrastructure construction group - VHS

2008 **Czech Republic**

Privatisation Agency of Serbia

Sell side advisory in the sale of Trudbenik Gradnja d.o.o. to a local construction company Montera

2008 **Serbia**

Spectrum

Financial advisor to the owner of Spectrum in the sale of the company to Suez Energy Services

2008 **Czech Republic**

TCHAS

Financial advisor to the owner of TCHAS in the sale of the company to Eiffage Construction

2008 **Czech Republic**

Romtelecom

Development of strategy for real estate portfolio optimisation

2007 **Romania**

KGHM Ecoren

Market analysis for a segment of construction materials, including market development projections

2007 **Poland**

Abantia Empresarial

Due diligence of a construction company

2007 **Undisclosed**

Introduction

Analysis of market drivers indicates that the growth prospects for CE construction industry are promising.

Market drivers:
- Companies focusing on residential segment construction will continue to benefit from the deficit of modern apartments in CE (constructed after 1989) as well as the development of the mortgage loans market.
- Targets involved in the commercial building segment will enjoy high demand for modern office and retail space; growing numbers of tourists will fuel the growth of the hotel segment and the dynamic growth of transit and trade between Eastern and Western Europe will boost the demand for industrial and logistics facilities.
- Companies involved in Civil Engineering will benefit from EU funding flows and PPP projects related to largely underdeveloped civil infrastructure in CE (roads, highways, airports, railroad transport).

For segment specific market drivers and issues please see pages 2 – 3.

All types of targets in the construction sector need to consider specific success factors and will face certain risks.

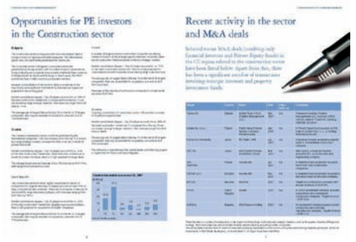
Sectoral challenges:
- Real estate developers will face rising costs of materials and services, growing land prices and building permit issues.
- Construction companies will have to cope with cash flow instability, growing costs of materials and labour as well as the threat of underbids in order to remain competitive.
- Building products manufacturers will have to secure access to cheap raw materials and energy sources along with the necessity to deal with environmental costs.

For analysis of Key Success Factors and risks specific for respective types of targets please see pages 4 – 5.

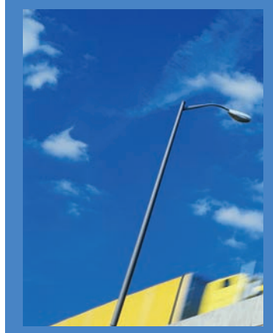
Private Equity can play a consolidation game in several highly fragmented segments of the CE construction market.

Private Equity fit:
In addition to specific issues related to the market segment or company type, the players in the construction sector may need to deal with:
- Lack of professional management in small and medium sized companies,
- Insufficient capital / resources, whereas economies of scale and in-house capacity are crucial for winning and delivering on the tenders.
- High fragmentation of the sector, numerous competitors.

Private Equity investors can play a unique role and add value through:
- Ensuring expert knowledge and governance tools.
- Providing capital for both national and regional expansion.
- Consolidating the competitors into large-scale efficient businesses.
- Employing professional management and supervision.



For an opportunity overview and latest deals in CE region in the construction sector please see pages 6 – 7.



Civil engineering

Civil engineering is expected to observe the most dynamic growth on the market in the next few years.
The substantial inflow of EU funds and big differences in terms of infrastructure development between Central and Western Europe indicate high growth potential. Moreover, Public Private Partnerships are still at an early stage of development.

Key market drivers:

- Roads: a low number of motorways and expressways compared to EU-15. For instance, Poland has only 674 km of motorways, compared to more than 10,250 km in Spain (a country of comparable size and population).
- Clear underinvestment in city infrastructures, especially in public transport, city roads, water and sewage infrastructures (underdeveloped underground lines in several cities, poor condition of city roads, shortage of bridges, etc.).
- Inefficient rail transport – in Poland only about 20% of rail tracks are compliant with EU norms.
- Small airports size, as compared to Western European countries. At the same time, the growth of the air transport industry accelerates the development of regional airports.
- Increasing road use – highly increasing numbers of vehicles and transport volume leads to the introduction of toll systems in many countries.
- In Poland alone, the administration planned to spend EUR 110bn on infrastructure programs to upgrade the transport systems (roads, airports, rail and urban transport) over the years 2007-2013. More than half of that will be covered by EU funds.

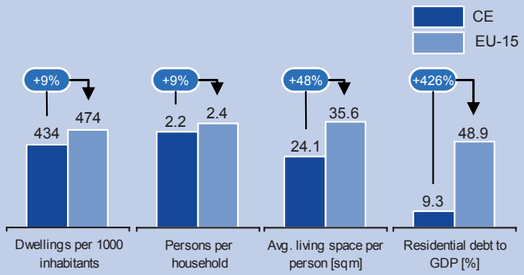
Residential estate

Residential property market in Central Europe witnesses a continuous development. Long-term trends will be driven by an evident gap in terms of number of dwellings (flats) per population and their quality, as compared to EU-15.

Key market drivers:

- Rising demand as a result of the growing supply of mortgage loans. Falling interest rates levels over the last few years affected many Central European mortgage markets. As a result, rapid growth of CE mortgage markets was observed over recent years.
- Number of flats/population: Large deficit of modern residential real estate in CE, especially in countries like Poland, Romania and Bulgaria. Very few apartments in the CE region were constructed post 1989, and most apartments built before then are of poor quality.
- As prices of residential real estate in new EU countries are already relatively high, foreign investors who were buying apartments in countries such as Romania and Bulgaria may shift their attention to new markets (for instance, Serbia, Moldova and Montenegro).

Residential estate market potential – CE vs. EU-15, 2006



Note: Data shown are averages for CE and EU-15 capitals.
Source: UBS – "Prices and earnings".

Recent M&A activity in the sector

A selection of recent M&A deals (involving only financial investors and Private Equity funds) in the CE region related to the construction sector are listed below. Apart from these examples, there has been a significant number of transactions involving strategic investors and property investment funds.

Target	Country	Buyer	Date	Comments
Bolix	Poland	Berger Paints India Ltd.	Apr 2008	Advent International sold a Polish provider of exterior insulation systems.
Toode	Estonia	Amber Trust II SCA (Firebird Management LLC)	Nov 2007	A financial investor,Firebird Management LLC, acquired a 50% minority stake in ToodeAS, building materials producer.
Izotem	Poland	Polish Nova Polonia Natexisll (Krokus Private Equity)	Jan 2007	A Private Equity fund acquired a 74% stake in Izoterm Sp z o.o., a building materials producer.
Kalnozols Celtnieciba	Latvia	MG Baltic UAB	Jul 2007	A financial investor acquired a majority stake in a residential construction company.
LEC	Latvia	Alta Capital (Silvano Investment Group)	Mar 2007	Alta Capital, a financial investor, acquired LEC, a construction and engineering company.
GIKl	Poland	GevekoAB	Jul 2007	A Swedish financial investor acquired two Polish road construction companies.
OSFER	Slovakia	GevekoAB	Nov 2007	A Swedish financial investor acquired a Slovakian road construction company.
BCI	Slovakia	Istrofinal	2007	Target is a construction company with annual revenues of EUR 9m.
VOKD	Czech Republic	Geofin	2007	A Czech investment company acquired a residential and commercial construction company. Target revenue – EUR 53m.
Softstroy	Bulgaria	Alfa Finance Holding	2007	An investment holding acquired a road construction and concrete manufacturer company. Target revenue – EUR 11m.

There has been a number of transactions in the region involving large multi-national strategic investors, such as Bouygues, Skanska, Eiffage and Strabag. Their main objective was to further increase market share by acquiring smaller companies.
The above table indicates that PE investors have been primarily interested in construction companies and building materials producers. As for PE investments in Real Estate developers, no recent deals in CE region have been identified.

Opportunities for PE investors in the Construction sector

Bulgaria

The construction sector in the Bulgaria is still not consolidated. There are a large number of medium and small companies. The international giants have not significantly penetrated the market yet.

The companies active in the Bulgarian construction sector are predominantly locally-owned, with a number of recent privatizations. Some multinational companies have actually established their presence in Bulgaria (such as Alpine and Strabag). In recent years, M&A activity has been limited mostly to privatization tenders.

However, consolidation of the sector is likely to accelerate in the near future, and significant investments by international players are expected in the coming years.

Market consolidation degree – Top 25 players account for ca. 15% of the total construction market size. 8 companies from the top 10 are not owned by large strategic investors, their revenues range from EUR 28m to 114m.

The average size of targets (below the top 10 on the list of the 25 largest companies), that may be available for acquisition, amounts to EUR 16m (revenues).

Croatia

The Croatian construction market is still not penetrated by international companies. Only one company from the top 15 is owned by a large strategic investor, whereas the other ones are in the hands of private individuals.

Market consolidation degree – Top 15 players account for ca. 60% of the total construction market size. Given that most of them are in hands of private individuals, there is a high potential for larger deals.

The average target revenue (average of top 15) amounts to EUR 110m, ranging from EUR 44m to 204m.

Czech Republic

The construction sector is rather highly concentrated in terms of competition for large tenders (top 10 players account for over 75% of state and public tender contracts). There are 3 companies in the top 10 not owned by large international players, with revenues ranging from EUR 190m to 767m.

Market consolidation degree – Top 25 players account for ca. 30% of the total construction market size. Despite ongoing consolidation, there is still potential for acquiring smaller companies.

The average size of targets (below the top 10 on the list of the 25 largest companies), that may be available for acquisition, amounts to EUR 77m (revenues).

Poland

A number of large European construction companies are already present in Poland. As far as large opportunities are concerned, there are still quite a few listed companies without a strategic investor.

Market consolidation degree – Top 25 players account for ca. 15% of the total construction market size. There is high potential for consolidating small companies and achieving a large scale of activity.

The average size of targets (below the top 10 on the list of the 25 largest companies), that may be available for acquisition, amounts to EUR 64m (revenues).

Revenues of the majority of construction companies in private hands are below EUR 20m.

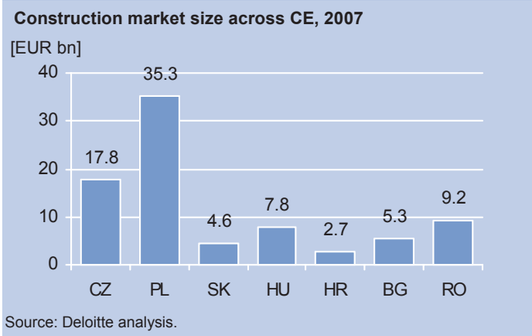
Slovakia

The ongoing consolidation of the construction sector still provides a number of acquisition opportunities.

Market consolidation degree – Top 25 players account for ca. 36% of the total construction market size. 4 companies from the top 10 are not owned by large strategic investors, their revenues range from EUR 56m to 344m.

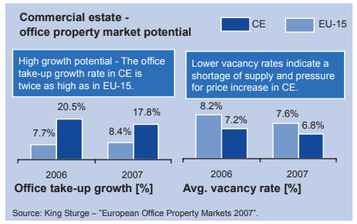
The average size of targets (below the top 10 on the list of the 25 largest companies), that may be available for acquisition, amounts to EUR 30m (revenues).

The difference in size between the market leader and other top players in higher than in Poland and the Czech Republic.



Commercial estate

Inflow of foreign investments as well as dynamic growth of local companies create a strong demand for office, retail and industrial space. Moreover, growing number of tourists boosts the development of hotel segment.



Key market drivers:

- Overall low vacancy rates of commercial real estate observed in many CE countries (ie. in Romania, Bulgaria and Lithuania they amount to ca. 5% in capital cities).
- **Office segment:**
  Modern office space area per capita is still low in comparison to Western European countries.
- **Retail segment:**
  Existing modern retail space per 1,000 inhabitants is lower compared to other European countries (i.e. in Romania 25 m² / per 1,000 capita compared to 142 m² in Poland, 248 m² in Spain, 319 m² in the Netherlands, EU-27 average - 205 m²).
- **Hotel segment:**
  Growing number of tourists in the CE region (average annual growth over 2000-2006 amounted to 4.7% in CE compared to the European average of 2.7%).
- **Warehouse segment:**
  Demand for industrial / logistics facilities is growing as a result of dynamic growth in trade as well as infrastructure development and transit between Eastern and Western Europe (an additional factor is that many CE countries have entered the Schengen zone).

Underdeveloped infrastructure:

- In CE, there is a large deficit of modern apartments built after 1989.
- Demand exceeds supply on the office property market – the supply of A and B class property is still low, especially in less developed CE countries. The area of retail space per capita is 31-88% lower in the new member states than the EU-15 average.
- The transport infrastructure and municipal utility are highly underdeveloped.

Growing demand:

- CE economies are growing 2-3 times faster than the EU-15 average, unemployment is falling and wages are going up. This results in increasing disposable incomes, growing consumption and investments.
- The demand for residential estate is additionally fuelled by availability of mortgage loans. Businesses are expanding their scale of activity, which leads to increased occupier demand for office and retail space. Retail sales in CE are expected to grow by ca. 70% over the next decade.
- The growing number of tourists and business travellers boosts demand in the hospitality segment. The growing air traffic and number of passengers requires investments in airport infrastructure.

Availability of financing:

- Central Europe will receive massive funding for transport and environmental infrastructure in the following years. Poland alone would receive ca. EUR 67bn until 2015 (almost 20% of the funds planned for all EU members), followed by the Czech Republic and Hungary with ca. EUR 20bn each. However, potential problems with efficient absorption of the EU funds will remain to be a challenge.
- Public Private Partnerships create opportunities for large civil engineering projects.

The expected high growth rate of the CE construction sector presents an opportunity for financial investors to capitalize on the market growth and realize above-average returns on investments.

Types of players and their characteristics

Real Estate Developers

When the sector booms, developers' margins (especially residential developers) can reach very high levels – for some developers, gross margins reached 50% (years 2003-2006 in Poland). Even during market slowdown the margins are expected to remain in the double-digits.

Key success factors:
- Real estate and land portfolio,
- Project fit to clients' needs.

Key risks:
- High administrative barriers,
- Rising costs of services and materials,
- High level of land prices,
- High interest rates may reduce access to financing (both for developers and clients).

Construction companies

Achieving the desired margin can be challenging for construction companies because of numerous upfront costs. In a competitive environment, operating margins of construction companies are slim, at ca. 5%. During construction booms, margins may reach much higher levels.

Key success factors:
- Efficient project management, especially in terms of planning (projecting, budgeting, forecasting availability of needed materials).
- Economies of scale and available resources (access to financing, labour force).
- Reliability of subcontractors.
- Quality of construction work.

Key risks:
- Underbids (bidding a contract at a price that turns out to be too low to complete the project).
- Possible cash flow instability due to early-on costs and relatively late incomes in most projects
- Rising costs of building materials and labour.

Building product manufacturers

This group covers a wide range of producers, from primary construction material producers to very sophisticated, highly processed product manufacturers. High CAPEX expenditures are a strong entry barrier, and so are high transportation costs (especially in the case of high-volume products).
Margins for primary products are rather low and stable, as a result of predictable demand; nevertheless, in boom periods, margins can grow to much higher levels. In case of low-volume, highly converted products' margins are usually higher.

Key success factors:
- Quality of products – construction materials need to have proper quality and features.
- Relatively cheap energy source – manufacturing of many construction materials is energy-intensive (this applies particularly to materials such as cement, clay brick, ceramic tile, construction lime, flat glass, fibre glass and gypsum boards).
- Access to relatively cheap raw materials (this applies particularly to the producers of plastic construction materials, asphalt paving and asphalt roofing, etc.)

Key risks:
- Environmental pollution risk – many construction materials producers create certain environmental pollution (air and water) – this may become an increasingly material cost item with effective introduction of CO_2 limits.
- Adjusting capacity to meet the demand takes time, making it difficult to decide on CAPEX levels – especially for materials that are expensive to transport.

Key success factors and risks – summary

Real Estate Developers
With shrinking margins (due to growing cost of services and land prices), the developers have to focus on optimizing their portfolios and adjusting the projects to the clients' needs.

Construction companies
Along with increasing costs of building materials and labour, the construction companies should focus on efficient project management (especially as the cash flows are risky and unstable), quality of work and reliability of subcontractors.

Building materials producers
Key issues for that type of potential target are securing access to relatively cheap energy and raw materials, as well as mitigating environmental pollution risk.

All types of targets across the construction industry will face a number of issues that Private Equity investors can help to resolve.