What policymakers can do to overcome CEE investor fears

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Central Eastern Europe (CEE) should be highly attractive to institutional investors, yet risk capital to the region remains surprisingly low.

The first Venture Capital and Private Equity (VC/PE) funds for the countries of Central Eastern Europe were raised shortly after the fall of communism. Though still in a transitional stage, the CEE nations offer promising economic growth due to improvements in governance, finance and the restructuring of enterprises. Having joined the European Union recently, investment opportunities abound.

Despite all this promise, at the time of this study, only little more than 9 billion euros in VC/PE funds had been committed to the region, even though many more euros were available. Professors Alexander P. Groh of Montpellier Business School and research affiliate of IESE's International Center for Financial Research (CIIF), Heinrich Liechtenstein of IESE and Miguel A. Canela of the University of Barcelona sought to understand why. Their paper, "Limited Partners' Perceptions of the Central Eastern European Venture Capital and Private Equity Market," identifies the obstacles that institutional investors face in the region.

What's right, what's wrong

Many things are going well for the CEE nations, which include Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia and the Baltic States of Estonia, Latvia and Lithuania. Growth expectations and the region's institutions would appear to make these states a prime VC/PE market.

But it's not just about these facts and figures: Investors base their allocation decisions on their perceptions of a region for delivering a satisfactory risk and return ratio.

To find out how investors feel about Central Eastern Europe, the researchers sent out a questionnaire to 1,079 (potential) limited partners based all over the world. The questionnaire linked institutional settings and investors' exposure to the area with their regional perceptions in the following areas: economic and entrepreneurial conditions, capital markets, social environment, investor protection and taxation.

"We can confirm that institutional investors regard the region very favorably, on an equal ranking with India and slightly higher than China," they write.

Within the CEE region, limited partners are most attracted to Poland, followed by the Czech Republic and Hungary. Investors there regard growth opportunities as attractive and appreciate the breadth of entrepreneurial opportunities. Investors appear knowledgeable about the region and satisfied with the historical performance of their allocated funds. The risk and return ratio is acceptable, they say.

Despite the positives, investors did express some reservations. What's more, when the researchers homed in on differences in capital allocation strategies and perceptions of certain sub-groups - European versus non-European, for example - they found that the differences were so minor that it would be fair to say that these reservations are shared by the entire population of limited partners across the board.

Protect property rights!

The dominant concern is the protection of property rights. Investors do not feel comfortable with the protection of their claims in the CEE region. This is surprising, because the EU accession countries benefit from EU legislation in principle. However, enforcement possibilities might still lack the European standard. Anyway, it is not clear whether this perception is based on an accurate view of CEE property rights laws or just insufficient knowledge about the actual situation.

The paper also highlights the second-ranked concern of investors: social criteria, which include the management quality of local entrepreneurs. A third concern is the insufficient size and liquidity of the CEE capital markets.

The paper concludes that if CEE countries are to compete with other promising regions, such as Latin America, India and China, in attracting funding from investors, then CEE

policymakers must be aware of t
he particular concerns and lack of confidence that investors have expressed about their region.

Simple means, such as greater transparency of property rights protection and informational campaigns, might clear up the situation and channel more risk capital to the region. Reassuring investors that their property is safe just might spur additional capital commitments - thereby contributing to employment and growth, and bringing the region a vibrant VC/PE market.

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