

ROUNDTABLE: GERMANY

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Mittelstand mettle

With newfound appreciation for operational change, low gearing levels and the 'traditional' approach to private equity, mid-market private equity professionals in Germany look set to enjoy some time in the sun. But as Toby Mitchenall found out hosting a roundtable discussion in Munich in early June, there are still plenty of things to keep GPs and LPs in the country up at night





Golding (left), Vorndran, Pauls, Burton, Hollenberg: Germany focus

The morning of June 7, 2010 and the previous night's storm – which had threatened to disrupt the travel plans of the roundtable experts as they arrived in Munich – has broken. The sun is tentatively shining on the city as five leading figures from the German private equity community convene to discuss the intricacies of a country that seems to have passed through the worst of the recent economic storm, but which is currently facing up to a number of related challenges.

Headlines in the morning papers describe the German economy as a “beacon of hope” in a European landscape that is still roiling from the sovereign debt issues of its Southerly members. Increasing factory orders – a happy by-product of the weakening Euro – give hope that when an €80 billion programme of cuts to public spending hit, they will be offset to some extent by the return of a robust private sector.

Against what appears to be a brightening macroeconomic backdrop, private equity professionals in the country sense an opportunity to generate stellar returns for their LPs and at the same time to improve the standing of private equity in the eyes of a business community and a population still sceptical that private equity can be a force for good.

Since the now legendary locust – or *heuschrecke* – debate brought the asset class into the spotlight for all the wrong

reasons in 2005, the industry has worked hard to regain some credibility, and as our roundtable participants report, some progress – albeit slow – is being made.

And with the supply of credit to Germany's *mittelstand* – the country's vast selection of small- and medium-sized companies – still tight, an opportunity exists for private equity firms to be the heroes, providing much needed funding and allowing these businesses to delever their balance sheets and grow.

But the promise of compelling investment opportunities is only part of the story playing out in Germany. Pending EU regulations from Brussels promise to alter the already changing German private equity landscape further still. Readers in the UK and US, look away now: some elements of EU private equity law are very welcome among German private equity circles.

Assembled in the intense atmosphere of an underground conference room in Munich's Sofitel hotel, were: two GPs, Christian Hollenberg of Perusa and Helmut Vorndran of Ventizz Capital Partners; two advisors, Richard Burton of PricewaterhouseCoopers and Sonya Pauls of law firm SJ Berwin; and one LP, Jeremy Golding of fund of funds Golding Capital Partners. The discussion was animated, varied and rarely straightforward. ➔

→ *PEI: Welcome to you all. We have come together at a time when the Eurozone is for the first time really feeling the stresses that a common currency can bring. Is a wobbling Euro something that should be of concern to private equity funds in the region?*

Hollenberg: We're trying to figure out what the impact on our portfolio would be. It's probably negligible overall. We just acquired one machinery company out of bankruptcy with worldwide exports, and the currency weakening is a blessing – no question about that. What we don't want to see is too much volatility: that tends to cost money. At the moment we don't think currency issues are too dramatic. What is more dramatic is the story behind it.

Golding: Well if you look at the euro/dollar exchange rate today, it is roughly where it was five years ago. Currency risk is always an issue for our investors, even if it can be somewhat mitigated by offering hedging overlay packages.

Pauls: What we as part of the private equity industry ought to be more concerned with is a possible loss of confidence in the European market at a macro level. We need to make sure that European GPs are not drawn into a perceived "European crisis" which is really isolated to certain member states.

Vorndran: On a short- medium-term basis the outcome for a private equity firm is very, very favourable if you are invested in one of the strong economies and if your portfolio companies are export-intensive. The "strong Euro states" are currently enjoying a relatively weak currency compared to the cost position of these economies. In addition they enjoy low interest rates and thus relatively benign financial conditions. How will this play out over the next three or four years? Maybe the Euro will fall apart, which would have a definite impact on attractiveness of Europe for private equity funds, because the strong Euro economies like Germany, the Netherlands or Austria will then have to live with a much stronger single currency, compared with today's Euro.

Burton: I agree that it's a confidence issue – certainly in the short term – the last thing everyone needed was another shock. We are also seeing the US funds – dollar funds – coming into the market in a big way for new transactions. Particularly the larger restructuring funds are showing a lot more activity.

Golding: I can recall back in 2003, when some of the international dollar denominated funds started looking at Germany and the dollar was around €1.15. The major concern at the time was whether the Euro was already too strong and then it strengthened even further up to nearly €1.60. So the euro may be perceived as being much weaker now, but basically we are only back to the level we had prior to the start of the last cycle. →

THE PARTICIPANTS



**RICHARD BURTON, PARTNER,
PRICEWATERHOUSECOOPERS**

Frankfurt-based Burton is a partner and private equity leader at auditing and consultancy giant PricewaterhouseCoopers. The firm's 600 transactions experts in Germany have advised on more than 1000 deals in the last decade.

**JEREMY GOLDING, FOUNDER AND MANAGING PARTNER,
GOLDING CAPITAL PARTNERS**

Golding Capital Partners, with approximately €1.5 billion under management, invests in private equity on behalf of predominantly German institutional investors. Based in Munich, the firm opened an office in San Francisco in 2004, and another in Luxembourg in 2007.



**CHRISTIAN
HOLLENBERG, CO FOUNDER, PERUSA**

Hollenberg is one of Germany's foremost turnaround specialists and one of three founders of Perusa, which opened for business in 2007. The firm is currently investing a €150 million debut fund. Prior to Perusa, Hollenberg was a key figure at fellow Munich-based investment house Orlando.

SONYA PAULS, PARTNER, SJ BERWIN

Active in private equity since 1996, Pauls joined SJ Berwin in 2000 and founded the firm's German private equity practice in Munich. Representing German and international fund managers as well as LPs, her areas of expertise include fund structuring and carried interest arrangements.



**HELMUT VORNDRAN, MANAGING
PARTNER, VENTIZZ CAPITAL PARTNERS**

After successful spells in the consulting and corporate worlds, Vorndran co-founded Ventizz in 2000. The firm, with bases in St. Gallen and Düsseldorf, is investing its fourth fund – which closed on €450 million after six months of fundraising – in high growth technology businesses.



Hollenberg: replacing debt with equity

➔ **Hollenberg:** As a local fund we have for the most part Euro-based LPs and they would look out for the competitiveness of our portfolio companies more than anything else. So in terms of currency it is a mixed picture and probably the net result is close to zero.

Aside from currency issues resulting from misbehaving PIGS, another product of the financial crisis has been a drive for more stringent regulation of the financial sector. Is the German private equity market bracing itself for an onslaught of new private equity regulation? Or will it take new rules in its stride?

Vorndran: The situation right now in Germany is better described like this: that we badly need a private equity law in order to have a solid and reliable framework to attract investors and the manage portfolios. It doesn't matter whether it comes from a European or a local level. We need a solid standardised legal framework, which an important industry like private equity, which is providing more than a million jobs, can rely on.

Pauls: It is of course still the tax framework – or the lack of a tax framework – that continues to cause particular concern in Germany and constitutes a clear competitive disadvantage faced by German based GPs. A new framework issue faced by German GPs is regulation. Germany is currently the only

“In many ways private equity is being taken back to the roots. It was never meant to be applied investment banking”

market in Europe where PE remains largely unregulated.

With the AIFM directive, we noticed that GPs generally ignored it to date because there were so many uncertain elements: more than a thousand of amendments to the first draft. What remains of concern – assuming the current Council draft goes through – are the disclosure standards to be imposed on private equity portfolio companies and the marketing restrictions,

both in- and out-bound.

Vorndran: Why would a private equity controlled firm have to disclose this information, when a comparable firm owned by a private family or sovereign wealth fund or a pension fund will not be forced to do so? It is a clear disadvantage and discrimination against private equity.

Pauls: Especially in family situations. In Germany a great number of family business owners have concerns about exposing their companies to private equity investment, and the disclosure requirements might make owners even more wary in this regard.

Vorndran: The concerns raised by the German private equity association include the disclosure measures and current plans that every single market would require a national passport. This would be a nightmare for anybody who is raising a private ➔



Burton (foreground left), Vorndran (back left), Pauls, Hollenberg: regulation needed

→ equity fund. We are therefore arguing strongly in favour of the European passport for fund managers.

And what of other regulatory developments? The likes of Solvency II and Basel III would effectively make it more expensive for banks and insurance company to hold private equity interests. Could these rules hamper European fundraising, given that it is quite reliant on these two investor groups?

Golding: It is ironic, because at the moment there is clearly increased interest from German institutional investors. Just as they are realising that they need to rebuild their portfolios, to kick-start their private equity allocations, they are being confronted by two big issues: Solvency II and Basel III. The real problem for investors is the uncertainty so it's ironic that in a jurisdiction in which so much is regulated, there is such a lack of clarity.

Hollenberg: All the pending regulation reinforces our belief that we want to be in a relatively small niche of the market. If there is any differentiation, then regulation would be lighter in this sector.

Pauls: I absolutely agree with Jeremy. We have also seen the local insurance companies and the *Versorgungswerke* – local endowments – starting to develop an increased interest in the asset class. Now we fear that they will consider retreating from the asset class pending further economic and regulatory developments.

Is the increasing interest from German institutional investors mirrored by a greater political acceptance of private equity in the country?

“Investors are often putting considerable pressure on GPs to invest”

Vorndran: If you talk to a politician off the record, they know the challenges and appreciate the extremely positive impact that private equity has on the overall economy. When they talk officially, then of course their message is somewhat different. They

put private equity in very simple terms and by simplifying the activities of our industry, the positive economical impact gets often lost.

Burton: The issue is that no politician in Germany is going to win votes by supporting private equity. Intellectually I think they would do so, they see the benefits for the German economy. There was a recent positive message from the German finance ministry that Germany does need private equity, but whether that gets translated into legislation is a different matter. It is not the first priority for a politician.

Hollenberg: The understanding of economic issues in Germany is extremely poor among the population. It is amazing that a country that is so wealthy and dependent on international trade has a population that understands virtually zero about business issues. It is completely different in any of the English-speaking countries. That is something that politicians have to pick up on. Even if they personally understand it better, they have to cater to their constituency and that constituency is economically illiterate to a surprising degree here.

Golding: Fundamentally Germany is in a strong position. In terms of the recession, Germany has come out stronger than expected and politically private equity is better positioned than it was three or four years ago when we had the locust discussion. That debate – with the icon and the rhetoric – may never completely go away, but the government implicitly legitimised private equity by selling its stakes in Telekom, Evonik and IKB to private equity firms.





Vorndran (left), Pauls: debt finance is a German tradition

➔ **Vorndran:** Just because the government is selling assets to private equity, it does not mean they are in favour of private equity at all. The just wanted to sell Tank & Rast some years ago, there were a few buyers out there and I'm not sure the politicians really wanted to know to whom they were selling those assets.

Burton: I can see Jeremy's point that at a political level it is still very difficult, but on an economic level there is more acceptance of private equity among entrepreneurs themselves. Over the last six or seven years, private equity has come a long way in that respect. It is a shame that the crisis hit when it did, because private equity had built up some considerable momentum – particularly in the *mittelstand*.

I still think private equity could provide one of the solutions to the financing issues of the next two or three years as a lot of the mezzanine programmes are falling away and coming up for refinancing. Also there is no longer much bank financing available from the local *sparkassen*.

Vorndran: One of the disadvantages we face is the long-term tradition of debt finance, supported by an easy access to bank loans and low interest rate. Another is that for nearly 20 years our industry has done not much in terms of public relations. Then the Grohe incident came up five years ago, and the industry started to talk more to journalists. In addition the trade body has been very active in this respect. But a hundred years of debt financing tradition plus some decades of not doing sufficient PR work makes our job difficult today.

Hollenberg: People do not realise that what we do is replace

“Just because the government is selling assets to private equity, it does not mean they are in favour of private equity at all”

debt with equity. We are undoing irresponsible leverage decisions, not least of which are the businesses funded by Landesbanks. It is really ironic that the public perception is still that private equity is doing the opposite and I don't think it's true anymore. We hardly have any leverage in our portfolio companies at the moment.

Pauls: There will be a continued opportunity for private equity, because a number of family-owned businesses simply will not have an alternative route for funding and I agree with Jeremy that the general sentiment towards private equity is far more positive than it was a few years ago.

Vorndran: There is a lot of work is still to be done. Today Ventizz published a study of the solar equipment industry, and 75 percent of all medium-sized, *mittelstand* solar equipment firms said they had no intention of talking to private equity firms, nor do the want to talk to private equity firms, nor they see any benefits from doing so.

Hollenberg: But that means that 25 percent do.

What sort of deals are you currently able to get done in Germany?

Hollenberg: *Mittelstand* deals with a heavy equity and relatively light debt component – these still get done.

Golding: Volume was down but there were still more than 60 deals completed last year in Germany, the bulk of them being in the small- and mid-market sector and including many

“We are also seeing the US funds – dollar funds – coming into the market in a big way for new transactions”

restructurings. The bigger deals are almost completely missing, as indeed they are in most countries.

Burton: The Springer deal that EQT did was technically the largest buyout in Europe last year at €2.3 billion with leverage of €1.5 billion. But it wasn't a plain vanilla LBO because the leverage was previously €2.2 billion: it was actually a deal that enabled the banks to reduce their exposure by about a third. That deal was celebrated as a “return to normal buyout activity” perhaps more than it should have been.

Vorndran: We have done only two transactions in the last two years, and both deals took more than a year from first contact to contracts being signed.

Hollenberg: Completion times are longer – that's our observation as well. You always need to add at least a couple of months for the sellers to come to terms with the new reality: that they won't get the valuations they initially thought they would.

Vorndran: On the subject of valuations: if you look at cleantech – where we invest most of our money – the “collective madness” in terms of too high valuations is already back. The EBITDA multiples are in some cases absolutely ridiculous – just as if there had been no financial crisis at all. I have seen in the first half of this year companies valued at “impressive” double-digit EBITDA.

Pauls: Investors are often putting considerable pressure on GPs to invest, which of course may be a contributing factor to the high prices we currently see on the market. For two years they could understand that there was very little investment activity, but there is now a growing impatience for GPs to show more creativity in deal sourcing and investing in this market.

Hollenberg: Not something I would necessarily call very creative: paying high prices.

Will elements of the financial and economic crisis play into the hands of German private equity?

Hollenberg: In many ways private equity is being taken back to the roots. It was never meant to be applied investment banking. This approach can be very profitable if the conditions are right, which they were for a time, but we no longer have the right conditions to make this model work. The original idea of private equity business was different – you are taking



Burton: private equity will step in where the banks have fallen away

on the role of the entrepreneur, running the business to some extent, and that puts a natural limit on how much you can scale the model up.

Pauls: Throughout the crisis we need to remind ourselves that we still have a very attractive and highly developed industry and, therefore, portfolio base to draw from, which is more than most of our European or global competitors can claim. Germany continues to be leading in high-end technology and our export-reliant *Mittelstand* may actually benefit from the Euro crisis going forward.

Golding: The German market is fundamentally still attractive despite the uncertainty, the volatility, the tax issues and all the other crises. Even in troubled sectors – automotive and textile, for example – selected deals are still getting completed because experienced private equity managers can cherry pick just those companies that have the potential to flourish.

Burton: It should also be an upside that private equity capital is available right now when bank finance and mezzanine is not.

Hollenberg: The fundamentals have not changed; we still have a lot of companies that no one has heard of, which are large enough to be institutionally investable. That hasn't changed at all. ■