Broader acceptance?

With 2014 a year of record distributions for many, private equity globally is expecting a strong fundraising year this year, but will German GPs also be beneficiaries? Despite the size and relative health of the eurozone's primary powerhouse, in private equity terms, it remains an under-penetrated market. As understanding of the asset class improves, is a broader acceptance of private capital finally taking place in a country which remains one of the most popular destinations for LP capital, and yet one many international GPs struggle to crack? Matthew Goodburn reports

Private Equity International arrived in Munich on a sultry early summer's day to find the squares and cobbled streets of the Altstadt buzzing with tourists and locals eagerly sampling the prosperous Bavarian city's cultural and culinary delights.

A mile to the north, in EQT's offices on the imposing tree-lined Leopoldstrasse, it sat down with four German PE specialists to discuss conditions on the ground and to find out which new entrants were approaching the market and how they were tackling it.

Data from *PEI*'s Research & Analytics division shows that of the $4.47 billion of private equity capital raised in Germany since 2008, a mere $0.36 billion has come from overseas players, but there are signs that a shift is taking place with private equity continuing to look relatively attractive compared with other asset classes.

Mark Nicolson, a partner at SL Capital, believes a number of factors are creating tailwinds for German and overseas GPs, not least the need by many LPs to allocate away from strongly performing stock markets.

"We are seeing a far higher level of distributions and many LPs are upping their allocations to private equity as they are not getting the returns they need from other asset classes," he says.

"Lots of quality managers have raised recently in Germany, so capital is therefore embedded with those managers. Those that haven't raised will have struggled for specific reasons. Those quality managers that are still to come to market should be in a good position because of the amount of capital looking for a home in Germany."

Nicolson points to a number of pension funds upping their allocations after the strong stock market run, as well as increasing European institutional interest, from insurers in particular.

Debevoise & Plimpton attorney-at-law Peter Wand has also noted a marked interest from the insurance sector for German PE at a time of prevailing low yields from fixed income.

"Insurers are very interested in increasing PE in the current low interest environment because it helps with hitting their return requirements," he says.

CO-INVESTMENT GATHERING PACE

PwC private equity leader in Germany Steve Roberts says much of the recent new

SPONSORED BY **EQT PARTNERS, PwC** AND **SL CAPITAL PARTNERS** entrant interest in Germany is coming from sovereign wealth funds, Chinese LPs and, what he terms, "North American LPs acting as GPs".

Such LPs, he says, have up to now ultimately tended to approach the successful candidate with a view to co-investing.

"You see them get to the second round, but they tend to take a large co-invest with the ultimate winner. Certain funds that we work with tend to have a much stronger co-investing GP alongside them."

While the fundamentals remain strong in Germany, the panel agreed that it still has some way to go to match the fundraising activity in other core PE markets such as Scandinavia and the UK.

While investment advisor EQT Partners' Dominik Stein acknowledges this, he notes the rising interest in Germany from "very large Asian funds" looking for co-invest opportunities.

On a broad note, Stein believes it is becoming more important generally for large LPs everywhere to secure co-invest opportunities.

Nicolson agrees that the co-investment approach has been a "very profitable one" for his firm recently, especially from bigger firms. "Our German co-investments have done very well."

Recent regulatory changes made by the Federal Financial Supervisory Authority (BaFin) have made private debt an area of focus for many LPs eyeing the DACH region, and, along with private equity real estate, it has become an increasingly hot area for private capital over the past year.

Wand and Roberts see private equity real estate as a key beneficiary of recent private capital activity, with Wand seeing sovereign wealth funds particularly involved.

Roberts says: "A lot of money has gone into real estate transactions – it has been a massive driver in German PE."

With the heightened interest in these areas, Nicolson added a note of caution as appetite for leverage – and the offers from providers – continues to increase.

"Now the banks are recovering, it is super liquid in the lending market, which is driving up prices and the debt packages on offer are starting to get ridiculous again. However, what we are seeing is most managers, particularly in Germany, maintaining discipline in their capital structures," he says.

SELLERS' MARKET

Germany has been an attractive market for some years owing to its strong economy and low penetration by private equity, but the consequence of that is that deal pricing remains at elevated levels.

For now, Germany remains very much a sellers' market, with Nicolson highlighting recent S&P data indicating that Germany had crossed over with the US in terms of the price of average entry multiples.

"It is sitting on upper eights now, which is a function of the amount of dry powder, liquid debt markets and also the need to deploy," he says.

Another key factor is the lack of appealing deals for private equity firms, which has also been behind the trend for more private capital heading into private debt and private real estate.

"There is still not an abundance of deals, especially quality ones, and there has certainly been no wave of deals coming out of corporate Germany. This is another reason why real estate and debt have become more popular as the larger funds continue to diversify," says Roberts.

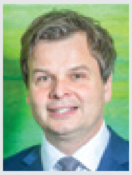
Most private equity players have struggled to compete for deals with the IPO market and Stein described the pricing of assets as "incredibly hot" and moving in the direction of levels last seen just ahead of the global financial crisis. »

MEET THE ROUNDTABLE

MARK NICOLSON
SL CAPITAL PARTNERS
Nicolson joined SL Capital Partners in 2007 and is a partner based in Edinburgh. He is responsible for primary and secondary fund investments and direct co-investments in Europe. Nicolson also leads the firm's coverage of the UK and Germanic markets. He serves on the advisory boards of a number of European private equity funds.

STEVE ROBERTS
PwC
Roberts joined PwC in 1993, qualifying as an ACA in 1996. He joined the transaction services team in 1998 and has worked exclusively within the M&A field since then. He joined the Frankfurt office in 2001 to focus on the private equity market and became a partner in 2005. He heads PwC's German Private Equity practice.

DOMINIK STEIN
EQT PARTNERS
Stein joined EQT Partners in Munich in 2006. Prior to that, he worked for McKinsey & Company in the Private Equity practice between 2001 and 2006. He currently holds company directorships with Blizoo, Bureau van Dijk, Springer SBM and Sportradar.



PETER WAND
DEBEVOISE & PLIMPTON
Wand is an international counsel in the firm's Frankfurt office, and a member of its M&A, Private Equity and Financial Institutions Groups. His practice covers corporate reorganisations and private and public M&A transactions. He advises companies in connection with all aspects of corporate governance, from compliance to crisis management and disclosure matters.

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>
> Steve Roberts

» He says: "We are not talking about 2006-8 levels yet, but in $100 million plus deals, valuations are going up. EQT is always cautious when acquiring an asset, there has to be an angle and opportunity to grow and develop the company."

However, elevated deal pricing has not deterred EQT from making deals, provided the asset remains a good fit with its added value ethos.

"EQT likes to buy good companies and turn them into great companies so we are not afraid of paying higher prices, even if it is tough to compete against the IPOs," he says.

CHANGING MODEL

Germany has traditionally lagged its core Europe and Nordic peers in integrating the operating partner model, but the panel believes that since the crisis, which hit many local PE operators hard, the days of buy and leverage up to sell are over.

"The operating model has changed. If you are putting your money in, you have to have a deliverable value creation plan, particularly in the current pricing environment," Nicolson says.

The panellists also noted a sharp increase in bolt-on acquisitions in Germany, with small caps continuing to offer the standout opportunities.

"The most attractive area of the German market is the small cap end because there are plenty of target companies and you are still able to buy well. For the right managers with a good aggressive sourcing model, they are able to acquire, implement a buy and build and get the EBITDA to a level where other PE or trade players want to buy it," says Nicolson.

"Now, rather than buy-hold-deleverage, the realisation is very much there that you have to have the ability to really add value to the companies you are buying," he adds.

EQT was an early pioneer of the operating partner model in Europe.

Stein says that over the past 21 years, driving up value and identifying the right people on the board to work with has been integral to its success.

He believes his firm's model to support its portfolio companies in its industrial approach with its industrial boards really paid off in the downturn.

"Buying a good asset, levering it up and then selling it a couple of years later without having a clear equity plan to further develop the company will not work now. That was one of the biggest changes that occurred in the downturn," he says.

The vast majority of Germany's 3.7 million "Mittelstand" companies are at the smaller end of the market, and some 95 percent are family owned. While the group agreed that there were few companies that looked attractive to would-be private equity buyers, there were a number of gems amid the rough, offering the opportunity to add value through a buy and build strategy.

Several sectors were catching the attention of the group, with the diverse healthcare sector throwing up interesting opportunities, but also technology, media, and telecommunications (TMT), and financial services.

Wand says: "If you go after nursing homes, quality of care issues can harm your reputation. Medical equipment might be a more interesting area offering great opportunities."

However, he believes financial services, an area that has seen low deal flow, offers potentially great rewards for those that do their due diligence on it.

Wand cites Cinven teaming up with Hanover Re to acquire German life insurer Heidelberger Leben and Bermuda-based

Athene Holding to acquire German life insurer Delta Lloyd as giving Germany two consolidation platforms for closed book assets in Germany's life insurance sector.

"This is an area where you can still have first mover advantage. There are few players with the expertise to enter the market so there are very high barriers to entry, but potentially great rewards.

"If you shy away from the heavily regulated core financial industry, there are a lot of opportunities in surrounding service providers. Insurers, for example, are looking more and more to outsource services, like in the banking sector."

He adds: "The question is not whether PE will enter the sector. It will be, which PE players will enter the sector?"

For Nicolson, the sector is still not attractive enough.

"There have been a few good deals done in the sector, but we have seen very few financial services-focused funds doing well. We see manufacturing and industrial businesses continuing to be the backbone of the German opportunity."

With a focus on the TMT sector, Stein is also identifying a number of growth opportunities among some of Germany's internet and tech entrepreneurs and EQT has been actively seeking selective opportunities within the Berlin tech hub.

"In TMT, we see fantastic growth stories in Germany which sooner or later are becoming private equity owned or go to the stock market," he says.

Stein takes the view that a management team can in fact focus more on growing a business instead of fundraising each and every year.

TMT is EQT's largest sector, which together with healthcare, makes up 60 percent of its investments.

Within healthcare Stein favours medtech, such as imaging companies, but is generally wary of pharma, which he describes as "more complicated and competitive", because private equity often competes alongside big pharma for assets.

Healthcare is one of the most important sectors at EQT, and Stein also likes service providers, such as hospitals.

The group highlighted pet healthcare as a potentially big growth sector, with the largest player in Germany still at only one percent.

LP TRENDS

All panellists agree that in terms of what LPs want, co-investment is the biggest individual trend, although all see evidence of some LPs consolidating accounts.

In line with most of their US and European peers, LPs are demanding ever greater levels of transparency, access and socially responsible investing.

"With increased sophistication and regulation, our LPs automatically want more information, whether it is geographic exposure or deal metrics but also environmental, social and governance [ESG]," Nicolson says.

"We have been putting ESG onto all our advisory board agendas."

Having better-run and socially responsible investments is not just a case of being ethically responsible, it also makes good commercial sense too, he says.

"There have been a few cases recently in the press where some GPs have been embarrassed by underlying exposure in specific companies, and it is far easier to sell a clean company." »

Buying a good asset, levering it up and then selling it a couple of years later without having a clear equity plan to further develop the company will not work now. That was one of the biggest changes that occurred in the downturn

Dominik Stein

» Stein says that EQT moved its business onshore to make things more transparent, after consultations with its LPs, and that the group was also at the forefront of ESG.

He says: "For EQT, sustainability is a differentiator. We believe that it is not only improving your reporting, it also improves the business. The industry has come a long way and there is much more transparency and enhanced reporting to investors. That should contribute to a better understanding of private equity in a positive way."

Wand points out that greater transparency over reporting is a two-way street nowadays.

"There is increasing demand from LPs, but also a genuine interest from GPs to accommodate those requests because the GPs want to be perceived in the market as someone that cares," he says.

But he warns that there is also a need to keep a handle on the reams of new information being produced to match LPs' demands.

"The danger to be aware of is that there may be so much data that no one knows exactly what is going on at the moment."

As in most other developed PE markets, ESG has come on in leaps and bounds in Germany.

"The industry is much more transparent now. You used to have certain PE funds with just a name and a phone number to now having full team information, biographies and interim reports," says Roberts.

All this has helped to improve the health of a number of German PE firms as well as boost the performance of many of their portfolio companies.

"The corporates are the ones now with the job cuts. Private equity does a very important job in Germany and a lot of people don't realise how big a part of the German economy it is," says Roberts.

The panellists were unanimous that a better understanding of the positive benefits of private equity through better communication could only be a good thing for an often sceptical German public and the workers' councils that play such a significant part in German company culture.

Nicolson says: "The more the public is aware that, in general, the vast majority of PE money comes from pensioners, the better. Within Germany, if the changes emphasise the benefits from PE ownership, it will become far more widely accepted and there would be greater deal flow."

He adds: "In the UK, private equity is automatically considered by managers and corporates. If we move towards that here, Germany can fulfil the potential in PE that it has always had."

But the culture of the Mittelstand does not necessarily lend itself to buyout culture and accessing potential interested parties for investment remains an intricate process in this often family-dominated sector, while private equity itself remains a very intimate world in Germany.

"You constantly see the same people in German PE – it is a very intimate community compared with the UK and US," says Roberts.

"Success breeds success. There is still a pride to being the largest employer in the village. It is one of the beauties of Germany. It is a lot more socially structured than the UK, where that seems to be a thing of the past."

He adds: "That's why a Mittelstand boom will never happen here: 99 percent of the businesses are not for PE, but there is still

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the odd little pearl. It's our job to search them out and find them."

Stein thinks that for those Mittelstand companies that are receptive to a private equity approach, acceptance of private equity has come a long way. He believes that for larger deals in Germany, it is important to work with the unions and get their support.

"There has been a huge progress in the last two years and don't forget, a new buyer has to stand in front of the workers' council before every deal and it is essential to have a good and respectful relationship," he says.

POSTER CHILD DEALS

A number of high-profile private equity deals have shone a more positive light on the sector over the past few years and for Stein, the non-corporate deals being struck with PE tend to be the newer companies and less often the more family-oriented companies.

Stein notes that there are several studies revealing how private equity-owned companies have outperformed publicly listed and other privately owned companies in terms of sales growth per annum and employee growth per annum.

Stein points to EQT's ownership of Swiss ingredients firm Symrise as a classic example of a positive long-term impact private equity story.

EQT sold the business in 2008, and since the IPO Stein says it has outperformed the DAX by around 99 percent.

He also cites Permira's recent final exit from Hugo Boss as another big tick for the reputation of German private equity.

"If you look at Hugo Boss today, it is fundamentally changed and a much better business. They did a great job and they are in the public domain. That is a very important metric because it proves PE builds long-term sustainable success."

Stein also believes his company's own work with German cable business KBW has also created a more positive image for private equity in Germany.

Stein notes his firm invested €650 million into KBW before selling it. In Germany and across Europe, KBW maintained its reputation throughout all that investment phase by a private equity owner as being one of the best for high-speed internet access. Its brand image for being reliable continues to the present day.

Despite better sentiment overall to the sector, the group agrees that it is crucial to have a presence on the ground and local knowledge of Germany and its culture.

Wand says: "You need to have your German team. Flying in a bunch of guys from elsewhere does not work in the long run, especially with respect to smaller companies. More and more PE firms now realise that and are setting up local offices."

Stein agrees: "Germany has a very particular culture. It can be challenging to understand, so you need local people on the ground."

EQT currently has 18 investment staff in its Munich office, but Stein says it will be 30 by year-end.

Despite the renewed positivity, all agree that it only takes one deal to go wrong to sour the perception of private equity in Germany again.

Nicolson says: "Private equity has come a long way here. But those few adverse headlines, such as the recent Dutch parliamentary hearings or what happened with Citylink in the UK can set the whole industry back."

Stein adds: "If a massive bankruptcy happened here, it could still cause problems for the industry." ■