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The future of German private equity

Private equity firms are aggressively competing for Germany's tech and healthcare success stories but, while currently unloved, the country's traditional strongholds may also be poised for a comeback. Carmela Mendoza and Amy Carroll report

Private equity firms deployed more than €12.5 billion in over a thousand German companies last year, despite the global pandemic, according to national private equity association BVK. These figures are down on a record-breaking 2019, certainly, but are nonetheless higher than in any other year in the past decade.

"Nordic Capital raised its largest fund ever during the pandemic. We had no issues with attracting capital, and I see no issues with deploying it," says Rainer Lenhard, partner and co-head of the DACH region at Nordic Capital, in our virtual roundtable discussion focused on the German private equity market. "In fact, we are deploying at a faster rate than ever before."

€12.5bn

Overall deal value in Germany in 2020, according to BVK

"It is surprising how brief the period of dealflow disruption actually was," agrees Andre Perwas, partner at Capvis. "As governments and central banks pumped money into the economy the outlook became more positive and dealflow picked up very quickly."

Till Burges, managing director at HarbourVest, is also seeing activity levels increase. "Everything went up a gear at the start of 2021," he says.

Rainer Lenhard
Partner and co-head of the DACH region, Nordic Capital

Rainer Lenhard joined Nordic Capital in 2019, with a focus on the firm's healthcare, technology & payments and financial services sectors. He was a managing director at Goldman Sachs, focused on European healthcare companies.

Andre Perwas
Partner, Capvis

Andre Perwas joined Capvis as a partner in the firm's Frankfurt office in 2019. Perwas has previously worked at both 3i and Accenture. His role at Capvis includes leading the advanced services and software sector.

Jin-Hyuk Jang
International counsel, Debevoise & Plimpton

Jin-Hyuk Jan is an international counsel based in Debevoise & Plimpton's Frankfurt office. He advises sponsors on the structuring of funds as well as regulatory matters. He also advises institutional investors on their commitments to private markets funds.

Alexander Friedrich
Managing director, Ardian Buyout

Alexander Friedrich has nearly 20 years of investing and deal structuring experience and serves as a managing director of Ardian's Frankfurt office. He previously worked in partner roles with Quadriga Capital in Frankfurt and Gilde Buy Out Partners in Zurich. In both positions he pursued transformation buyout and growth expansion transactions in Germany, Switzerland and Austria.

Till Burges
Managing director, HarbourVest

Till Burges joined the primary partnership group of HarbourVest in 2006. He focuses on buyout and venture capital investments and serves on a number of advisory boards. Prior to joining the firm, he was a consultant at Bain & Co in both the UK and Germany.

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>
> **RAINER LENHARD**
> **Nordic Capital**

But Burges also cautions that valuations have been commensurate with the flight to quality that has occurred. "The pandemic has increased the demand for crisis-resistant assets. Unsurprisingly, this has included businesses in the healthcare and technology sectors. As with any market, a disparity in supply and demand will inevitably lead to a surge in pricing. This surge has been compounded by a 'fear of missing out' with record high prices being paid for strong assets across the whole of Europe."

Burges adds that the pandemic has also positively challenged German, and indeed European, investors in two ways. "Firstly, they're looking beyond popular sectors and exploring other investment themes. Secondly, private equity can take an active position in the post-pandemic recovery by finding value assets that suffered during the crisis and helping these businesses rebuild. This can be an important value driver for the German market portfolio over the next 12-18 months."

But Alexander Friedrich, managing director at Ardian, based in Frankfurt, says that, for now at least, the country remains a tough market. "The dealflow we are seeing coming out of Germany is not as interesting as it was last year," he says. "We see a lot of secondary buyouts involving businesses that have been sitting in the portfolios of our fellow GPs for quite some time. Trying to extract a strong equity story in those situations is tough and often impossible if we want to stick to our rigorous selection process. Last year there were a lot of carve-outs and family-owned situations, which is not the case this year. That means active sourcing for short to mid-term primary situations is again, very much on our agenda."

Mitigating high prices

What is clear, is that the deals that do come to market in Germany are being aggressively pursued by private equity. It is incumbent on managers, therefore, to be disciplined in their diligence and robust in their value creation planning.

"Valuations are high in all quality assets, no question," says Lenhard. "The way we get comfortable with that

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> **TILL BURGES**
> **HarbourVest**

is by being particularly selective and by rigorously adhering to a value-creation strategy. We lean heavily on our operational teams in supporting the portfolio companies."

For example, last year Nordic Capital acquired RegTech, a German software company focused on the regulatory value chain, with plans for product development, enhancement of organisational capacity and an expanded international footprint. "We spent a great deal of time putting together a full value-creation plan with the management, bringing in operational experts, well before the signing," Lenhard explains.

Friedrich agrees that when prices are high, it is all about how you drive value. "You need digital teams, talent

Has Germany benefited from a Brexit brain drain?

It has been five years since Britain's historic vote to leave the EU, but has the threatened brain drain from the UK to continental Europe actually happened and has Germany been a beneficiary?

"I think Germany is benefiting from a Brexit brain drain, although perhaps not quite to the extent that it would have liked," says Jin-Hyuk Jang of Debevoise & Plimpton. However, Jang adds that there may still be more movement to come.

"When details of the free trade agreement which will govern the future of the EU's relationship with the UK were revealed earlier this year, there was no mention of equivalence for the financial services industry, which is the basis for cross-border provision of financial services under a third-country passport. I think that may increase the number of UK-based firms interested in setting up subsidiaries in Germany, as well as other EU jurisdictions in order to have access to the European Single Market."

Alexander Friedrich adds that Ardian is receiving large volumes of CVs for jobs in its German-based investment team from individuals currently based in London. "But that tends to be for more junior roles," he says, while Andre Perwas of Capvis says that although he is seeing an influx of people coming to Germany, it is still insufficient to meet the level of need. "Talent shortages remain," he says. "It is the same for real estate. If you are looking for an office in Frankfurt's banking district it is as difficult as it has ever been."

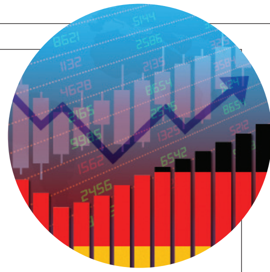
Germany's fundraising fortunes

Covid hasn't stopped those who know the capital-raising path well

Almost €4 billion was amassed by German private equity managers in 2020, according to the BVK, excluding German allocations of pan-European and global investors. Indeed, the fundraising environment was markedly buoyant despite travel restrictions and social distancing measures. In fact, according to Jin-Hyuk Jang of Debevoise & Plimpton, the use of technology meant quicker decision-making. "With people no longer having to travel and meet in person to make things happen, processes have been accelerated," he says.

However, fundraising fortunes favoured those with a strong network of existing relationships. "For those new to the market, it was more difficult to gain traction," Jang explains. "Emerging managers need to have something really special to sell to investors. We have seen some strong fundraisings from new managers focused on growth niches, such as tech and healthcare, but it seems more challenging in the buyout space where established managers tend to share the market amongst themselves."

HarbourVest is one LP willing to invest in new teams both in Germany and across Europe. "As a global investor, we like to find and back new managers because they bring a different energy and opportunity to our portfolio," says Till Burges of HarbourVest. "These new firms are dynamic and entrepreneurial which means they're keen to implement best practices in all areas of the business right from the start and aren't hindered by legacy processes."



Home-grown investors

While German managers have had significant fundraising success of late, home-grown institutional investors are still markedly under-represented in the asset class.

"There has been a push in recent years, but the inherent risk aversiveness of German institutions means LPs in this country still tend to favour debt over equity," says Rainer Lenhard of Nordic Capital.

Jang, meanwhile, comments on the regulations that limit the amount of capital the country's pension funds and insurance companies can deploy in alternatives, but says he has noticed increased interest nonetheless. "In a protracted low interest rate environment, it is inevitable that appetite for alternatives is growing. But not all of that money makes its way to private equity. Some is allocated to infrastructure and private credit."

Jang also explains that the German legislature recently missed an opportunity to increase the country's attractiveness as a domiciling jurisdiction for alternative fund managers when it failed to expand VAT exemptions from venture capital to the entire spectrum of alternative asset classes as part of proposed changes to enhance the fund industry in the country. "That puts Germany at a huge disadvantage as an alternative fund management jurisdiction," he says.

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ANDRE PERWAS
Capvis

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> **JIN-HYUK JANG**
> **Debevoise & Plimpton**

teams, operational experts that really know the sector, and even the business," he says.

"To be fully convinced on how you want to create value and to finalise your investment hypothesis, you need to work hand in hand with all those people for months before any sort of sales process even gets started."

Meanwhile, Friedrich adds it is still possible to circumnavigate full auction processes but that only becomes easier the further south within Europe you go. "In Germany it is rare. The market in our size range is very much intermediated and so it is all about conviction – conviction that you have lined up everything that you need in order to justify the valuation."

Perwas also says there is potential to persuade founders or management teams to work with you, by offering a partnership-style approach. "That doesn't mean you will pick up companies on the cheap – an entrepreneur isn't going to leave millions on the table just because he thinks you are a nice guy. But in certain situations, it can help avoid a highly competitive process."

Digital transformation

Chief among private equity firms' value-creation weaponry, of course, is the potential to initiate digital transformation. Nowhere is this more evident than in Germany's *Mittelstand*. "There is huge opportunity to implement tech transformations in Germany's more traditional industries, without paying the high prices of investing in tech companies per se," says Perwas.

"Covid has led to digital transformation in a whole range of businesses. The digitisation of sales, for example, is a big step for a company to make. Many organisations have historically had a field sales force, used to a certain way of doing things. Transforming that to a tele- or digital sales force is a bold and ambitious move that will potentially require large-scale investment in infrastructure and IT, as well as new talent.

"That is a good investment case for us. It may take a couple of years, but you will have more efficient processes in the end. Ten years ago, sponsors would have run away from IT projects, which had a reputation of running over and costing more than planned. But there is now a recognition that you can achieve a clear return on your investment, particularly if it is in a tangible area such as sales channels or procurement."

Lenhard agrees that digital has become key to all portfolio companies over the past 12 months. "For some it has been necessary for survival. One of Nordic Capital's portfolio companies is a homecare business for example,

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> **ALEXANDER FRIEDRICH**
> **Ardian Buyout**

where they had introduced digital tools for some time but with limited take-up. When the pandemic occurred, there was no alternative. There is a recognition now that these changes are here to stay. Even service businesses are embracing digitisation at a speed that would never have been deemed possible prior to the pandemic."

Regardless of a firm's ability to avoid the most hotly contested situations, and to deliver on value creation initiatives, however, there are always macro factors at play, not least a stubbornly persistent pandemic.

"What keeps me awake at night?" asks Lenhard. "I just hope that Germany can get its act together and push ahead with its vaccination programme, so that we can open up and continue doing what we need to do, for the sake of our investments and for the sake of German society."

Inflation, of course, is deemed by many to be another cloud on the horizon, with the associated risk of interest rate rises. But Germany's private equity practitioners appear sanguine on the matter.

"Inflation is a hot topic, but I don't believe interest rates are going to change dramatically any time soon," says Friedrich. "All our value drivers remain intact, and we build our portfolio along clear long-term growth trends. Currently I don't see inflation inhibiting our ability to generate returns."

Perwas agrees. "I think the risk of inflation spilling over to interest rates in the short-term is moderate. It is worth keeping an eye on input prices, of course," he says. "Overall, however, I think the economic outlook is solid and the market will continue to be attractive."

Burges, meanwhile, points out that no one has a crystal ball, making it difficult to predict how global markets will recover. "International pressures will no doubt have implications for the German market. The deeply entrenched manufacturing sector and reliance on open borders and exports has meant an ever greater need to innovate and diversify. Adaptation and evolution have been absolutely key to Germany weathering the covid storm with local investors quickly pivoting business and investment strategies to adapt to these challenges."

He adds that sectors related to technology have been at the forefront of change, driving the covid recovery.

"Germany has become a springboard for tech development, and the pandemic has increased that tenfold. Hubs like Berlin and Munich bring in talent, spur innovation and attract local and international investment attention.

"It has been incredible to witness the volume of software solutions that have been developed in Germany alone, so there is a great deal to be optimistic about in those sectors."

Burges is also positive about "areas where Germany has traditionally excelled – with sophisticated production and processes that are so deeply rooted in the country's culture and ethos". ■