

From left: Wendelin Thönes, Mirja Lehmler-Brown, Patricia Volhard, Georg Helg



Time to run faster

Valuations are sky-rocketing across Europe thanks to plenty of capital, and Germany is no exception. In this environment, GPs must relentlessly drive dealflow – because not investing is not an option, Isobel Markham writes

PHOTOGRAPHY BY STEFAN EFFNER

The attractiveness of Germany for private equity is undeniable. For starters, compared with its northern European neighbours, its economy – if not quite booming – is certainly healthy in relative terms.

Germany's GDP grew 0.6 percent in the first quarter of this year, compared with 0.4 percent for France and 0.2 percent of the UK, according to Eurostat, the European Commission's statistics bureau.

Despite this, the country has always been a tough nut for private equity to crack. Figures for 2016 were respectable, with €5.7 billion invested in around 1,000 companies,

down slightly from the €6.6 billion invested by private equity firms in 2015, according to data from BVK, the German Private Equity and Venture Capital Association. This compares with €53.7 billion invested across Europe last year, says trade association Invest Europe.

PEI data found that fundraising by Germany-headquartered funds almost halved in 2016 to €1.95 billion raised by six funds, from €3.05 billion raised by 12 funds in 2015. This is against a backdrop of a nine-year high in fundraising by European private equity firms last year, according to

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Invest Europe. Buyout funds raised €56.3 billion in 2016, compared with the €33.6 billion raised in 2015, despite a 9 percent decrease in the number of funds raised.

Nevertheless, if you're a regional or pan-European player, you can't afford to discount Germany. In early June we gathered a panel of market experts in Frankfurt to discuss how to prepare for the next downturn and how to put money to work when not investing is not an option.

Q What's the biggest challenge facing the German private equity industry?

Mirja Lehmler-Brown: Many of the regions in Europe have the same challenge at the moment, and it's liquidity. There's a massive amount of capital driving pricing »

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Patricia Volhard



MEET THE ROUNDTABLE



MIRJA LEHMLER-BROWN
Senior investment manager in private equity
Aberdeen
Private Equity

Lehmler-Brown is a member of the firm's investment committee. She previously worked for nearly 10 years in the investment banking division of Goldman Sachs and Morgan Stanley.



WENDELIN THÖNES
Director,
private equity
Allianz Capital
Partners

Thönes joined the firm in 2007. He focuses on investment opportunities in Europe (fund investments and co-investments) and serves on the advisory boards of a number of European buyout funds. He previously worked at Ernst & Young Transaction Advisory Services.



GEORG HELG
Managing director
Capvis Equity Partners
Helg has been with Capvis since 2011. He has 20 years of experience in consulting and corporate finance/investment banking

with Deutsche Bank, ABN AMRO and The Royal Bank of Scotland.



PATRICIA VOLHARD
Partner
Debevoise & Plimpton
Volhard is a member of the firm's investment management group. Her practice focuses on advising private funds on a range of

regulatory issues. Previously an associate at Debevoise, Volhard rejoined the firm in 2017 from Pöllath + Partners, where she was a partner in Frankfurt.

» to extremely high levels again. If you give up some of the upside by paying a high price, you'd better run faster. I think most markets today are not that fast growing, which makes high return linked to the aggressive pricing challenging.

Georg Helg: High valuation levels and a lot of competition focusing on attractive acquisition opportunities are the biggest challenges, not only in Germany but in the entire German-speaking region which we cover.

Patricia Volhard: The main challenges I see from the perspective of European institutional investors, in particular with respect to Germany, is the complex tax and regulatory issues that German institutional investors have to face, in particular German investors investing through German *Spezialfonds* [funds set up for institutional investors allowing for a more lenient regulatory framework].

The challenge for Germany over the next few years will be to enforce its position from a regulatory and tax perspective and to create legal certainty to investors and fund managers. That means with respect to alternative investment funds from a regulatory perspective to have a good understanding of how private equity funds operate and the concerns of their investors; to supervise managers and advisors in light of such understanding, thereby creating a regulatory environment that gives sufficient comfort, is competitive in terms of timing when it comes to handling applications and requests, and considers specifics of private equity funds and their investors (rather than imposing requirements which are made for UCITS). It will also be important to continue to permit delegations to group entities in other countries, including the UK, as private equity fund sponsors often operate globally and have teams all over the world.

Q Is your concern that GPs are paying too much or that they're not getting the capital in the ground?

Wendelin Thönes: The concern about the liquidity is really investment discipline. Having more and more capital to invest may increase the temptation for managers to find a somewhat higher price or a somewhat less attractive risk profile acceptable which they maybe didn't find acceptable when investing the smaller predecessor fund.

Lehmler-Brown: It's a combination of it. It's really important to be disciplined but if you've sat out for two years and haven't done a deal, people are asking what's going on. You need to be relentless in driving origination around your themes and verticals, and you still need high conviction on the things that you're doing, selectively. You can't

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Georg Helg



just go out there and bid on anything. It's about knowing your deal, investing in the organisational set-up to be able to deliver significant value creation to enable, even with a high price, attractive returns.

Q Would you like more exposure to Germany?

Thönes: We don't mind having more of it, because if you look at the overall size of the economy and the overall size of the private equity market, you always have the impression that the German private equity market is underweight or below potential.

Lehmler-Brown: Germany has always had phenomenal businesses, but the mentality and the culture makes it harder for financial buyers to unlock. Newer, more technology-related companies might be different, but you still have quite a lot of the *Mittelstand* [small and medium-sized enterprises] where it takes a bit longer and they're more mindful of making sure the partner portrays themselves as industrial or family or entrepreneurs themselves. Currently we would particularly like to increase software-focused funds or software companies in the German region.

Q German LPs face particular tax and regulatory challenges when investing in private equity – is it tough for them to gain access to top-performing global funds that may not feel the need to accommodate them?

Volhard: German institutional investors often have specific regulatory concerns that need to be taken into consideration. We see that global fund managers that have an important investor base in Germany – and Germany is an important investor country in Europe – listen and try to address the concerns that these investors have. It's often not only the Germans, it's the Europeans generally. For example, if you take the insurance companies, for Solvency II purposes, it's clearly better to have a European fund



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Mirja Lehmler-Brown

vehicle for a private equity fund. That's not a German-specific issue, that is for all insurance companies in Europe.

Thönes: With regard to legal and regulatory requirements, [Allianz has] the advantage of being relatively large, also in terms of resources. Usually it means it's more complicated for our legal department but it doesn't prevent us from investing. From that perspective it might even be an advantage for us in some cases because we can handle situations that some other investors may not be able to deal with.

Q We're seeing very popular fund managers become more aggressive with fund terms – is this happening among German managers?

Lehmler-Brown: If you've built up a »



“**The concern about the liquidity is really investment discipline**”

Wendelin Thönes

€500 million just in co-investments since 2010 on top of more than €900 million in equity from Capvis Funds III and IV.

Lehmler-Brown: There is competition to get co-investment, and I think it's backfiring to a degree. You try to negotiate the best positions, but then you have a feeling that some people do not want to worsen their relationship with the fund manager because when it comes to selection for co-invest, particularly in a smaller fund, it's very much down to who the GP chooses. Some people tend to negotiate less hard because they don't want to worsen their position. They're so pressured to put the co-investment to work that they are willing to take more aggressive terms and are not negotiating as hard as they can to maybe stand in a better light.

Q **Has the German mid-market become more competitive in recent years?**

Helg: We have to try to identify transactions at a very early stage through focused and proactive origination efforts, much earlier than when they hit our desk in form of a teaser. Then you can select deals where you are truly a good home for that company and you can start working on creating an angle. You can think about bolt-on transactions or other means of value creation way ahead of the transaction process starting. That is something of value besides the price which you can bring to the seller and management team and which will also make them more

» position to be a premium brand in fundraising, in any other industrial or consumer area you would think 'why don't we raise our prices'. You could do a bit more carry or change the carry structure to deal by deal or you could lose the hurdle rate. I think there's a fair amount of that in the market because people can. Evaluating that from an LP position, it's whether you think they'll keep on doing pretty much what they've been doing and it's just because they can, or whether you think the culture or motivations within the firm have tilted to the degree you might choose not to work with them.

Volhard: [German] investors have so many tax and regulatory issues they must face before they invest into a structure that very often we feel clients have to get

these issues solved before they can even talk about terms. Even before you talk about your track record or your return, the German investor would be asking: 'Is your structure complying with German or European insurance regulatory requirements and can I invest in it from a tax perspective?'

Q **Are you seeing increased demand for co-investment as LPs seek to blend down management fees?**

Helg: There is a lot of interest in co-investments and we are frequently asked by our LPs whether they can participate. It's not the LPs only, it's also 'outsiders', large family offices or multi-family offices which are regularly calling and would like to co-invest.

We have done a fair share of that in recent years, roughly we have placed around

skewed toward selling the company to you. It's not just the price.

Sometimes we as private equity players have an advantage [over trade buyers] because we typically don't have synergies and we would not centralise anything, at least unless we already had a portfolio company in that space. That from time to time helps us winning a transaction against competition from trade buyers, especially when the target is a family-owned company.

Q Industry insiders can't agree on whether we've already reached the top of the cycle, but at some point, we will see another downturn. How are you preparing for that?

Lehmler-Brown: We live in a cyclical world for sure and nobody knows exactly when things will turn, but it will turn. Exponentially we see the capital structures getting more and more aggressive, which they tend to get towards the end of a cycle. We have an unprecedented liquidity situation, backed by central banks, etc, which

are making some downturn aspects hard to predict.

The majority of what we do is fund investing; funds invest over a period of time, so it's making sure it's time-diversified, and sector-diversified as normal. It's harder in today's markets to invest in highly cyclical industrial companies because the pricing is still high. There is more capital deployed in more defensible areas. We are also invested a bit in the distressed market that should be well-positioned to pick up value when markets turn. Some managers are better at riding out choppy waters than others and making sure they're positioned for that. Good managers will remember the 2008 extreme cycle and are making sure they have built in multiple cushions, capital flexibility and operational Plan Bs. Whether we will have another 2008, nobody knows.

[The global financial crisis] instigated a succession among many of the larger funds. People that grew up in and have seen the GFC took on the reins and had to sort quite a lot out. You see lots of firms set up better

when it comes to how they drive origination, the value creation process, particularly growth initiatives.

If you buy at these multiples, in most sectors you need to [project] an exit multiple that is one or two turns lower, so you will already have prepared for things coming off.

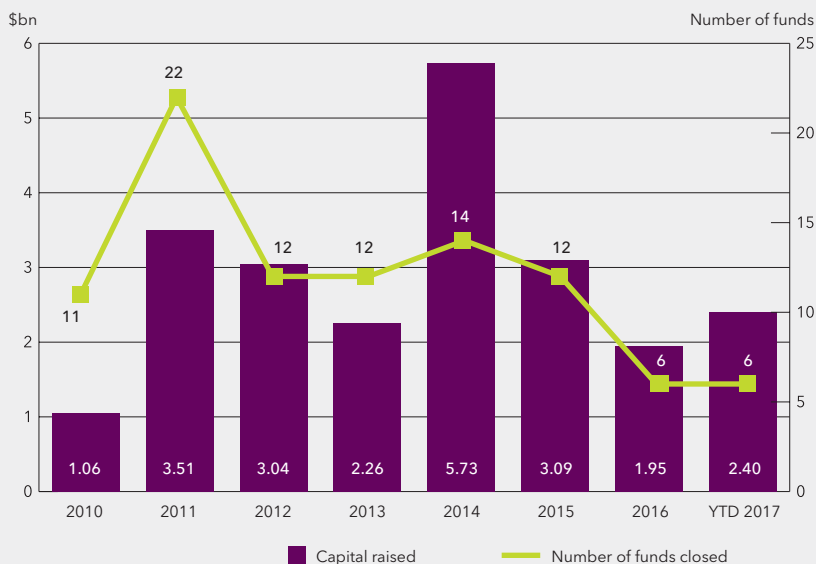
Helg: We don't take all the debt offered to us. You see debt multiples recently which we have never seen before. Valuation multiples some two years ago crossed over to what we had seen in records in 2008, but debt multiples, that happened only in recent months. If you take the maximum debt package offered onto a cyclical company, I couldn't agree more that you are set up for significant problems.

We did two acquisitions during the summer of 2008, just before the crisis happened. They both developed very well delivering a pretty nice return. So it's not necessarily the case that if you invest on the top of a cycle you end up in shambles. If it's the right company and your investment case is working out over a longer period of time, then you can still be successful. Who knows when the cycle is going to turn? If you look at the European economy, growth is accelerating still and which shock will change that we do not know. Not to invest is also not a solution.

Thönes: With regard to a potential cycle downturn, as an LP there's only so much you can do. What we can do is look at what managers might do. We look at Plan Bs, we look at how they are set up, whether they have operational resources, we look at the investment discipline they have shown in the past, their investment committee processes. That's what we can look at, because in the end it's the managers that take the decision, that have to react to the situations that their companies are facing and that also have to, in the end, time the investments. ■

INVESTING AT HOME

Germany-based private equity fundraising



Source: Private Equity International