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Method to the Mittelstand

Even amid a wider dealflow drought, Germany's mid-market is thriving. This comes as a result of relatively low PE penetration, fragmented industries and a new generation of ambitious managers, write Amy Carroll and Adam Le

Dealmaking in Germany slumped in 2022. According to research by PwC, the country saw a 33 percent fall in the number of transactions completed and a 50 percent fall in value. However, market participants say these statistics belie their own experience of a still-vibrant Mittelstand.

"We saw our highest-ever volume of deals last year, with 900 transactions coming across our desk, up from 720 in 2021," Marc Thiery, managing partner and founder of Deutsche Private Equity, tells *Private Equity International* at our annual Germany roundtable in May. "This year we are up again, which is great and perhaps unexpected given that we hear about a slowdown in the market. My impression is that, macro-wise, the lower end of the market where we invest appears much less affected. The large deal market, which is more impacted by the availability of leverage and secondary and tertiary buyouts, has come crashing down."

"The very largest transactions are definitely more challenging today as leverage has become much more costly," says Jin-Hyuk Jang, international counsel at Debevoise & Plimpton. "With small-cap deals, there are always ways to find finance, whether through private debt funds, by injecting more equity or by turning to co-investment."

Thiery adds that established players are being granted access to a disproportionate amount of dealflow when compared with later entrants. "There was a point towards the end of 2021 when only around 40 percent of our opportunities were proprietary or involved limited auctions. That has now risen to 70 percent in the first quarter of this year.

"Well-resourced and respected firms in the German market with a trusted network of M&A advisers are

Marc Thiery
Managing partner and founder, Deutsche Private Equity

Prior to launching DPE, Marc Thiery held roles at a number of European private equity firms, including Englefield Capital (now Bregal), Morgan Stanley Capital Partners, Apax and Allianz Private Equity Partners. Thiery comes from a family of entrepreneurs that established a longstanding Mittelstand company in the pharmaceutical packaging industry.

Jin-Hyuk Jang
International counsel, Debevoise & Plimpton

Jin-Hyuk Jang is a member of Debevoise & Plimpton's funds/investment management group and corporate department, and is based in Frankfurt. He advises on the structuring of private equity, real estate, infrastructure, venture and credit funds, as well as regulatory matters impacting those industries.

Boris Zoller
Managing partner, Capvis

Boris Zoller has been with Capvis since 2008, having previously worked as a strategy consultant at Oliver Wyman. He is a member of the Capvis investment committee and is responsible for the healthcare sector. He serves on a number of boards, including Schurter, Tertianum and Variosystems.

Andreas Schmidt
Managing partner, AltamarCAM

Andreas Schmidt has spent more than 17 years with AltamarCAM and has 23 years of private equity experience. He originally worked in the investment team at AltamarCAM's predecessor company, and was later global head of DB Private Equity and co-CEO of CAM Alternatives. Schmidt previously worked at Boston Consulting Group and Gerling Group, now Talanx.

faring much better than an international firm that opened an office in Germany a few years ago in order to accelerate its fundraising prospects. Those types of managers simply aren't getting invited to the table."

Boris Zoller, managing partner at Capvis, agrees that dealflow does not appear to have been meaningfully impacted by the current macroeconomic environment. However, he adds that it is taking longer to complete deals, and processes are sometimes simply falling silent. "Sellers' price expectations are still often not being met. It takes time to adjust to the new normal, particularly in some industries," he says. "Some sectors, such as healthcare, are still running at a fast pace, but other more industrial-orientated segments have definitely slowed down."

"Dealflow remains high, but the question is how much is actually getting transacted," adds Andreas Schmidt, managing partner at AltamarCAM, who cites the firm's experiences in the co-investment market. "Our impression is that there were definitely fewer deals completing in the last quarter of 2022 and the first quarter of this year."

The shadow of conflict

In many respects, Germany is riding the same rollercoaster as other European markets. Still, there are idiosyncrasies that set this region apart.

"Germany stands out for the level of fragmentation in the economy," says Thiery. "There is also less private equity penetration than in more efficient markets, such as the UK. There are therefore more primary private equity transactions available, which should help maintain dealflow."

Germany has clearly been impacted by the war in Ukraine, particularly in terms of the resulting energy crisis. Schmidt cites the example of an asset AltamarCAM was looking to sell last year, before postponing due to buyer reticence. "Everyone knows that Germany was more dependent on Russian gas than most other European countries and has closer links with Eastern economies. My sense is that sentiment has already changed," he says, adding that the asset is likely to return to market within the next 12 months.

Overall, fallout from the conflict appears to have been limited, says Zoller. "The indirect effects of the war, such as rising inflation and interest rates, have driven a slowdown in dealmaking, but there have only been a few businesses on our radar with minor direct links to the region."

Thiery adds: "Dealmaking was impacted by the general macroeconomic uncertainty that came with the war, and the energy crisis, rather than any direct exposure to either Russia or Ukraine. Less than 1 percent of revenues in one

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JIN-HYUK JANG
Debevoise & Plimpton

portfolio company were linked to the region, and there is nothing we came across in due diligence that would have stopped us transacting. Fundraising has been more impacted than dealmaking."

Indeed, fundraising has taken a dive in the region, in line with a global slowdown. According to data from Invest Europe, €14.2 billion was raised for DACH-headquartered strategies in 2021. In 2022, that figure dropped to €11.1 billion.

"Until mid-2022, it was possible to raise huge funds in a very short period of time. That simply isn't the case today," says Zoller. "Some LPs are cash constrained, as their GPs are not providing enough distributions. In addition, many LPs explain that they are suffering from the denominator effect. There are also a lot of funds in the market right now, so LPs are having to make decisions about where they deploy their resources, both human and financial. There are investors out there that are still below their target private equity allocation; the challenge is to find those investors and convince them of your proposition."

Thiery adds that the situation has been exacerbated by US LPs becoming more cautious about Europe: "These topics [the war and energy crisis] are being overemphasised in their thinking, which is natural given geographic distance and typical investment board risk aversion."

European LPs are better positioned to calibrate what these events actually mean for local economies, he explains. "Of course, FX developments have had an impact as well, given how strong the dollar became. Overall, as we saw post-GFC and the EU debt crisis, US LPs just aren't very active in Europe right now."

Zoller agrees that it has become more challenging to convince US investors to deploy in Europe in light of the geopolitical situation. However, he adds that LPs from other regions such as the Middle East are less concerned about Europe.

Meanwhile, smaller German managers are also suffering from the ongoing migration of capital to mega-funds. "Funds of €1 billion or less represented over 50 percent of the European fundraising market just five years ago. These days they represent less than one-third," Thiery says. "Large allocators are looking to put big tickets to work in institutional firms with huge marketing and reporting departments. A firm like us, with 60 people, just can't match that."

According to Jang, the key to a successful fundraising today is to have strong existing relationships. "LPs want to invest with trusted partners that have demonstrated past performance," he says.

Thiery agrees. "As a rule of thumb, for a successful fundraising today, you need around 80 percent of existing LPs to re-up at a realistic 80 percent of their previous commitment level. That gets you about 60 percent of the way, which should give you enough momentum to get to target," he says. "But a lot depends on how strategic you have

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ANDREAS SCHMIDT
AltamarCAM

been with your investor base, historically. Managers that were overexposed to the US or funds of funds that are also struggling to raise money will face challenges."

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> **MARC THIERY**
> **Deutsche Private Equity**

Retail therapy

A gruelling fundraising market has inevitably directed attention towards the prospect of raising capital from retail investors. On this topic, Jang points out that it is important to define exactly what it is we mean by 'retail'. "In Germany, for example, we have a semi-professional investor category, and other jurisdictions have similar terminology regarding qualified investors. I would suggest that this is the pool of investors that private equity firms are contemplating targeting, rather than genuine 'retail'."

Jang adds that the administrative burden of accommodating thousands of retail investors would be prohibitive for the vast majority of German private equity managers – coupled, of course, with regulatory restrictions. "What we are seeing instead is GPs teaming up with private banks to target their client base, or else teaming up with specialist tech-led service providers, which can pool retail investors into a feeder structure. That is far easier for private equity firms to handle."

Schmidt, meanwhile, is sceptical about German GPs' prospects for tapping into the retail segment in the near future. "This is something that can only be done if you have a true global brand, even if you are working with a private bank or digitalised platform," he says. "European Long-Term Investment Funds and other semi-liquid structures are typically adopting a diversified secondaries or co-investment strategy to accommodate liquidity needs. It simply wouldn't work for a focused, Germany-only primary fund."

Jang points out that ELTIF revisions made this year – or ELTIF 2.0 – have increased the structure's appeal by expanding what can be invested in. "The big benefit of the ELTIF is that you can market to retail investors on a European passport basis," he says. "Nonetheless, I still don't believe this is the route the majority of firms will go down given the administrative and cost burden. There is a lot of interest in ELTIFs, but I haven't seen many actually come to fruition."

The asset class does clearly face an imperative in terms of diversifying its investor base, however. That is particularly true for larger-cap firms. "Ten years ago," Schmidt explains, "institutional investors were piling more and more money into alternatives because it was the only place they could achieve alpha. But that is now shifting. Many LPs have overcommitted in recent years and are now either maintaining or even reducing their exposure. Managers are therefore thinking of ways to replace that growth, and retail is one obvious answer."

Thiery is more sceptical, however. "Mega-managers are more preoccupied with accessing the $45 trillion non-institutional pool of capital than they are in making money for their LPs, in many instances," he says. "Increasing their AUM, and share price if listed, has become an obsession, but that is not the best way to serve your customers."

The ESG angle

ESG is a critical component of value creation for Germany's Mittelstand companies, according to Deutsche Private Equity's Marc Thiery, whose firm has recently hired two ESG specialists to support its team.

"Without a doubt, we are seeing greater interest from LPs when it comes to ESG initiatives," says Thiery. "It is a fantastic development, because private capital has the power to effect change quickly [compared with] the political manoeuvring required to coordinate a global response."

"It is vital that ESG forms part of a manager's culture," says Boris Zoller of Capvis. "It should be deeply integrated into the overall strategy of the portfolio company and should be a permanent item on the board agenda."

European regulation is, of course, also playing a role. Jin-Hyuk Jang of Debevoise & Plimpton says Article 8 has now become the de facto standard for European investors. "The irony is that SFDR is a transparency regime. It doesn't seek to provide an ESG label, although that is the way that it is widely being used."

Despite EU regulation, myriad different standards remain and investors continue to make individual data requests to managers regarding ESG performance. "That is putting real pressure on smaller managers who either need to resource up internally, or employ consultants," says AltamarCAM's Andreas Schmidt. "There is no alternative, however. This is the way that the market is moving and there is only going to be more scrutiny on GPs' approach to ESG going forward."

Thiery agrees that the task can seem overwhelming, but adds that accessing the necessary data is possible so long as a firm is truly committed. "For us, what has made the difference is a change in motivation. We have moved from viewing ESG as an LP requirement, a regulatory requirement and a risk management tool to something that can drive top-line growth, as well as multiples at exit. It also leads to better recruiting, staff retention and productivity.

"Amid war in Ukraine, meanwhile, it has clearly led to cost reductions in the form of energy savings, and so has ultimately enhanced profitability."

Private equity acceptance

Despite a challenging fundraising environment, market participants are confident that Germany has a strong proposition to put to LPs, particularly as the Mittelstand continues to open up to alternative investment.

"We have come a long way since Müntefering's locust comments and all the bad press that we used to receive," says Thiery. "In fact, there was a recent survey that suggested more than 80 percent of business owners would consider private equity ownership. This shift has partly been driven by a realisation that private equity is making a meaningful contribution to the economy, and partly by a realisation from management teams that there is a lot of money to be made. In addition, the reputation of large corporates has slipped through a combination of scandals and instances of manufacturing being taken offshore. Those companies are no longer assumed to be the more reputable buyers."

Schmidt adds that there is also an understanding that you cannot access the full breadth of the German economy through the public markets. "The public markets represent just a fraction of what Germany is all about. And I agree that fortunately the perception of private equity has altered dramatically. Private equity ownership is a great deal more accepted today."

This perception shift has been supported by legislative change at both a national and EU level, according to Jang. "Politicians recognise the need for alternative financing. They understand that it can't all come from the banks, particularly given the regulatory restrictions they face.

"Legislation does tend to focus on fostering the start-up and growth markets. But there are positive knock-on effects for buyouts too, such as discussions around VAT exemption on management fees in Germany."

There are still areas where the German government has taken a more combative stance against private equity, however, like for example when it comes to the social acceptability of generating profits in healthcare, says Zoller, referring to the ongoing discussion around stricter regulation of ambulatory healthcare centres in particular. "What is frustrating is that those discussions are purely centred on profits, and not the quality of care and the outcome."

Meanwhile, concerns remain around the thorny issue of the treatment of carried interest. "There have

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> **BORIS ZOLLER**
> **Capvis**

been some suggestions that the regulator is considering capping carried interest in the same way bonuses are capped for banks," says Jang. "We, along with the trade associations, are arguing that carry should be exempt from that application given the clear alignment of interest between investor and GP. There is a huge difference between the way that banks earn their variable compensation, and the way private equity does."

Operational improvement

Certainly, carried interest is going to be harder to come by going forward, as a high interest rate environment puts the onus squarely on operational improvement. "Managers will no longer be able to rely on the use of leverage and multiple expansion," says Thiery. "And Germany – with its highly fragmented industries, large operating improvement potential and higher-than-average proportion of primary buyouts – is ideally suited to benefit from that shift."

Schmidt agrees. "It has been more challenging to distinguish between those managers that are genuinely improving revenues and margins through operational knowhow and expertise, and those that have relied on multiples and leverage given the flood of cheap money that has been available until recently.

"Just as everyone claims they are top quartile, so everyone claims they create value by being hands-on investors. But now we are entering an environment where we will see a greater divergence in returns, and those that are genuinely driving value creation through operational improvement and buy-and-build strategies will come out on top."

Furthermore, Thiery believes that a more debt-constrained environment favours the German market, given that the Mittelstand has always been debt-averse. "Historically, the German market has been less leveraged than the Anglo-American markets. That means it is less impaired when it comes to making money now that debt is scarcer and more expensive."

Indeed, market participants are undeniably bullish about what Germany has to offer. "Germany remains one of the largest economies in Europe and is superior in many areas, including high-end manufacturing, healthcare, digitalisation and the energy transition," says Schmidt. "Meanwhile, the succession issue that we have been talking about in the Mittelstand for the past 20 years is now more pronounced than ever."

"The Mittelstand is relatively underfunded compared to other markets. The dry powder available is far lower," adds Thiery. "Germany also boasts hugely fragmented industries, and the generational change is ongoing. A younger, more sophisticated and energetic group of management teams is hungry to work with private equity. All of this makes this region extremely appealing, in contrast to other more centralised markets where private equity penetration is higher." ■