ROUNDTABLE

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German private equity rebounds defiantly

Mittelstand deals, venture and corporate carve-outs are all poised to accelerate, but sourcing remains challenging in a covid-19 environment, write Adam Le and Amy Carroll

The German private equity market was sizzling in the lead up to the pandemic. Spurred on by a spate of mega deals, a total of €32 billion of investments were completed in 2019, according to EY. That represented an 80 percent year-on-year rise and the highest tally since the financial crisis.

Transacting inevitably ground to a halt when covid-19 struck, as GPs frantically worked to shore up their existing portfolio companies and transitioned to a work-from-home model. But outside of the most badly hit consumer sectors, activity has quickly rebounded, in parallel with public markets.

"Companies that have continued trading well – the covid winners – have come to market, and the capital is still there waiting to be deployed," André Perwas, partner in the Frankfurt office at Capvis, explains at *Private Equity International*'s annual German private equity roundtable, conducted via Zoom in late October.

€32bn

Investments in Germany completed in 2019, up 80 percent year-on-year (EY)

$4.6bn

Capital raised by Germany-headquartered PE funds in Q1-Q3 2020 (PEI)

"There has been a flight to secure areas such as healthcare and software, but for companies with good market positioning, strong growth and strong management, we are seeing no negative impact on pricing and no reluctance to do those deals whatsoever."

"The snap back was bigger and faster than anyone expected," agrees Richard Hope, head of EMEA in the fund investment team at Hamilton Lane. "And it was more pronounced in Germany than any other European market."

Unlocking the Mittelstand

It would appear there is more to come. Fallout from the pandemic could finally unblock dealflow in Germany's famed Mittelstand. As state support schemes are eased, there will be owner-founders that simply don't have the stomach for the fight, and businesses that need stabilising equity on their balance sheets to meet debt

Frank Amberg

Head of private equity and infrastructure, MEAG

Frank wwwww is responsible for the private equity and infrastructure investment activities at MEAG, the proprietary asset manager of Munich RE. Prior to joining MEAG, Amberg spent eight years in the banking sector. He has also worked in private equity fundraising. Earlier in his career, he was responsible for M&A transactions with a German industrial company.

Patricia Volhard

Partner, Debevoise & Plimpton

Patricia Volhard is a partner in Debevoise & Plimpton's Frankfurt and London offices and is a member of the firm's private equity and funds groups. She focuses on advising private funds on a range of European regulatory issues and on structuring funds for EU insurance companies and pension funds. Volhard has also been heavily involved with both Invest Europe and BVK.

André Perwas

Partner, Capvis

Capvis hired André Perwas as its 10th partner in October 2019. Perwas is responsible for the advanced services and software sector and is based in the firm's Frankfurt office. He has more than 13 years of private equity experience, having previously worked at 3i and Accenture. He serves on the board of BSI Software.

Richard Hope

Managing director and head of EMEA, Hamilton Lane

Richard Hope leads Hamilton Lane's London office, focusing on equity, credit and secondaries investment. He is also a member of its investment committee. Prior to joining the firm in 2011, Hope worked as a director with Alliance Trust Equity Partners, where he helped establish a private equity fund investment business, as well as completing a number of direct deals.

German VC in the ascendancy

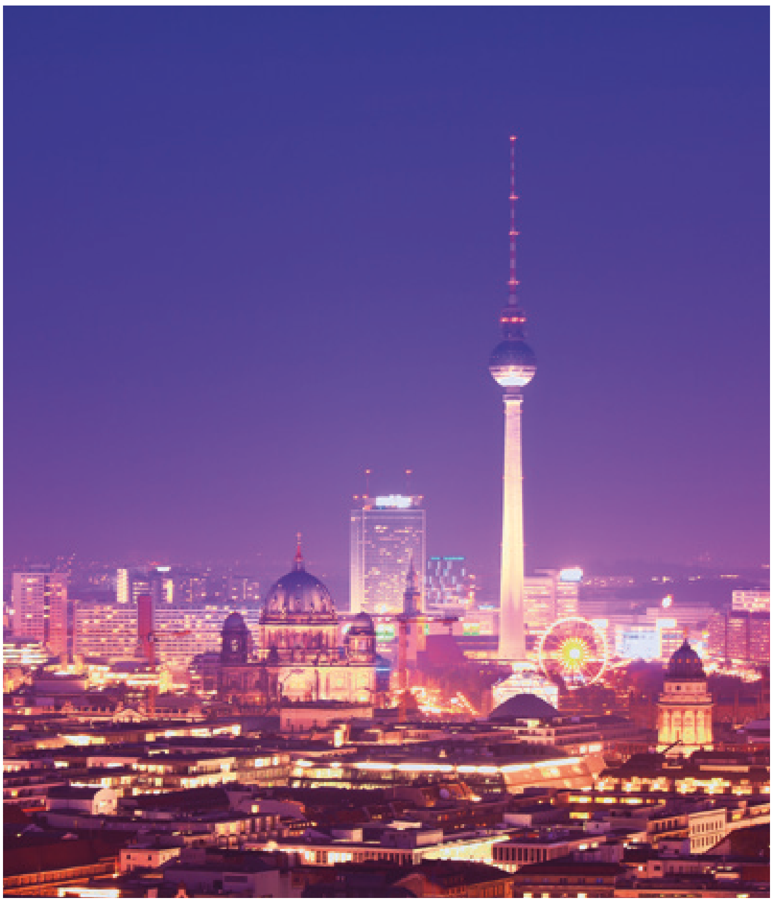
Berlin's tech hub is causing a stir. Limited partners are showing increasing interest in the city's early-stage and growth capital managers, according to MEAG's Frank Amberg, and valuations of tech businesses are climbing.

"Venture is one of the big winners at the moment, riding on a wave of digitalisation," he says. "It is a very hot area, although there is still room for future growth."

Debevoise & Plimpton's Patricia Volhard has also noticed growing appetite among LPs for German venture. She has seen US firms in particular eyeing opportunities in Germany, as well as other EU countries.

Meanwhile, the €5.25 billion listing of Permira's remote desktop software TeamViewer has opened the industry's eyes to the potential of the Frankfurt stock exchange.

"That IPO was astonishingly successful," says Hamilton Lane's Richard Hope. "Yes, it was a more established business that had been owned by private equity for many years, but it is still good to have such a strong example of a domestic IPO at a time when venture capital and growth are gaining in popularity. The aftermarket performance has been exceptional, and it is fantastic to be able to point to those kinds of success stories."



repayments and tax bills as they fall due.

"We have been talking about the wall of succession that exists in the Mittelstand for a long time," says Frank Amberg, head of private equity and infrastructure at MEAG, the asset management arm of Munich Re.

"But I strongly suspect we will finally see much more of those opportunities coming to fruition in the next few years, catalysed by covid."

Crisis situations typically cause corporates to refocus, and carve-outs should also start to emerge as state support eases and balance sheets come under strain.

"There are solid, non-core business units, sitting within larger organisations. Those organisations will want to prioritise what's most important to them," says Hope. "That is bound to create interesting opportunities through 2021 and 2022."

Of course, the challenge is to source and cultivate deal opportunities in an environment where travel is largely prohibited and face-to-face meetings banned. Building trust can be a long process, particularly when courting entrepreneurs and family owners. And with Germany re-entering lockdown the day before our roundtable was held, origination is likely to be difficult and protracted for the foreseeable future.

Meanwhile, valuing businesses is as tough as finding them. "Covid has massively impacted the ability to forecast and the ability to reach agreement on forecasts," says Perwas.

As a result, there have been more earnout mechanisms employed to get deals over the line.

"A lot of people are wanting to sell on future earnings and multiples," adds

> *"Overall, I am optimistic. I see more opportunities than challenges. The capital is there. The debt markets are continuing to work. It is just a question of forging the right partnerships"*
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> **FRANK AMBERG**
> **MEAG**

Hope. "Where there is volatility, that takes a brave investor."

For strong and resilient businesses, in strong and resilient sectors, the direction of travel has been one-way. Sponsors are piling into processes for the most attractive assets and prices are sky high.

Overall, however, while there will undoubtedly be opportunities emerging from the pandemic down the line, for now, building relationships, confidently forecasting future performance and agreeing on price remain stumbling blocks. As the number of viable deals that were already in the pipeline prior to the pandemic reduces, many GPs are starting to focus their attention on bolt-ons instead.

"If you already own a platform company and you know and trust the management team, bolting on can be less risky than backing a new business, particularly in an environment such as this," says Hope.

Build back better

The global pandemic has accentuated emphasis on ESG considerations, the roundtable participants agree. The concept of ethical investment is in the ascendancy and will dictate the way private equity firms deal with their existing businesses and employees as they grapple with the fallout from the virus, as much as it will create new deal opportunities.

"Climate requirements are going to be increasingly important for European limited partners and that will, of course, affect European GPs," says Hope.

"One of our insurance clients, for example, has very publicly stated net zero targets. You can understand why. Not only will reducing emissions make the world a better place, it will have a tangible benefit for the insurance industry in terms of weather-related liabilities."

Perwas adds that private equity's understanding of ESG is broadening to take new areas of sustainability into account, such as around plastic use, or sustainable clothing. "The whole process was becoming far more institutionalised and structured," he says. "Then covid comes along and propels health and safety issues into the spotlight and that accelerates the trend once again."

Indeed, private equity has a critical role to play in enhancing ESG standards, Perwas says. "A lower mid-market company will typically not have highly established ESG practices and procedures in place. Just as private

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> **ANDRÉ PERWAS**
> **Capvis**

equity ownership professionalises financial reporting and governance systems, it can raise ESG standards in smaller businesses."

Of course, private equity's renewed focus on ESG is not only a matter of benevolence. With a new EU-wide ESG disclosure regime becoming effective in March next year, rudimentary box ticking is no longer an option, explains Patricia Volhard, a partner in Debevoise & Plimpton's London and Frankfurt offices.

"GPs will have to be transparent about how they conduct their due diligence and how their portfolio companies perform against ESG targets," she says. "That will be a major change in terms of how some firms operate, and it should absolutely be viewed as a positive thing."

Indeed, taking a lead in building a sustainable economy and society will prove crucial to private equity preserving its fragile reputation. The asset class has been vilified by politicians and the press in the US amid high-profile failures and large-scale layoffs.

That said, Germany's private equity industry seems to be quietly gaining public support. "We have seen a steady increase in more positive public opinion in recent years," says Perwas.

"Those negative connotations are fading away and more emphasis is being placed on how value is being created."

"A lot of this comes down to a willingness to be transparent," adds Hope. "'No comment' just doesn't cut it as a response."

Amberg agrees: "We must be more proactive about sharing our stories and educating the public and politicians about what it is that we do."

In particular, German GPs need to emphasise that their underlying investors are pensioners and insurance customers – a winning argument, particularly when those pensioners are German.

Perwas says Capvis emphasises this point in pitches with founders. And according to Hope, one of Hamilton Lane's regional sponsors asked the firm to help them source more German LPs because they realised it was a positive story to tell management teams. "It helped give them credibility locally," he says.

Politics and private equity

Currying favour with politicians is also important, though not necessarily straightforward in a world where the political landscape is changing fast. Although covid-19 may be dominating the headlines, it is not the only situation with the potential to disrupt. We have just experienced an extraordinary US election, while Brexit is looming on the horizon.

For Germany, Brexit was initially perceived as offering some opportunities, in terms of bolstering Frankfurt's position as a financial centre and as a hub for European private equity. Volhard says she has seen an uptick in

More opportunities than challenges?

"The biggest challenge facing German private equity right now, has to be the pandemic and its subsequent economic effects," says Frank Amberg of MEAG. "You have to ensure your portfolio is bulletproof."

André Perwas of Capvis agrees. "There are going to be challenges in sourcing in a virtual world," he says. "A long-term sourcing approach will be crucial – taking the time to learn about a sector, then a subsector, then identifying companies and gradually building relationships, even if there is no immediate deal on the table. It is better to focus on a handful of opportunities where you have an angle, rather than take part in mass auctions on Zoom."

But out of chaos comes opportunity. Hope is particularly excited about the prospect of large corporates restructuring. Perwas adds that we could see businesses with lower short-term trading and hence more affordable overall valuations, despite strong business models and market dynamics.

Amberg, meanwhile, is also confident that German private equity will continue to deliver. "Overall, I am optimistic," he says. "I see more opportunities than challenges. The capital is there. The debt markets are continuing to work. It is just a question of forging the right partnerships."

"A lot of people are wanting to sell on future earnings and multiples. Where there is volatility, that takes a brave investor"

RICHARD HOPE
Hamilton Lane

firms opening offices in Germany. "We do see GPs creating a presence or beefing up their presence," she explains. "In large part, that is driven by Brexit, but it has been exacerbated by covid. If you want to do deals in Germany these days, it is even more helpful than in pre-covid days to have boots on the ground."

Meanwhile, new regulation, including the cross-border distribution directive, due to be implemented into national law next year, is intended to facilitate cross-border marketing within the European Economic Area, but is likely to make it more difficult to market from outside. That will heighten the need to have a regulated firm in the EEA and to demonstrate genuine substance in Europe. Luxembourg has been the obvious beneficiary of this trend, but firms are also setting up authorised management or investment services firms in other European countries.

"That is something we wouldn't have seen a few years ago," says Volhard. "And with regulatory and legal environments largely uniform across the continent, the question becomes, 'Where can I find the right people and talent in order to have useful substance?' The answer to that question varies from one firm to the other – there is not one EEA country that would be the most natural fit for all firms. But if a firm has a strong investor base in Germany, or portfolio companies in Germany, then Germany certainly makes a lot of sense."

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PATRICIA VOLHARD
Debevoise & Plimpton

However, the brain drain expected after the Brexit vote has not happened. "While we are seeing more applicants for positions from the UK, these are primarily expats looking to return. That has as much to do with covid as with Brexit," says Amberg.

"The idea that banks would move tens of thousands of jobs to the continent just hasn't materialised," adds Hope. "But I do think Germany should be a beneficiary at some point if the regulatory environment gets tougher."

Neither is Brexit the only significant political event on the agenda in Europe. With Angela Merkel preparing to step down as chancellor in 2021, all eyes will be on her replacement.

"Will we see a regime change?" asks Hope. "Germany has long been viewed as a stable country with a stable leader – the backbone of Europe. But what will happen with the election next year?"

Amberg, however, is sanguine, as long as populism can be held at bay. "Germany has fantastic companies. It has a great education system. I have no concerns about its economy," he says. "After Brexit, the world will have to make up its mind about where the UK stands on the global stage, but here on the continent, there is no doubt that Germany is perceived as the most important country from an economic and political standpoint. I am confident that Germany will continue to offer an attractive environment for jobs, for business and for private equity." ■