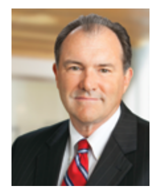
BDO KNOWS INTERNATIONAL PRIVATE EQUITY:

SPOTLIGHT ON GERMANY

Private equity (PE) is a prominent segment of the German economy. According to Preqin, Germany boasts the second largest number of PE fund managers in Western Europe, just behind the U.K. However, after years of rapid growth—and following a heated public debate about the role of PE firms in Germany—PE activity in Germany may be evening out. BDO USA Private Equity practice leads **Lee Duran** and **Kevin Kaden** sat down with **Michael Maxeiner**, who heads BDO Germany's Private Equity practice, to discuss his firsthand observations and predictions for private equity investment in the region. Here are some insights from their conversation.

Lee Duran



Kevin Kaden

Michael Maxeiner

What is the investment environment for private equity funds in Germany? Do you predict this environment will change at all in the next six to 12 months?

The investment environment has been very favorable for private equity funds in Germany, though it may now be showing some signs of overheating as a result of low interest rates and extreme liquidity in the capital markets. However, the business environment in Germany remains strong, which is good news for PE firms despite weaker deal flow.

In terms of deal flow, Germany saw quite a bit of activity in 2014 and 2015, though we found that the PE industry was feeding itself: Eighty percent of the transactions were secondary buyouts. Primary deals were rare; smaller and mid-market entrepreneurs and families were cautious to sell because it can be difficult to reinvest proceeds in other asset classes. Spin-offs and carve-outs from larger entities were limited. As a result, most of the well-established private equity funds are on the sell-side, and good deals are hard to come by.

Meanwhile, PE firms must also navigate an intensely competitive environment as the universe of bidders continues to grow—especially in the mid-market. Larger strategics dominate the bidding processes, family offices have grown their market share, and we're seeing a growing pool of international investors, particularly from the U.S., U.K. and China. Many big private equity players have come downmarket to take advantage of lower valuations and have been zeroing in on midcap and even small-cap platform transactions.

Over the next six to 12 months, we expect that these market conditions will cool down, with surface scratches already beginning to emerge. Banks have started to rein in acquisition financing in Germany since the beginning of the year, albeit yet to a limited extent and not as pronounced as in the U.S.; there have also been significantly fewer PE recapitalizations recently. We're observing debt funds stepping into the breach for the banks, but we still expect these developments to leave more acquisition financing on the table for fresh PE deals.

What are PE investors generally nervous about at the moment?

PE investors seek to benefit from challenging conditions. But if there is a reason to be nervous, however, it may be that they risk

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overpaying for growth in current market conditions while a recession looms. The more sophisticated ones may recall the turmoil of 2009 and 2010 and try to select their targets carefully—ideally with countercyclical business dynamics in mind—and invest effort in calibrating their investment strategies and portfolio companies to be bulletproof.

In addition, there are no low hanging fruits left on main street and, to continue the analogy, PE firms have to either stretch or to stoop down for the windfall. Nowadays, cutting promising deals that yield good returns requires far more time, personnel resources and negotiation. Straightforward leverage, cost reductions and multiple arbitrage are history. Based on our experience, the most successful players sometimes spend years preparing to invest in the right platform. Increasingly sophisticated operational value enhancement strategies, such as buy-and-build, growth by internationalization or restructurings via divestments of non-core segments, have become paramount to success, as have efforts to shore up portfolio companies' purchasing, production, and sales/business development capabilities. We also see successful PE firms leveraging senior industrial advisors.

Successful players have also worked to diversify their entire business models in order to hedge against disruptive developments. Strategies include entering new regions, markets, sectors and alternative asset classes.

What do you believe is holding back additional PE investment?

As discussed, deal flow has slowed in recent years—there simply are not enough quality targets out there for the volume of buyers in the marketplace. In addition, private equity still suffers from a certain stigma in the eyes of German "Mittelstand" (small and mid-sized) entrepreneurs and families as a result of the "locusts debate" of 2005, but that is increasingly diminishing.

What do holding periods look like, and what exit trends are you observing?

In general, holding periods are increasing. We're seeing more evergreen and extended fund maturity structures (e.g., 15+1+1 instead of the classic 10+1+1 funds), especially in the small and mid-cap segment. These structures are rather compatible with the long-term-oriented mentality of small and mid-market entities. At the extreme end, however, there are industrial holdings in Germany with pure buy-and-hold approaches who explicitly exclude exits.

In terms of exits, the IPO exit channel still remains quite small in Germany, and secondaries remain dominant. Chinese buyers are particularly hungry, and sales to them are an increasingly popular exit strategy.

Which industries are particularly attractive to foreign investors and why?

Both domestic and foreign investors alike are attracted to the sectors experiencing growth globally: Healthcare and pharmaceuticals; technology, telecoms and software; consumer non-cyclicals; and chemicals/industrials. These industries not only offer attractive growth perspectives but also—at least almost all of them—a certain downside protection in case of a bumpier road ahead.

What do you think will be the next hot opportunity for PE investment in Germany?

Distressed asset investments have bottomed out in recent years as high liquidity and near-zero interest rates have helped a number of struggling entities delay restructurings, leading many equity houses specializing in this space to diversify to other segments of the market where deal flow was stronger. The rising tide has lifted all boats, including those with leakages—meaning many of the restructurings that have been delayed remain inevitable, and we expect to see opportunities for PE firms to invest in distressed assets crop up again in the near future.

What impact, if any, has the persistent Eurocrisis had on private equity activity in Germany?

Germany has actually been a beneficiary of the Eurocrisis to date. German businesses were able to take advantage of the economic conditions to boost exports and grow international sales, ultimately having a very positive effect on PE returns thus far. Most PE players doubt that this is sustainable, however, and are preparing for a more difficult environment in the months and years to come.

How does Germany handle the taxation of carried interest, and how has this impacted private equity activity?

Sixty percent of the individual carried interest income of a private equity manager is subject to individual income tax (normally taxed by the maximum tax rate of currently 47-52 percent). The remaining 40 percent is tax exempt. In 2003, Germany introduced this partial income method since private equity managers increasingly threatened to migrate to tax-privileged areas. The measure has clearly worked; since then, the number of private equity executives migrating for tax reasons has been insignificant. The potential disadvantages associated with Germany's tax regime are more than made up by the advantages of being able to do business in close proximity with targets and the shareholders.

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