

The German Private Equity Market

Dr Holger Frommann

In recent years, the German private equity market has become the focus of attention of more and more international investors, and not only because of its 40-year history. Almost every important European private equity firm and many firms operating outside Europe started their investment activities or established branches in Germany - a clear indication of the growing importance of Germany's national economy and the vast investment opportunities it offers. Today, the German private equity market is one of the leading and most mature markets in Europe. According to latest statistics of the European Venture Capital and Private Equity Association (EVCA), Germany ranks third behind the UK and France in terms of investment value.

The Establishment of a Market

The first German private equity firms were established by banks and individuals in the mid 1960s, targeting mid-size companies in traditional industries. A first boost was experienced in the 1980s when venture capital funds were launched according to the pattern of US American venture capital firms. But the German private equity firms faced several difficulties, the principal ones being the lack of exchange for exits and a lack of understanding and acceptance of the business model by the companies.

The cautious development of the market until the mid 1990s then turned into an unprecedented boom

- thanks to soaring venture capital investments. Germany and Ireland wrote the European venture capital success story. Private equity investment values surged to €4.5 billion in 2000. The rise in investment was the result of successes in technology industries, the establishment of the Neuer Markt exchange and an immense inflow of new capital for German funds.

Companies' increasing demand for capital was met by an increasing supply of private equity from existing and new established private equity firms with expanding funds especially in the venture capital sector. In 2000, Germany became the leading venture capital market in Europe with venture capital investments totalling €3.7 billion. Technology investments made up more than half of the total investment value.

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Buy-outs take the lead

After the crash in the international private equity markets in 2001, the German market faced many new challenges and found itself at the beginning of a long and hard consolidation period.

Market players faced extreme difficulties raising funds and the losses incurred made institutional investors very cautious in providing new funds. With the consolidation, investments slumped and total losses rose while IPOs and trade sales were rare.

Simultaneously, the stage and sectoral distribution of investments changed. Venture capital in general and early stage investments in particular fell behind, while buy-outs and large transactions gained importance - making up about 70 per cent of all invested funds. From 2000 on, international buy-out firms were attracted by changes in the German economy and the strategies of German enterprises and intensified their activities in Germany by finding numerous investment opportunities.

With the consolidation process, investments dropped to €2.5 billion in 2002 and €2.4 billion in 2003. After the first signs of optimism in 2004, when investments reached €3.8 billion, the German private equity market continued to recover - something that was reflected in increasing fund-raising and exits in 2005. However, in contrast to the optimism prevailing, German private equity market investments fell by 19 per cent to a total of €3.0 billion in 2005 because large buy-outs were missing. While buy-outs continued to dominate investment activities, constituting 58 per cent of investments, they were dominated by small and mid-sized transactions.



Early stage deals were hit worst by the consolidation. The result was a shortage of funds, falling investments and rising total losses because young companies closed their businesses. Activities of venture capital firms shifted from early stage to more mature and developed companies. The Bundesverband Deutscher Kapitalbeteiligungsgesellschaften (the German Private Equity and Venture Capital Association, or BVK) and the venture capital industry were very active in getting support from the German government for the promotion of early stage venture capital.

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At the end of 2003, the German government in collaboration with the European Investment Fund, decided to launch a €500 million venture capital fund of funds focusing on German early stage and other venture capital funds. The fund started its work in the middle of 2004 and convinced private investors to leverage the total amount to €1.7 billion. In 2004, the €250 million ERP Startfonds started to co-invest together with private venture capital firms in young technology companies. In 2005, the new structure of promoting German venture capital was completed by launching the High-Tech Gruenderfonds which will invest €262 million in German early-stage companies.

The recovery in the market and intensified public activities to promote venture capital have resulted in an optimistic outlook for the German venture capital market.

In addition to the wide-open IPO window in Germany that young technology firms have been regularly using since 2005, German and international venture capital firms find many opportunities to invest in established technology firms and entrepreneurial companies with experienced managements.

The growing importance of buy-outs and the rising number of well-known transaction targets within the German economy kicked off a debate about the economic impact of private equity. Buy-out firms were addressed as "locusts" and the German private equity industry in general and international buy-out houses in particular were confronted with prejudices against their business model. The industry took the chance to argue and convince the public, the press and political decision-makers of the advantages of private equity.

In recent years, private equity firms could enjoy a growing reputation but nevertheless there are still prejudices especially when it comes to growing transaction values and debt packages offered by banks. At a time when interest rates are very low and buy-out houses raise new record funds Germany will keep being a very attractive location for investments. After five years of intensive activities and competition in the German buy-out market international players face new challenges such as finding targets and dealing with long auction processes.

Fundraising conditions

After years of unfavourable environmental conditions for raising funds, the year 2005 saw a revival of these activities both in the venture capital and buy-out sectors. Nevertheless, institutional investors in general and German investors in particular remain cautious about investing in German private equity funds, although, other than in the consolidation years, German institutional investors have committed to a

substantial number of newly launched funds. While many investors continue to be wary of early-stage funds, there are clear signs of their growing interest in investing.

Alongside the losses incurred by institutional investors after the crash, fund-raising by German funds was additionally hampered by more than three years discussion surrounding the taxation of private equity funds. From 2001, fund managers were involved in the issue of defining funds as 'commercial' or 'tax transparent' and on the taxation of end-investors and carried interest. Both issues - tax transparency and carried interest - were sorted out in December 2003, when a Federal Administrative Pronouncement of the Ministry of Finance was published. This ended the uncertainty surrounding these issues. The pronouncement contained criteria defining the commercial character of a fund. In June 2004, an additional law on the taxation of future carried interest was passed which is ruled by internationally competitive legal regulations according to which half the tax rate has to be paid.

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Economic importance

By the end of 2005, German private equity firms, the majority of which are members of the BVK, had invested €21.5 billion into about 5,700 small and medium-size companies. The 797,000 employees of these private equity-financed companies generated an annual turnover of €170 billion. These figures prove that the German

private equity industry is one of the three leading national employers.

In its work, the BVK focuses on political communication to foster the reputation of private equity, inform the broad public of the economic impact of private equity and help create internationally competitive tax and legal conditions. To that end, the BVK provides statistics, analyses and studies as well as publications on various topics and issues and keeps permanent contact with the press. The BVK cooperates with other associations and scientific institutions on relevant issues

and is in close cooperation with national ministries. For its members, the BVK organises events and meetings to spread information, exchange opinions and foster communication among them. ■

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