

European School of Business

Thorsten Gröne

Private Equity in Germany

Evaluation of the Value Creation Potential for
German Mid-Cap Companies

Schriftenreihe des ESB Research Institute

Herausgegeben von Prof. Dr. Jörn Altmann

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SCHRIFTENREIHE DES ESB RESEARCH INSTITUTE

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ISSN 1614-7618

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ibidem-Verlag
Stuttgart

Bibliografische Information der Deutschen Nationalbibliothek

Die Deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über <http://dnb.d-nb.de> abrufbar.

Bibliographic information published by the Deutsche Nationalbibliothek

Die Deutsche Nationalbibliothek lists this publication in the Deutsche Nationalbibliografie; detailed bibliographic data are available in the Internet at <http://dnb.d-nb.de>.

Dieser Titel ist als Printversion im Buchhandel
oder direkt bei *ibidem* (www.ibidem-verlag.de) zu beziehen unter der

ISBN 978-3-89821-620-3.

∞

ISSN: 1614-7618

ISBN-13: 978-3-8382-5620-7

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PREFACE

The idea to write a diploma thesis about private equity was shaped during my internship experience with J.P. Morgan in the fall of 2004 in London. Although I spent most of my time on projects related to the advisory of large energy clients in the Natural Resources Group, I also got the chance to work on a task related to the advisory of financial sponsors in the European private equity market. As I gathered a broad overview of the private equity industry in Europe, I realized the strong and growing position of this industry. I was immediately attracted by the macroeconomic view on private equity as an enabler that re-shifts economic resources to profitable industries and hence contributes to much-needed economic reform processes in many European countries. My idea was further fueled by discussions with my co-worker Ken Eichmann, who himself wrote a dissertation on private equity in the US market.

When I handed in my proposal for the diploma thesis in early 2005, I had two major aspects in mind: (1) To write about a topic related to financial theory, preferably private equity, and (2) to leverage my experience in both the continental European and the Anglo-Saxon business world. After an initial high-level research, I decided to focus on the Anglo-Saxon financial concept of private equity and apply it to a specific segment in the German market that is of major importance to the overall state of the German economy: the mid-cap segment, also known as the “Mittelstand”.

It was not until April 2005 before a controversial public discussion about private equity was raised by key opinion leaders in politics and industry in Germany: ‘Are helpless German companies being squeezed-out by greedy financial investors from overseas, especially the US’? At that point in time, my thesis was already handed in, but understandably I followed the discussion and found the analysis I had done in this thesis to be very suitable in this context – rather than being squeezed-out, I conclude that value can be generated by private equity investments in German mid-caps. Given the lack of comprehensive literature on

Private Equity in Germany and based on the distorted public opinion of Private Equity, shaped by the ongoing discussion, the idea to go public with my analysis was born.

I discussed this idea with Prof. Dr. Ottmar Schneck, professor for finance and banking at the European School of Business (ESB) Reutlingen, who not only gave valuable input as I wrote this thesis, but also supported my idea to publish the results. I am grateful for his support and would like to especially thank him in this regard. Furthermore, I would like to thank Ralph Jäger of JPMorgan Partners for his valuable input and interview time, Patrick Schoennagel for his active support on the finishing line, Simon Land for cross-checking my ideas and orthography, and of course the rest of the Boston Terrace Street Crew, Marcel Beyer and Karsten Hendricks, for a great time, fun, and support in the first four months of 2005 despite our high workload of getting all this down to paper.

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Table of Abbreviations

ADR	American Research and Development Corporation (USA)
AG	Aktiengesellschaft (German public company)
AktG	Aktiengesetz (German Stock Corporation Law)
AR	accounts receivable
BGB	Bürgerliches Gesetzbuch (German Civil Code)
BVCA	British Venture Capital Association
BVK	Bundesverband Deutscher Kapitalbeteiligungsgesellschaften (German Private Equity & Venture Capital Association)
CAGR	compound annual growth rate
CapEx	capital expenditure
DCF	discounted cash flow
EBIT	earnings before interest and taxes
EBITDA	earnings before interest, taxes, depreciation, and amortization
EVCA	European Private Equity & Venture Capital Association
FCF	free cash flow
FCI	Finance and Capital for Industry Organization (UK)
FDI	foreign direct investment
GEX	German Entrepreneur Index
GDP	gross domestic product
GmbH	Gesellschaft mit beschränkter Haftung (German limited liability company)
HGB	Handelsgesetzbuch (German Commercial Code)
ICFC	Industry and Commercial Finance Corporation (UK)
IfM	Institut für Mittelstandsforschung (Institute for SME-Research)
IFRS	International Financial Reporting Standards
IKB	Deutsche Industriebank (German Industry Bank)
IPO	initial public offering
IRR	internal rate of return

KBGen	Kapitalbeteiligungsgesellschaften (private equity investment companies)
KfW	Kreditanstalt für Wiederaufbau
KG	Kommanditgesellschaft (German limited partnership association)
KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (law on control and transparency in enterprises)
KKR	Kohlberg Kravis Roberts
LBO	leveraged buyout
MaK	Mindestanforderungen an das Kreditgeschäft (basic requirements in the credit business)
MBGen	mittelständische Beteiligungsgesellschaft (promotion-oriented private equity association for mid-caps)
MBO	management buyout
MBI	management buyin
NVCA	US National Private Equity & Venture Capital Association
OHG	offene Handelsgesellschaft (German general partnership association)
PLC (plc)	publicly listed company
SBIC	Small Business Investment Company
SME	small and medium-sized enterprises
R&D	research and development
SIPO	secondary initial public offering
SWOT	strengths, weaknesses, opportunities, threats
USM	unlisted securities market
US-GAAP	United States Generally Accepted Accounting Principles

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Executive Summary

This diploma thesis evaluates the value generation potential of private equity for German mid-cap companies. A discussion of the private equity industry and the analysis of the value generation levers serve as a basis to further explore private equity value generation in the German market. First, the special features of German mid-cap companies are examined with a special focus on their financing needs. Second, the German private equity market is introduced and its differentiating features are revealed. The comparison of the findings assesses the general suitability of private equity as a financing option for German mid-cap companies and suggests that many mid-cap companies are not (yet) suited for private equity investments. Finally, the applicability of the identified value generation levers on the German mid-cap segment is analyzed with the help of a conceptual framework in order to evaluate the value generation potential. The results show that the traditional value generation levers are applicable but have to be adjusted with respect to national differences. Private equity associations have to specifically address the strong social considerations in the German business culture and the traditional unity of management, ownership, and supervision in the mid-cap segment in order to realize high rates of return. Anecdotal and recent empirical evidence indicates the relevance of many theoretical conclusions.

Introduction

Private equity activity in Germany is reaching new levels both in volume of investments and number of transactions. Multi-national private equity associations have discovered Germany's attractive market and as a result currently drive German buyout activity. However, German mid-cap companies need to overcome their equity weakness in order to remain competitive in the 21st century, particularly with respect to the consequences resulting from the increasingly global nature of markets and major changes in traditional bank lending. Furthermore, many prospective company successions demand strong equity investors in the near future. This sets the stage for the analysis: (1) Is private equity a suitable financing option for German mid-caps in general, and (2) can it create additional economic value?

Currently, the overall economic importance of German private equity activity is below the European average, mainly because the German public continues to attach social stigma to private equity investments. However, recent studies on German private equity reveal positive results on buyout activity. The purpose of this thesis is to evaluate the value generation potential of private equity for the German mid-cap segment. Specifically, this thesis applies the major empirically-proven value generation levers of the private equity industry on the characteristics of German mid-cap companies and reveals the special circumstances of the value generation process in the German market. The results give valuable insights for both mid-cap companies considering private equity investments and private equity associations seeking further understanding of the German mid-cap market.

An extensive amount of private equity research was conducted in the 1980s and early 1990s, initiated by a wave of leveraged buyouts in the US and in the UK. These transactions were able to substantially create value for investors despite high acquisition premiums. Because most studies examine just a few features of the entire value creation scope, only a comprehensive view, based on the combination of relevant results, can draw a complete picture on the various value-generating aspects in private equity transactions. The most important scholarly