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Germany

German M&A in 2008:
the ongoing resilience of the Mittelstand

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The German M&A market remains buoyant despite the continental trend for a slowdown in the larger buyout segment. The legendary strength of the Mittelstand has served Germany well in the past during times of economic difficulty, and looks set to do so again. Daniel Wilkins spoke to a number of leading advisers from the German market about the resilient sectors, the credit crunch and the prospects for the future.

Stories of doom and gloom abound across Europe concerning the dearth of large buyouts being completed at present. The write-downs that major lenders have been forced to make following the collapse of the US sub-prime mortgage market have made them reluctant to lend the large sums of acquisition finance that they were happy to lend during the buyout boom of 2006 and 2007.

However, these stories fail to tell the whole story. As an example of a sophisticated European M&A scene, Germany boasts far more than just big buyouts. The diversity and depth of the market ensure that there are still plenty of opportunities for investors.

In recent years, a large number of venture capital opportunities have been created in the cleantech and renewable sectors. The international emphasis on climate change has driven demand for renewable technologies, and Germany's history of innovative engineering has made it the world leader in the production of cleantech solutions.

The growth of cleantech

Doerte Hoeppner, managing director of BVK, the German Private Equity and Venture Capital Association, said: "German companies lead the cleantech and renewable sector on a global scale, with fuel cells and solar energy products giving just two examples. We have already seen several investment surges into German solar energy and other cleantech companies. Since 2006 several venture capital backed companies within this sector have gone public."

Simon Robbins of AMR International also sees this as a growing sector: "We have analysed these markets on a number of occasions recently for private equity clients," he said.

This view is corroborated by Joer Dreisow, Principal of private equity house Waterland. His company specialises in mid-market private equity investments in Germany and Benelux and is focused on numerous service industries. As he explained, the sectors that are less impacted by financial shocks are more likely to remain buoyant.

"We still see significant growth in those sectors that follow fundamental macro-economic trends, such as aging population, outsourcing, sustainability and the leisure and luxury sector. We predict that the overall economic climate will cool in the coming years with diverse demotions of Germany's key economic indicators. Therefore industries that are less severely affected by economic cycles are very much in favour at present."

Sector specifics

Traditionally, the manufacturing sector has been at the heart of the German economy, even following the gradual decline in the sector that has taken place across Europe in the last decade. In Germany the buyout boom of H1 2007 was reflected most tellingly in the sector, as Guy Street of Deloitte explained.

"In 2007 manufacturing was the sector in the German market where PE houses were most active, with over 50% of transactions," Mr Street said. "This was followed by 12% in Telecommunications, Media, Technology.

"Consolidation in the financial services industry is an area of expected activity in the wake of the credit crisis, which has hit a number of German based credit institutions hard. Otherwise we are expecting continued interest in the infrastructure related sectors, with banks showing a continued readiness to finance deals in these areas in particular. This is because these companies are perceived as stable cash generators with good underlying growth drivers."

Rainer Mayer of Maconda Corporate Development cited a growth in deals in the outsourcing-related sector. "There was a lot of activity last year in temporary staffing, which has continued this year, albeit at a lower level. We have also been involved in numerous deals related to customer care and direct marketing. Whether such a transaction is recommendable or not still depends very much on the case itself and its specifics rather than pure economic factors."

Credit crunching

In 2007, Germany was the largest continental buyout market when measured by transaction value. It was ahead of both France and the Netherlands with a total estimated €26.5 billion in deals. Of the 135 buyout transactions in 2007, 36 were recorded between €50 million and €250 million down from the record 63 in 2006. The number of buyouts over €500 million was, however, at a record of 15 in 2007 compared to 10 in 2006.

The collapse of the sub-prime market has certainly taken its toll on German M&A, as it has on the markets across Europe. However, as elsewhere, the most marked affects have been at the top of the market in the large buyout sphere. Since the middle of last year there has been practically no activity in this arena in Germany as banks are reluctant to structure debt financings at this level.

Christian Kollman of InterFinanz detailed the change in approach taken by the banks in the last 10 months. "They have become more risk averse. They tend to offer lower debt multiples and are doing so with stricter covenants. The consequence of this is that there tends to be a larger proportion of equity required to get deals away. Some debt providers have almost backed out of the market completely."

Resilient mid-market

However, the small and mid-cap markets have remained resilient, in part due to the nature of businesses at this level. Wolf Wagner of Kurt Salmon Associates commented: "The fundamental value behind many of the targets in this segment is still positive. There is more fragmentation in the German market as consolidation is less advanced than elsewhere in Europe, so there are opportunities for private equity buyers to invest in strong businesses."

Another feature of the German mid-market is the extent to which it is dominated by privately owned, cash generative businesses, which tend to be more easily leveraged. "Although the German market is conservative, especially in this difficult financing situation, it is a more attractive one for private equity investors than many of the other markets in Europe," Mr Wagner said.

Guy Street agreed that there are still good prospects for the financing of quality propositions. "This year the mid-market has continued to be pursued by the many active players that have established a presence in the market over the past few years. Financing remains available for the better deals in attractive sectors, but at a higher price and with a higher equity commitment, which may impact exit returns in the future."

Rainer Mayer narrowed down further the window of opportunity that remains attractive for financiers. "In particular we have seen plenty of work in the segment between €30 million and €150 million since Easter. The figures are still not as high as they were in 2007, but they are enough to provide investment opportunities for private equity houses and also for business advisers like ourselves. Financing is still possible here and the acquisition finance departments also seem to be pretty busy."

Despite this the credit crunch has still created challenges for deals in the mid-market as the banks have become increasingly restrictive here, albeit not to that same extent as they have at the higher end of the market. This is especially the case in deals that necessitate syndication of bank debt.

Joerg Dreisow said: "There seems to be a fundamental trust issue amongst all financing parties at present. It is not as if there is quasi ban on financing, like in the larger buyouts, but potential leverage has declined and the whole process of securing sufficient financing has become more complicated."

Impacts on the adviser

The new found aversion to risk displayed by major lenders has had a knock-on effect on the advisory community, not least those providing due diligence and transaction support services.

Volker Strack of PwC explained: "That extra level of care taken by the banks has affected us in that we need to do more now than we did 18 months ago. 12 months ago financing was not an issue; you just needed to choose which bank offered the best conditions. Therefore, to some extent we have seen very limited due diligence analysis in the market. Now the banks want to see far more solid numbers. It is good for us in that sense. We believe it might help us to overcome the affect of having fewer large transactions to work on, since the smaller transactions require a greater number of man hours now."

Simon Robbins of AMR International agreed that banks and private equity providers alike are looking far more closely at due diligence reports now. "A lot of the businesses that we look at in Germany have a high export sales percentage," he said. "Therefore the banks are concerned about how that is going to hold up and whether the demand is going to continue to grow.

"There is also a concern about low-cost Chinese or Indian competitors developing the quality

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Environmental due diligence in German M&A

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Corporate UK spoke to Werner Schulte of environmental due diligence provider ERM about the application of EDD in the German M&A marketplace.

Environmental due diligence has become a prominent feature of M&A in Germany and our services are well known in the marketplace. More and more companies seek an environmental report when acquiring a business.

At present, in light of the international financial crisis, acquirers are taking much greater care over the due diligence process and the reports are examined in more detail. Therefore the situation in the credit markets has had an impact on our business. The number of transactions taking place has fallen, while those deals that do go through are more carefully performed.

Increasingly, there is a trend for companies to look for opportunities in the environmental arena, rather than just looking for risk. Some businesses find themselves under pressure from stakeholders and employees to establish more explicit environmental policies.

However, fewer small businesses carry out environmental due diligence when acquiring a target. We do have some projects from smaller companies but the majority of our projects come from larger international acquirers.

There is less pressure on smaller businesses to carry out this kind of due diligence. The larger businesses have more extensive corporate guidelines, which often include carrying out environmental due diligence. From our perspective those corporate guidelines are very useful. There are less well established guidelines for smaller businesses.

Following the influx of legislation that we saw from the EU in recent years, the next few years will be relatively quiet in terms of new regulations coming into force. Most of the guidelines, ordnances and EU Directives are already established.

However, there are some new regulations that will be implemented in the coming year. For example, the REACH regulations, concerning the registration, evaluation, authorisation and restriction of chemicals, are in the implementation phase at the moment. This began at the end of last year, but there are still some deadlines that are expected to be met in the coming year.

Environmental Resources Management (ERM) is one of the world's leading providers of environmental consulting services and health and safety. The organisation has over 135 offices in more than 40 countries and employs over 3,000 staff. It is committed to providing a service that is consistent, professional and of the highest quality.

Simon Robbins

of their products and taking share from German manufacturers. For example, in the last dozen or so machine building projects we have been involved with, we have carried out detailed research and interviews in both China and India to allay these fears."

Indeed, this is not the only impact the banks' reaction to their write-downs has had on the advisory community. Another, as Wolf Wagner explained, is that deals have the potential to take less time. "We have clients that have a very clear opinion about the target and are ready to act fast and do due diligence knowing that the deal will go through. They understand that in the auction process time is of the essence and they really need to act quickly."

This has informed the trend that existed before the credit crunch for acquirers to seek exclusivity early on and avoid costly and time-consuming auction processes.

Public perception

Another interesting question is what impact all this is having on the public perception of private equity among the German public. Germany was probably the first country in Europe to see a political backlash against the private equity industry after the now famous comments likening houses to locusts in 2005.

The BVK has been instrumental in emphasising the importance of private equity to the German economy. Now that a large number of transactions at the higher end are floundering, there is also an opportunity to more widely publicise the positive input private equity has in the mid-market and the exit solutions the industry providers to owner-managers.

Joerg Dreisow said that a major challenge of mid-market M&A is developing a relationship of trust with the company. "In general we experience very positive feedback towards our strategy where we approach the entrepreneur to expand his business significantly through a buy and build strategy in partnership with us."

Simon Robbins compared the German market to that in the UK: "I don't think that the German market is on its own in the negative press it has seen," he said. "We have seen a similar backlash in the UK. I get the impression that the work of the BVK has made the public image of the industry more positive. Many of the Mittelstand business owners are individuals seeking to retire who are concerned about how their business will go on after they have exited.

"In that scenario, the best thing that can happen is that they get an influx of professional managers with the capital to continue developing the business. Private equity ticks a lot of boxes for those types of owners in that they can guarantee an exit without having to sell up to a competitor or lose the brand that they have built."

Volker Strack commented that there may be more that the industry could do to overcome the 'locust' debate. "The word always pops up when a larger portfolio company gets into trouble, usually because of high debt financing. It remains an ongoing discussion in Germany and is not something that we have completely overcome yet. It is really a question of the private equity lobby giving more information to the public than they have in the past."

As a part of this need to engage with the public sphere, 3i has recently announced plans to sponsor a professorship at Johann Wolfgang Goethe University in Frankfurt to further research and education in the field of private equity. An unorthodox move, the announcement seems to augur a greater awareness of the importance of liaison with the academic community, as well as the public sphere.

Mike Robins of 3i commented: "The private equity industry must continue to work on its image with all stakeholders in Germany. 3i takes this responsibility very seriously. We usually encounter only positive sentiment about our activities in Germany."

The return of the trade acquirer

As many of the private equity sponsors have retrenched, opportunities have opened up for trade acquirers, who previously might have been muscled out of transactions by broader shouldered investors. Konrad Deiters of Mercer has seen evidence of this in his recent workflow. The resurgence of strategic acquisitions has highlighted the differences that exist in the approaches to due diligence by corporate acquirers and private equity houses.

"In the HR due diligence sphere, private equity advisers tend to be concerned with long term employee benefits, including pensions and contracts of management," he said. "Strategic investors on the other hand tend to look at HR more holistically. They will typically ask us to do a fully fledged HR due diligence looking at compensation structures, long term incentives, variable pay etc. The background for this is that there is more focus on issues during the post-merger integration. There is also far more interest in works councils and union relationships."

This increased focus on a more in depth view of HR issues has driven the demand for M&A HR consultants such as Mercer to develop specific cultural integration offerings. These assess the differing cultural milieux of acquirer and target, with an eye towards assisting in post-deal integration and adding value after the transaction.

Mr Deiters said: "Mercer has developed the cultural offering in recent years and it is being used more and more now to get profitability back quickly, because profitability tends to go down after an acquisition. The harmonisation of the cultures really helps in achieving that.

By way of an example, we recently advised a German biotechnology firm during its acquisition of an American company also in the biotech sector. We carried out a cultural integration project in order to facilitate the combination of the two firms. This is a trend we see more and more in the corporate M&A world. Strategic acquirers look into the potential cultural alignment of the target and how it will integrate with the culture of the acquiring company."

Looking forward

Rainer Mayer predicted that deal activity in 2008 is likely to remain relatively subdued, although new opportunities are continually opening. "We do not expect to see a significant relaxation of the credit markets until at least mid-year, which will keep volumes lower that we saw in 2007. However, there are some potential transactions coming onto the market, such as spin-offs. Eventually, these will come, albeit with a lower valuation compared to last year. The credit crisis will also help to rectify the previous situation of somewhat racy valuations, bringing more cautious investors back to the negotiation table."

Added to this, Christian Kollman sees a distortion of deal figures as a result of changes to Germany capital gains tax regime, which will certainly ring true to those attempting to exit UK business in Q1 of this year. "We expect to see a higher deal volume than in 2007 because of negative capital gain tax changes that will come into effect on the 1st of January 2009."

German M&A: the legal perspective

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The consensus from the German legal profession appears to correlate largely with the picture of the marketplace proffered by the rest of the advisory community. Larger deals tailed off towards the end of 2007 while the mid-market has remained robust.

This trend, matching those of other European jurisdictions, presents a number of interesting situations for legal advisers, not least those relating to more demanding covenants and the added legal complexity of the club deals that are the consequence of a leaner financing market.

Friedrich Graf von Kanitz of Susat & Partner OHG, a German member firm of Grant Thornton International Ltd, commented that the German market has not seen anything that has not also been witnessed elsewhere in Europe. "The trend is represented in exactly the same way as in other European countries. Mid-market deals are still getting debt financing, of course at more competitive terms. The large-cap market has been rather silent since autumn 2007."

Gerald Thomas of SJ Berwin detailed the impacts that this trend has had on the way in which financing structures are created. "We have seen an increased number of club deals," he said. "The financing architecture has changed slightly in light of that. The traditional senior/mezzanine debt funding structure has been re-established, including A tranches. Headroom on planning has reduced and second lien funding has virtually vanished."

Dr Thomas Shulz of Nörr Stiefenhofer Lutz commented that a boost has been provided to the German marketplace by some recent large scale privatisations. "The privatisation of Deutsche Bahn is one example," he said. "This was a transaction that has been heavily disputed among politicians for a long time, and now there is a movement to have the deal executed before the next elections, because otherwise it will be too difficult.

"If Deutsche Bahn becomes partly privatised it is expected to spur a number of transactions by the company in other logistics businesses, particularly those related to Germany and Eastern Europe."

The legal challenges that have always been associated with deal structure have not changed. However, as Mr Thomas went on to explain, there have been some new developments in Germany of late. "As has always been the case, tax optimisation is a predominant issue in structuring deals," he said. "New limitations on interest deduction on acquisition finance have been in the spotlight recently. A dogmatic change in regulations, which is not unusual in the German tax jurisdiction, has made interpretation of new rules difficult."

Thomas Heymann of Heymann & Partner added: "In the case of leveraged deals, managing financial assistance and capitalisation preservation rules present a challenge at the moment. Upstream securities and the like have become hard to grant. For example, this includes cash pooling, where there is a risk of trapped cash. This is the kind of scenario that one does not expect in a European jurisdiction. Added to this, labour law tends to be more challenging than in some other European jurisdictions, and it is certainly a bit hard to digest for non-European investors."

Mid-market migration

One of the consequences of the slowdown in higher end deals has been a trend for large cap investors to seek opportunities in the mid-market, in order to mitigate the shortage of transactions at the higher end. However, many investors have found new challenges in the mid-market as they have not been able to deploy as much money, despite the fact that the deals require a similar amount of work.

It seems unlikely therefore that a long term migration of large cap players to the mid-market will be a trend that will remain constant once the larger cap market is revitalised. Rather this trend appears to be a short-term development. Larger buyout type investors will dabble in the mid-market temporarily, at least until the large end gets back on track.

When does the recovery happen?

The pertinent question, of course, is when is this likely to occur? Judging by the German banks and the extent to which they have been affected by exposure to US sub-prime mortgages, the signs look relatively good. Jan Wildberger of Haarmann explained: "The large German banks seem to be doing OK in comparison with UBS etc.

"However, Deutsche Bank has reported a sharp drop in profits in the first quarter 2008. One example of a bank running into difficulties is IKB, the Düsseldorf bank. However, a lot of the public attention created is due to the circumstance that IKB is sponsored by KfW, the state-owned banking group. The fact that the banks start clearing their books by selling off leveraged loans to investors is interpreted by some as an early sign of recovery. But everyone remains cautious."

There may be some cause for concern in the fact that, at the end of 2007, the attitude from the advisory market in Germany seemed to be that things would have recovered by the second quarter of 2008. Matthias Bruse of P+P Pöllath + Partners commented: "Now we are in the second quarter of this year and we have not seen a full recovery yet. We have to be realistic about that. At some point there will be a recovery, but whether one can be too optimistic for the remainder of the year remains to be seen."

Restructuring portfolios

The caution still being expressed by the banks is clear in the tracking back to smaller EBIT multiples, which was a feature of the market before the hysteria that surrounded M&A in Europe 18 months ago. However, as Thomas Heymann of Heymann & Partner commented, this has not been as pronounced a trend as some commentators would have us believe.

"Several people have talked about EBIT multiples coming down to five, but we still see deals with multiples of eight," he said. "This is of course dependent on the target having reliable cash flow. Another interesting development from is that, in our recent experience, the banks tend to be a little nervous when it comes to waivers and renegotiations. Of course, a lot depends on the approach of the individual bank. Deutsche Bank for example seems to have more appetite for debt/equity swaps than others."

At the end of April Deutsche Bank announced a net loss of €141 million in the first quarter of 2008, and a loss before income taxes of €254 million. Markdowns of €2.7 billion were recorded in respect of leveraged loans and loan commitments, commercial real estate and residential mortgage-backed securities (predominantly Alt-A). However, a gain of €77 million arose from the widening of credit spreads on certain Deutsche Bank debt.

In a press statement, Dr. Josef Ackermann, Chairman of the bank's Management Board, was sanguine, saying: "In the first quarter of this year, financial market conditions were the most difficult in recent memory. In the month of March, pressure on the banking sector was more intense than at any time since the current credit downturn began. Inevitably, this left its mark on Deutsche Bank's results. Nevertheless, relative to the environment and the industry, this is a solid performance.

"We remain rigorous in controlling costs and monitoring investment spending. We are redeploying both human and capital resources towards growth businesses and regions. We are swiftly and decisively reducing our risk exposures. We have consolidated our capital strength. The fundamental trends shaping our operating environment are unchanged, and Deutsche Bank is very well-positioned to emerge stronger than ever from a recovery in business conditions."

The restructuring of the bank's portfolios at the higher end may have some knock-on effects for the Mittelstand. However, as Friedrich Graf von Kanitz said, there is not much evidence of this at the moment: "The financial institutions have restructured their CDO portfolios and have tightened the covenants and guarantees that are required to be met in debt agreements. While this may have an impact on the mid-market to some extent, presently we are not seeing any significant changes for this segment."

Vendor expectation

The extra frequency of strategic acquisitions in the mid-market that has accompanied the slowdown in

Wilhelm Haarman
Jan Wlidberger

large buyouts has turned up some interesting phenomena. Perhaps chief among these is a concern on the part of trade acquirers that there is a differential between vendors' expectations about what their business is worth and the harsh realities imposed by the slightly depressed economic conditions.

"There are still a number of transactions in which we see a significant gap in the expectations of the vendor and the acquirer," Matthias Bruse said. "That may change in the next few months. The prices will come down to some degree and the private markets will follow what the capital markets have already gone through.

"We have already seen some evidence of the message sinking in with vendors. As EBIT multiples comes down pricing assumption are adjusted. There is an organic shift towards more realistic pricing and multiples now. The message is spreading that the boom is over for the time being, although cautious optimism still prevails in the mid-market M&A segment."

The lawyer's workload

This general note of caution has had the effect of deals taking slightly longer to complete. Fewer transactions means less pressure on timeframes and more cautious lenders means more rigorous due diligence. What are the impacts of this on the legal adviser?

Stefan Weinheimer of Holters & Elsing explained that this development presents a double edged sword for the lawyer's workload. "It is better for us in the sense that we have more time to devote to each piece of work and we don't go to bed at night wondering whether we might have missed something," he said.

"But from an economic viewpoint, we are not working on the same number of deals. My feeling is that it is better for us to do 10 deals a year rather than 20 if it means that we feel better when we close the transaction and are happy that we have done a thorough job."

Following some concern from the UK legal profession about workflow, a number of large firms have expressed sentiments that they may have to release staff from their banking and finance sectors. Of course, this is a concern for the legal profession, but it is also slightly worrying for the economy in general, since the take up of corporate legal services is a good barometer of the health of activity.

However, Mr Weinheimer is not worried. "The deal flow in our practice is still very strong and we are not concerned about a shortage of work," he said. "In fact our firm has had a better quarter in the first quarter of 2008 than it did in the same quarter of 2007.

"It tends to be the financial departments of law firms that are being affected at the moment, rather than the corporate and commercial practices. Throughout the market the big players are seriously thinking about laying off people in their banking and structured finance departments, and that is where the real slowdown is at present."

Turnaround opportunity

The slowdown in the European economy is likely to provide an opportunity for development in the turnaround and restructuring markets of individual jurisdictions. The USA, and to a lesser extent the UK, have seen development in this area in recent years and it is expected that a number of European jurisdictions will follow suit. Germany is an example of a highly sophisticated economy in which new initiatives in corporate recovery could mean the difference between life and death for distressed businesses.

Stefan Weinheimer predicted that the lean economic backdrop that is expected for at least the next year will have an effect on the German market. "Whoever is in restructuring at the moment will probably have plenty of work to do. For instance, I have a close relationship with Alix Partners, who I know had a tremendous year last year. They are optimistic for this year and for the future.

"There are already well trained people over here in Germany in the turnaround market. Like many of the things that are relatively new to Germany, the people in my profession who have experience in the USA and the UK tend to be at the forefront of bringing those new initiatives to the German market."

Thomas Shulz explained that there is a trend across Europe at present for investigating the possibilities of international turnaround. "We do quite a lot of restructuring and work-out work. An example would be the restructuring of a privately operated mail delivery service, which came into financial difficulty.

"There is currently a huge internationalisation taking place, and a lot of thought is going into how one can migrate a German insolvency process into the UK for example. There are differing concepts across jurisdictions, which create challenges for that internationalisation. For example, in Germany you need to have a plan to turn the business around within three weeks otherwise you have to go to insolvency. In other jurisdictions, the UK among them, there is not the same level of stringency."

Predictions

The commentators for this particular article were very positive about the future of M&A work in Germany, especially in the Mittelstand. Gerald Thomas said: "Currently, we see a comparatively satisfying level of activity, not as active as in 2006 but certainly not as slow as was anticipated for the market at the beginning of the year. For the remaining part of 2008 we expect to see an acceleration in deal activity. There is still a large amount of money to be invested and good businesses looking for investment."

With this in mind, it is with optimism that we should look to the immediate future of German M&A. Although deal volumes themselves may be slightly depressed at the top end at present, this is not expected to be a long term feature. While the fundamental indicators of supply and demand remain positive, the reports of a collapse of M&A in Germany specifically, and in Europe in general, seem premature to say the least.