KFW RESEARCH

Focus on Economics

No. 98, 16th July 2015

Germany's private equity market lacks venture capital

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Start-ups are often the first to adopt new technologies and develop marketable products from them. These enterprises are therefore of special importance to the competitiveness of the German economy. However, some start-ups also have considerable financing problems as their chances of success and growth are more difficult to assess than those of established enterprises. For them, venture capital is an appropriate and important financing alternative. Germany's venture capital market is rather small and still lags far behind in an international comparison. Countermeasures must be taken to enable promising start-ups in Germany to realise their ideas and innovations. In particular, the aim should be to close the gap in the market for start-up finance and large-volume growth finance.

In the innovation system, start-ups play a particular role because they often use new technologies, are the first to develop marketable products and processes and therefore have a high potential for growth but also a high need for capital. At the same time, the chances of success are difficult for outsiders to assess (information asymmetry). This constellation – high need for capital, high growth potential, high risk – makes equity financing so important for start-ups and, thus, for the economy.

Private equity, as the generic term for equity capital provided by private investors rather than public markets, is therefore an indispensable financing instrument, particularly for business founders and young, innovative start-ups, but also for established enterprises that want to finance their further growth. The reason is that credit financing often reaches its limits for these innovation and growth-oriented enterprises.

Since equity providers, unlike lenders, participate directly in the rising business value of successful enterprises, they can weigh their higher risks against higher opportunities. Besides, taking in private equity improves the balance sheet structure and, thus, the credit rating of an enterprise, which also benefits from the investor's expertise and contacts. It must be kept in mind, however, that private equity is only suitable for entrepreneurs who are willing to surrender decision-making and controlling rights to investors – because no investor will provide equity without these rights.

Ups and downs in the development of the private equity market

For a long time, private equity hardly played any role in the German financial system. A significant market for over-the-counter equity emerged for the first time in the second half of the 1990s. The market volume newly invested each year increased nine-fold to around EUR 4.5 billion between 1995 and the turn of the millennium. When the New Economy bubble burst, however, the private equity market collapsed. Particularly new venture capital (VC) transactions – i.e. private equity investments into young innovative firms – held off. It was not until the High-Tech Start-up Fund and the ERP Start-up Fund were launched by public authorities that the situation for seed and start-up financing eased again.

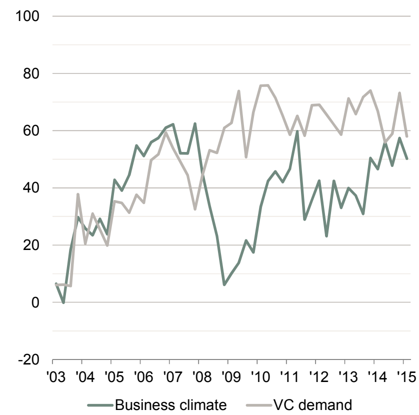
The market was dampened anew by the economic and financial crisis, although only briefly. In 2014, more than EUR 5 billion was again invested by private equity firms residing in Germany. Nevertheless, private equity remains an alternative for only relatively few enterprises. As a comparison: The volume of private equity invested in 2014 is only around one per cent of the volume of new loans granted to enterprises during the same period.

The overall development of the last 20 years is also reflected in the German Private Equity Barometer jointly surveyed by KfW and BVK (Figure 1). It found that, in general, the mood on the German private equity market is improving again despite a slight dip at the start of the year 2015.

However, the recovery of the private equity market as a whole diverts attention from the venture capital segment. After all, a significant shift of market activities has taken place on the German private equity market since the end of the new economy euphoria. Today, large-scale buyout deals with established enterprises predominate. VC investments, on the other hand, have become less and less

Figure 1: Business climate for equity providers has improved again

(Balance points, max: 100, min: -100)



Note: The indicators reflect the weighted balances between 'good' and 'bad' reports by participating BVK members.

Source: German Private Equity Barometer

significant. In 2014, a mere EUR 560 million in venture capital was invested in Germany – a small sum in relation to its economic power. As a comparison: In the USA, around seven times more VC is invested in relation to gross domestic product (Figure 2). VC investment is also higher in European industrial nations such as the UK or France. So the German VC market has a great deal to catch up on.

Venture capital seekers are young, innovative and technology-oriented

Private equity plays only a secondary role for the broad SME sector in Germany. The "Business Survey", conducted jointly by KfW Research and industry associations, shows that equity financing is much less important than internal financing, bank loans, supplier loans and leasing.[2] The KfW SME Panel confirms: The German Mittelstand finances lion share of its capital expenditure by cash-flows, loans and public allowances. In 2013 only 1.5 % was covered by equity financing.

The more innovative and younger an enterprise, however, the more important this financing alternative is. Debt capital providers often consider the absence of a company history, insufficient collateral and the high uncertainty of success of their innovations to be unsurmountable information deficits. Accordingly, VC is more important for them. While only 8 % of all enterprises regard private equity as important, this proportion is 13 % among research-intensive and younger enterprises.[2]

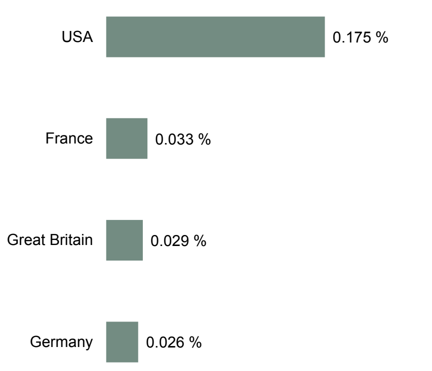
This is also reflected in the external financing of start-ups. The findings of the KfW/ZEW Start-up Panel show that only 5 % of the external funds acquired by all new company formations are covered by private equity. This share is 13 % in high-tech manufacturing start-ups and as high as 35 % in high-tech start-ups in the service sector.

Providers keep an eye on exit channels

Start-ups in Germany have a demand for venture capital (Figure 1). The reasons considered to explain the comparatively low supply include not just the legal and tax environment but primarily the exit

Figure 2: Germany is lagging behind with VC investments

(VC investments in relation to GDP)



Source: OECD (2014).[1]

prospects. After all, the incentive to invest is higher when the chances of achieving a high return when exiting an investment are better.

A successful initial public offering (IPO) gives investors the best prospects for returns. However, after the New Economy bubble burst and the Neue Markt – a particular stock market segment for young innovative companies at the German exchange – collapsed at the beginning of the millennium, that exit channel was virtually blocked in Germany. The German IPO market has not (yet) recovered from the downturn. Even before the Neue Markt was established, the number of IPOs was many times higher than today. Besides, it will likely take some more time for the recently improved climate for IPOs in Germany to translate into a higher number of IPOs of VC-financed enterprises.

Although IPOs are the most profitable exit channel for VC companies, they are not suitable for every start-up because of the substantial effort they require. That is why the exit channels that enable VC providers to exit an investment with the highest volume are typically trade sales, that is, the sale of a participation in the enterprise to a strategic investor, for example an industrial firm from the same branch of industry. The "secondaries" industry, which involves selling equity on to another private equity firm, also plays a significant role.

Comparison across the Atlantic

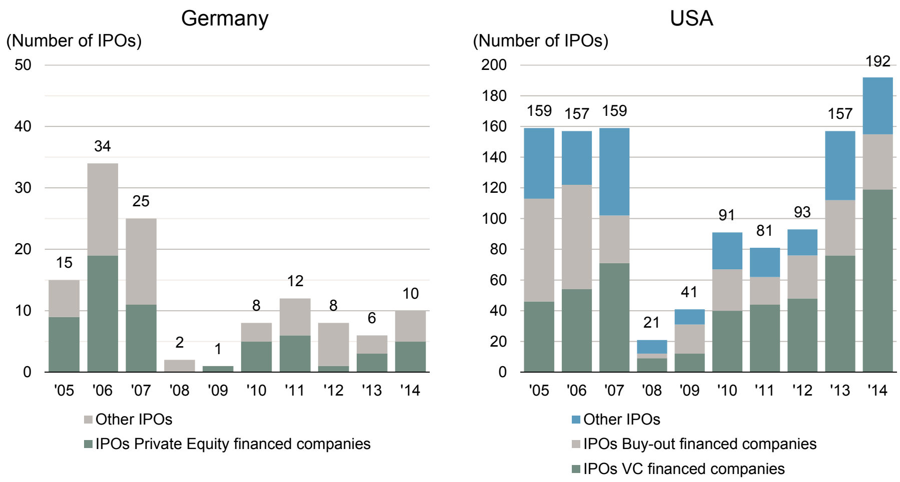
In the USA, IPOs of start-ups are an established element of the stock market landscape. During the financial crisis, the US IPO market slumped temporarily but recovered quickly. In 2014 alone, some 120 VC-financed enterprises went public there while in Germany it was only a handful (see Figure 3).

The more lively IPO activity is likely to be one reason why deal sizes on the US VC market are around eight times higher than for investments in German start-ups (see Figure 4). Investors are likely to be more willing to invest where there is an exit market with buyers for large-volume participations.

Growth financing is becoming more important in the digital economy

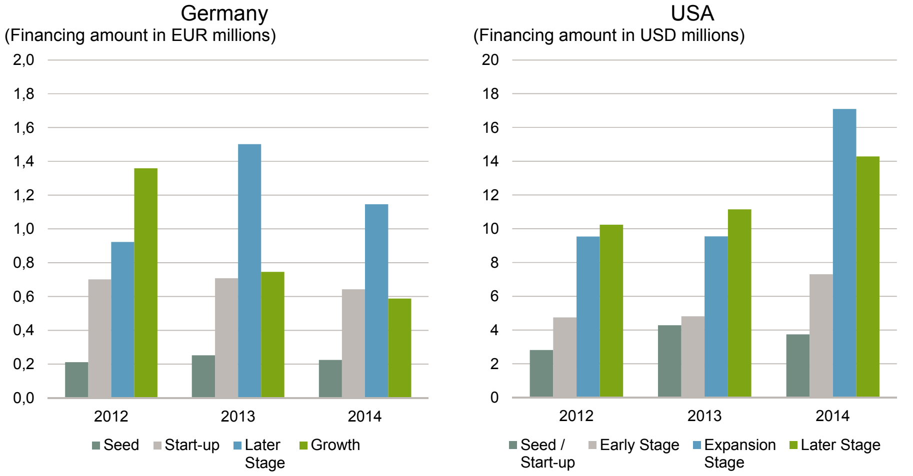
The big-ticket items being made available to US start-ups appear to be a crucial advantage, particularly in the global growth environment of the digital economy. The business models of digital

Figure 3: IPOs in Germany are few, while US IPO market thrives



Source: BVK for Germany, Ritter (2014) for the USA.[3]

Figure 4: US start-ups attract significantly more VC



Note: The average financing amount was calculated as a proportion to the annual investment volume in the relevant country and the number of financed enterprises. The statement "deal sizes on the US VC market are around eight times higher than for investments in German start-ups" also applies after adjustment for exchange rate variations.

Source: BVK, NVCA, own calculations.

start-ups are fundamentally different from those of classic technology start-ups. In many cases, they need only relatively low seed or start-up financing in order to develop a "digital" business idea. So they face lower hurdles to entering the market.

If such start-ups want to remain globally competitive, however, they will quickly have to attract many customers (market share) and establish a lead in brand recognition. In other words, what is crucial to them is not the high cost of developing a technically mature product prototype but the speed at which they introduce it into the market.

The classic VC financing process, which involves several financing rounds that grow bigger every time a milestone is reached, is hardly suitable for this type of strategy. Rather, what is important after the provision of relatively low start-up financing is large-volume follow-up financing to enable growth and market penetration. The US venture capital scene has adapted to these special needs of start-ups in the digital economy. This development should be followed in Germany as well.

Closing the gap in the start-up and growth phase

Overall, a gap can be observed in the supply of venture capital in Germany, particularly in follow-up financing for enterprises that are in the start-up and growth phase. The options for exiting deals through IPOs have not reached their potential either. Experts have already discussed whether start-up enterprises should undergo specific training to prepare them for going public, as is the case in the UK. Some voices out of the venture capital industry also call for reintroducing a specific segment of the stock exchange in order to generate greater awareness and visibility among investors.

During the low phase of the VC market after the bursting of the New Economy bubble, it became clear just how important the public supply of VC is for the survival of the German VC market. It is important precisely because providing public venture capital can mobilise VC from private equity providers (crowding-in). Founders of high-technology enterprises in particular can be motivated by the prospect of obtaining VC. More start-ups are founded when the supply of VC improves.[4] A public supply of VC is therefore crucial to the development of a sustainable start-up scene. ■

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[1] OECD (2014), Entrepreneurship at a Glance 2014, OECD Publishing

[2] Schwartz, M. and V. Zimmermann (2012), Unternehmensbefragung 2012, Unternehmensfinanzierung trotz Eurokrise stabil (only available in German), KfW Bankengruppe, Frankfurt am Main, May 2012.

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