Private Equity in Germany and Great Britain – A comparison of market structures

Executive Summary

In autumn 2002 KfW Bankengruppe (KfW banking group) conducted a survey of private equity companies in Germany and Great Britain together with a German-British group of researchers from the Universities of Cambridge, Edinburgh, Eichstätt and Hamburg. This survey was addressed to all members of the Federal Association of German Private Equity Companies (Bundesverbandes Deutscher Kapitalbeteiligungsgesellschaften - BVK) and the British Venture Capital Association (BVCA). The findings of the survey regarding Germany have recently been published by KfW Bankengruppe. Now a comparison of the German and British private equity markets has been presented, which provides a number of new and additional information.

Sources of finance and behaviour of equity providers

- The structure of the funding sources of private equity companies mainly reflects the obvious differences in the economic and financial structures of the two countries. The private equity segment in Germany is dominated by group-internal financing and borrowing from banks while in Great Britain private equity is provided on a large scale by private individuals and institutional investors. The investments themselves are also orientated towards the general structure of the respective industry and go primarily to those industries, which are the focus of the respective national economy.

- Major differences exist in the handling of financing requests: The share of financing requests which is accepted (5%) is roughly equal in both countries. But in Germany private equity companies spend much more time and effort on the appraisal of individual investments than their British counterparts do. Nevertheless, the German companies relatively more often use standardized rating procedures to appraise investments.

- The difference is even more pronounced when we look at the intensity put into handling a deal after contract conclusion: In Great Britain almost all deals are handled hands-on, whereas this applies to only half of the deals in Germany. This also corresponds with the different importance of mezzanine financing forms in the two countries, which are represented much more strongly in Germany than in Great Britain.

- Another marked difference between the two markets is the concentration of market actors on specific stages of financing. For instance, German private equity companies specialize more frequently on early-stage investments, their British counterparts rather on the later-stage segment.

- A closer look at the investments shows: On average commitments in Great Britain have higher volumes than those in Germany, though in the area of early-stage financings British private equity companies are also willing to accept smaller commitments than their German counterparts.

Yield structures

- In addition to a comparison of the size and structure of the commitments, the survey also enabled a comparison of the yields requested by the respective market actors:

Overall, the yield expectations of British private equity companies are much higher than those of German companies. This difference is particularly obvious in the field of early-stage financing.

- At the same time default rates in both countries are relatively similar and when looking at the total portfolios of the companies the differences between the actual yields achieved are far less pronounced than those between the expected yields.

Market gaps and promotion

- The survey also looked at the questions to what extent both markets ensure that the demand for private equity is actually covered and in which areas additional promotion is required. At just under 70%, the share of private equity companies that make out a permanent lack of private equity, is roughly equal in both countries. In Germany this concerns primarily the service sector and the low-tech sector of the producing industry and in Great Britain rather the sectors of IT, telecommunications, media and life sciences.

- Additional important insights were gained with regard to gaps in the range of products offered for specific financing stages: In particular in the field of early-phase financing the demand often exceeds supply of private equity companies in both countries; this is especially so in the British market. This might at least partly be due to the fact that promotion in Germany strongly focuses on early-stage financing.

- Major differences exist with regard to the level of public promotion requested by the private-equity companies: German private equity companies make use of public promotion on a much broader scale than their British counterparts and prefer support in the form of exemption from liability and refinancing on favourable terms, whereas British private equity companies prefer public co-investments.

Conclusion

The British private equity market has a longer history than the German counterpart and clearly dominates in Europe in terms of size. Especially the segment of later-stage financings in Great Britain has benefited from favourable legal, tax and political conditions.

Though one cannot say that the German private-equity market, which is primarily dominated by financing through commercial banks and by group-internal financing, is stuck in the infant stage, it might probably be fair to say that it still has clear development potentials. Its development so far was driven not least by targeted promotional activities, which also led to comparative advantages – for instance in the segment of early-stage financing – with regard to the offer of private equity.

The comparison has shown that when it comes to promoting the private equity market the right mix of favourable framework conditions and the targeted use of specific market-conforming promotional instruments is important. Favourable conditions (e.g. tax regulations) help to free up market forces, and market-conforming promotional instruments support the market development where market failure hinders an efficient allocation.

The private equity markets in Germany and Great Britain took off from different starting points and, under unequal conditions, experienced different developments. Differences in how the markets function are partly due to the differing structures of the market participants and their portfolios. The survey provides a great deal of evidence that despite their diversity the markets are still converging with regard to many characteristic features. This development will be enhanced not least by the further internationalisation of the private equity market.