

## **Private Equity in Germany – A young but maturing market**

### **Executive Summary**

In autumn 2002 KfW conducted an extensive survey on 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. The objective of the survey was to identify and compare the market structures and behaviour patterns of private equity firms in both countries, with the focus on identifying market deficits and on the role of promotion. In the following KfW presents first results of the survey for Germany. The survey in Germany comprised all members of the Federal Association of German Private Equity Companies (Bundesverbandes deutscher Kapitalbeteiligungsgesellschaften – BVK). Given a participation of 50% of those questioned the results provide a comprehensive picture of the German market.

### **Structures and behaviour patterns on the German private equity market**

1. Overall, the relatively young German private equity market already shows a considerable variety of equity providers. However, the comparably high number of promotion-oriented private equity companies, the only moderate but growing degree of specialisation of the providers, and the low importance of institutional investors are an indication of the early stage of development of the market.
2. The behaviour of the different groups of providers differs substantially depending on their investment motives. The first aspect is the selection of the potential equity recipients. Yield-oriented companies receive 10 times as many financing requests than the promotion-oriented companies and their selection is much more pronounced: For instance, as regards independent private equity companies on average only 13 % of the requests are usually short-listed and only 3% are finally selected, whereas the corresponding figures for promotion-oriented private equity companies focusing on SMEs are 47% and 23%, respectively. Independent private equity companies more frequently exercise a “substantial” influence on the company management, while private equity firms focusing on SMEs follow the equity recipients less closely and rely much more on standardized procedures (rating instruments) in the selection and monitoring of candidates.
3. Moreover, the portfolio structure of the different groups of equity providers differs greatly: The promotion-oriented companies focus much more on enterprises from the producing sector, on later-stage financings and, in particular, on smaller commitments (below EUR 1.5 million equity finance volume). On the other hand, many yield-oriented companies rather focus on the more risky New Economy market segments and early-stage financings or specialize on larger buy-out transactions.
4. In consequence, the yield expectations of the different groups of private equity companies also differ: The expected yield for individual commitments of SME private equity companies is – partly due to regulatory requirements – 12 % p.a. at maximum, while the large majority of yield-oriented companies expect a yield of at least 20% p.a. or in some cases even considerably more. However, the actual yields achieved throughout the entire portfolio are clearly lower. In 2001 more than half of private equity companies showed an actual yield of below 4% and more than a third of the companies even showed a negative yield. The main reason for the discrepancy between the expected and the actual yield is management costs incurred, taxes and depreciations. In 2001 alone, around one third of equity providers showed default rates of more than 10 % of their portfolios. These huge discrepancies and heterogeneities are typical characteristics of still young and not so established markets.

### **Gaps in the range of private equity offered**

5. Despite the obvious trend towards more professionalism, the German private equity market is still underdeveloped. This is shown, among others, by the fact that more than two thirds of private equity companies still see a permanent lack of private equity in many market segments. Though for a long time Germany was considered exemplary in the field of early-stage financing, this segment of the market – according to private equity firms – still displays major deficiencies. In particular, in the field of smaller private equity volumes there is a considerable pent-up demand and with regard to the sectors, especially the Old Economy is considered to be undersupplied.
6. The reasons why private equity companies are not able to fill the market gaps they have themselves identified are first of all risk aspects and unrealistic yield expectations followed by exit problems. Other reasons, such as the lack of qualified private equity managers or fund-raising problems, were clearly of secondary importance in the period of survey. It is to be expected that when the overall economic situation in Germany improves the market assessment of private equity providers will be more optimistic again and that, in consequence, they will focus more strongly on the above-mentioned market gaps.

### **Promotion and promotional needs**

7. Given the huge macroeconomic importance of private equity and the large market gaps that exist one has to ask which role promotion may play, and is to play, in this context. In fact, three quarters of private equity companies have identified a significant promotional need in at least one market segment. A promotional need has been identified mainly in research and innovation-intensive industries, in early-stage financing, in the field of small enterprises and in the new federal states, this is in areas in which the risk is above-average.
8. The comparison of the existing range of private equity products offered and the identified promotional need shows a good deal of overlap. This is also confirmed by the fact that the private equity companies use the promotional products offered very intensively: In the last three years three quarters of the companies made use of such products to finance or safeguard on average one third of their investments. Thus, public promotional activities are of major importance for the investment activities in the German private equity market. A comparison of all different promotional offers at the regional, federal and European levels has shown that the programmes of KfW and DtA are by far used the most intensively. The main focus here is on the programmes for early stage and innovation finance.

### **Conclusion**

On the one hand, the still very young German private equity market already shows a great variety of private equity companies which in part differ significantly from each other with regard to investment motives, target groups and behaviour. On the other hand, however, the market is by no means consolidated and is partly characterized by considerable gaps and imbalances, which are a clear indication of insufficient market depth and breadth. The task of a subsidiary promotion is to strengthen the market further, to fill market gaps with modern instruments that are in line with market conditions and, at the same time, to support the continued development of the market.