PEMBERTON

A LONG-TERM PARTNER
FOR COMPANY GROWTH

Private Debt in Germany

Pemberton: A European view

One of a series of papers where our in-country leaders examine key themes and trends important to investors and corporates in Europe. Here Jürgen Breuer looks at Germany.

Jürgen Breuer
Head of Germany, Austria and Switzerland

Introduction

Germany is one of Europe's leading economies and the home for some of its most successful, export-oriented businesses. But for some years it lagged behind the UK and France as a target for direct lending. That has changed. Germany is increasingly important within investors' portfolios, a trend driven by the growing role of private equity, retrenchment by traditional banks, and investors' search for yield in a low interest rate environment.

Why Germany is attractive

In the last few years Germany has developed an increasingly prominent role in institutional investors' private debt portfolios. Over six years to the end of 2018, the country accounted for 11% of new issuance compared with 25% for France and 38% for the UK (source: Deloitte Alternative Deal Tracker, Spring 2019). At Pemberton Asset Management we are proportionally overweight in Germany, with about a quarter of our portfolio now invested in DACH (Germany, Austria and Switzerland), rising to over a third in our second mid-market fund.

This enthusiasm for Germany should not be surprising. Jürgen Breuer, our head of Germany, notes: "The country offers a combination of being the largest economy in Europe and the anchor for European stability since the financial crisis. It is also enjoying a strong, globally competitive mid-market segment – the Mittelstand."

These advantages have driven a wave of private-equity sponsored deals, in many cases financed by direct lending. Mainstream corporates are also accounting for a notable proportion of completed deals, so in spite of the current headwinds that the Germany economy faces, direct lending is only going to increase its importance there.

German GDP accounts for 28% of the Eurozone (IMF data 2017), so it is an economy that investors cannot ignore. The economy has enjoyed nearly a decade of economic growth since the financial crisis and GDP in 2018 was $3,996.78, 16.9% above its 2009 level of $3,418.01 (source: Tradeconomics.com/World Bank).

The Mittelstand offers a wealth of well-run, efficient, often family-owned businesses with annual sales in the range of €100-500m. Many have a proven ability to consistently innovate in their sector and compete globally, so it was only natural for private equity firms to target them.

For a while sponsors found it difficult to break into the market but that is changing, driven by generational change and a shifting attitude to private equity investment. These factors have been very important for the growth of direct lending, given that in countries such as the UK and France the largest user of direct lending funds is the private equity community.

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Germany has long struggled to embrace the private equity model. We asked Jürgen Breuer to share his insights from a 24-year career in leveraged finance about the attitudes in Germany towards the asset class:

Much has been written over the last 20 years about the eternal promise of the German market to the private equity industry that goes something like this: "Germany has a wealth of medium-sized, family-owned companies that are leading on an international or even global level in their industry. More and more of them will run into a succession problem as the heirs to the throne are either no longer interested or not suitable to take over the running of these companies. Hence there should be a rich quarry of opportunity for private equity investors to mine". And year after year, articles would appear that lamented the lack of that promise coming to fruition.

Today, private equity is an accepted source of growth capital and has helped solve many a succession issue in Germany. According to the Financial Times (20/3/18), approximately 840,000 owners of small and medium-sized enterprises in Germany face the prospect of selling their firm to an outside buyer as the generation of post-war entrepreneurs reaches retirement. Private equity investment in Germany has grown from €4.98bn in 2010 to €9.60bn in 2018, and that looks set to continue. PwC's 2018 annual report on the private market in Europe showed that 90% of respondents to their survey, when asked about the attractiveness of the private equity market believed that the German market would become still more attractive.
(source: www.pwc.lu/en/private-equity/docs/private-equity-trend-report-2018.pdf).

Pemberton's Position in Germany

Number 1 direct lender in Germany 2.5 years running by deal count*

Strong deployment record, **18 deals** since the start of 2017 totalling c.€1.1bn

5 direct lending professionals based in Frankfurt

Established relationships with **c.50** private equity firms in Germany

*Source: Deloitte Alternative Lender Deal Tracker Spring 2019

Why has it taken so long for Germany to fall in love with private equity?

Germans are surprisingly unsophisticated when it comes to all matters economic and financial. The phrase "It's the economy, stupid", whilst coined by the Bill Clinton campaign in 1992, would be an evergreen in a German context. For the majority of us, investing money still primarily means putting it in a savings account (despite the loss of any interest), buying a life insurance policy, or saving money until we can afford to contribute 25-40% of equity towards buying our first (and often last) home (at the age of 40).

In the face of a dramatically ageing population, we still rely on the ability of ever fewer people in active employment to finance the twilight years of ever more pensioners rather than getting a little help from our friend the capital markets.

A number of cultural reasons are responsible for that, with the collective trauma of hyper inflations in the first half of the 20th century most often cited. One of the consequences has been a school system in which the teaching of fundamental economic context and financial skills is recklessly neglected.

Another important underlying driver of economic realities is our history as a federal state. Before it became a national state in 1871, Germany was a congregation of small princedoms. As a result, we don't have a strong centre like London or Paris but lots of regional centres and strong state and municipal legislative powers which have an impact on local economic structures.

Circling in further on our subject matter, the German economy's backbone of Mittelstand companies is a result of these structures, in which inventors and entrepreneurs founded their companies on their doorsteps, recruited personnel from nearby and maintained a close connection with their local environment.

The result is a closely-knit interdependence of local communities and the businesses they are home to, with family entrepreneurs developing a sense of social responsibility in return for the loyalty of their workforce and their contribution to the advancing of the companies that employ them. The inventiveness of German workforces and their continuous fiddling about with products and processes to make them better is legendary and will thrive in an environment of social stability and a sense of belonging.

Reflecting on these dynamics, we start comprehending why the idea of "selling out" is not one entertained lightly by owners of family businesses. If it is entertained the owner will want to be seen in his community as having acted responsibly and secured "a good home" for his or her business with respectable buyers that will continue its long-term development.

The concept of private equity as temporary owners of businesses that want to make a return on their investment within "only" three to five years and pass the company on again is not easy to sell in this context. The famous coining of private equity investors as "locusts" by the then German labour secretary in 2005 distilled the rather shallow thinking of the broader public and added to the sense of suspicion.

When you look back at what I said above about the financial acumen of that very public and the way we organise our pensions, you can see why it's not an easy job to point a German audience to some of the wider economic benefits of the private equity model, not least in providing a financial return to the ultimate providers of their capital, many of which are pensioners!

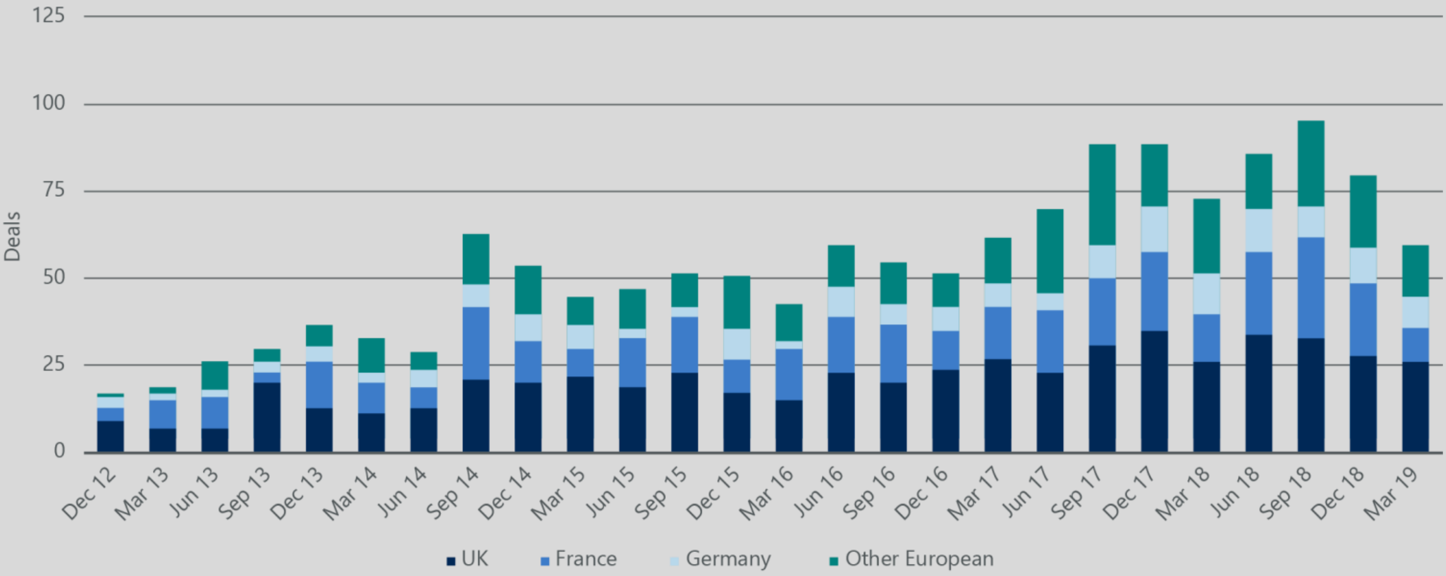
Why has the acceptance of private equity improved? What has changed?

- The generation of potential family business successors has been educated and trained in a more open, flexible and often international way, leading to a higher likelihood of embracing external investors to advance and grow their businesses. Where family successors are not available, today's generation of external managers has a higher awareness of the private equity model and are likely to have a network of peers that have managed successful buyouts (and become rather wealthy as a result).
- Cohesion in local communities is waning as younger generations are more mobile, tend to live more in an urban setting and are less inclined to spend long spells of their working careers at the same companies.
- There have been changes in the sectoral make-up of the economy. In a more and more digitalised environment, consulting, IT-related and tech business models have become more relevant for the German economy overall. As these business models have matured significantly over the last 20 years, they have come onto the radar of late-stage private equity investors. An IT services or consulting business model, which needs to constantly attract and secure young, qualified personnel, the physical location of which is less relevant, will not be as embedded in a local community as, say, an automotive supplier that recruits its engineering talent in its region (which will be physically close to its customers).
- Finally, ten years of low interest rates and the sober outlook that this is unlikely to change anytime soon, is placing private equity firmly on the radar not only of institutional asset managers but increasing groups of the broader public as they struggle to make a return on their savings.

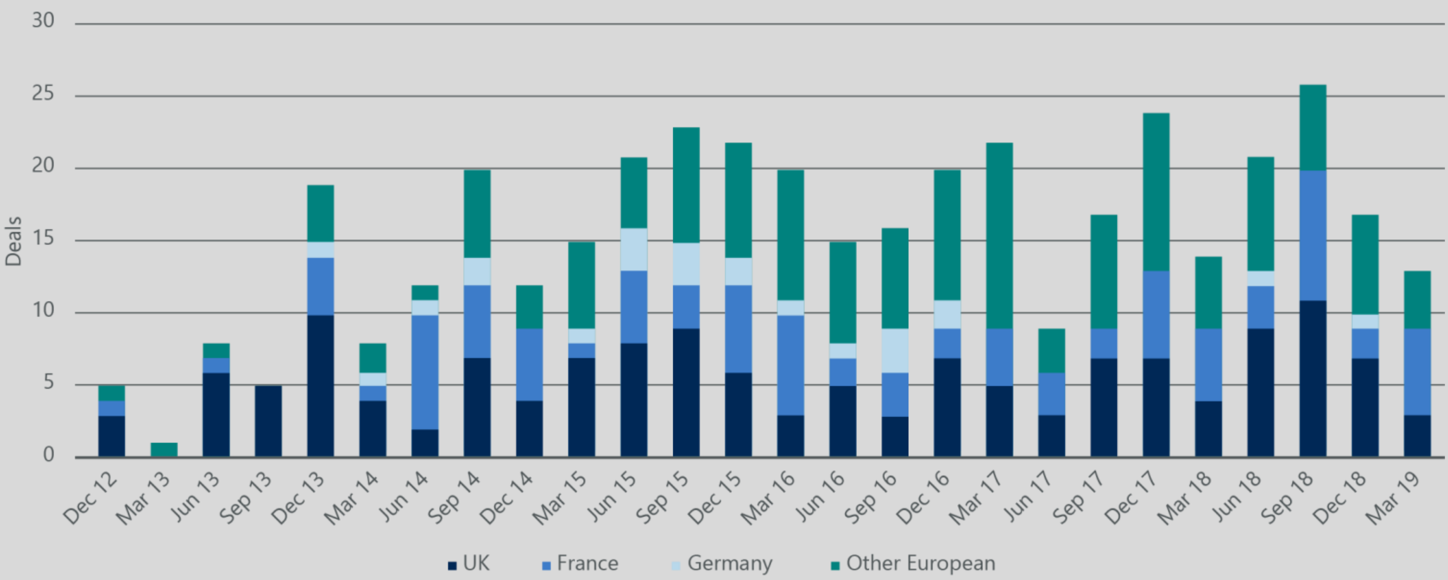
We finally appear to have embraced the benefits of the asset class. A 2017 survey by professional services firm PwC revealed that only 3% of German family-owned businesses had some involvement with private equity. However, 83% said they could imagine working with private equity sponsors in the future, up from just 18% in 2011. This increased openness to the idea of private equity ownership among mid-market companies is a major driver behind the growth of direct lending. Private equity sponsored deals account for 81.25% of our German deals at Pemberton to date.

Private equity firms value the ability of direct lenders to engage in new lending opportunities, including complex ones; give early visibility on whether they like a deal; and deliver on tight deadlines. As a result, private debt has a 50% market share of the overall sponsored buyout market compared with roughly 25% five years ago (source: GCA Altium, Midcap Monitor Q4 2018).

Direct Lending Deals with a Sponsor



Direct Lending Deals without a Sponsor



Source: Deloitte Alternative Lender Deal Tracker Spring 2019

Commercial banks pull back

The rise of direct lending has also been helped by the relative decline in Germany of lending by traditional banks.

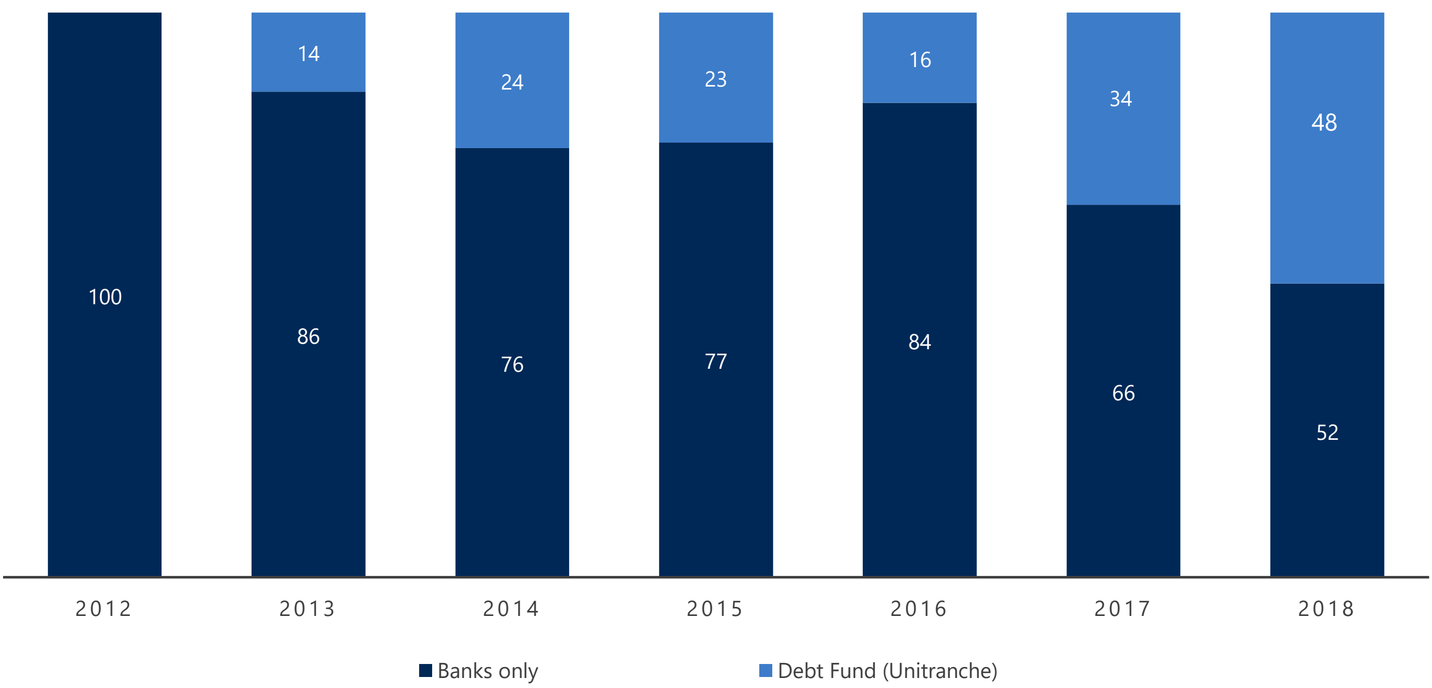
Historically the German lending market could be divided into three broad suppliers: private commercial banks, savings banks and cooperative banks. It was the commercial banks such as Deutsche Bank and Commerzbank that provided the big-ticket loans (€50-250m) that direct lenders can now supply. However, since the financial crisis the commercial banks have been forced to refocus domestically and down-size. Deutsche Bank's recently announced job cuts are just the latest phase in this process.

Like the rest of Europe, German banks have been affected by the regulatory changes resulting from implementation of Basel III. The changes have forced a reduction in balance sheet size and in risk-weighted assets (RWAs). The ability of traditional banks to provide loans to middle-market companies has been reduced due to the capital requirements incurred by holding what is usually a sub-investment grade loan.

Mid-market companies in Germany did not feel the full effect of the changes as quickly as their peers in other European jurisdictions as the large network of regional savings and co-operative banks helped to soften the blow. However, the retrenchment from lending by traditional banks is well established as a long-term trend that has created huge opportunities for direct lenders. Even more fundamentally, institutional lenders like Pemberton, backed by insurance companies and pension funds with long-term liabilities, are simply better equipped to refinance long-term corporate lending than banks that fund themselves heavily through short-term wholesale funds.

As a result, direct lending in Germany has already experienced strong growth over the last ten years although the number of deals remains lower than in the UK or France. Figure 2 shows the relative mix of bank vs non-bank provision of debt finance.

Market Share of Debt Funds and Banks in the German Market



Source: GCA Altium, Midcap Monitor Q2 2019

Investors search for yield

Retrenchment by traditional commercial banks and the growing acceptance of private equity ownership has generated increasing demand from companies for private debt finance. But there has also been a change in buy-side attitudes, to the benefit of the asset class.

Investors' search for yield has been a key feature of financial markets since the introduction of quantitative easing (QE) in the Eurozone, and as of June 2019 the aggregate amount of negative-yielding debt hit $12.5trn. This trend has continued even in an environment of negative rates, and the European Central Bank is now hinting at restarting its quantitative easing programme. This situation has forced investors to search for higher-yielding assets, often illiquid non-listed assets, to meet their liability targets.

Institutional investors such as insurance companies and pension funds are therefore moving away from the perceived volatility of listed markets towards less liquid but secured assets. Here direct corporate lending is one element in a broader picture that also includes infrastructure debt and real estate debt.

For the moment there is no indication that this quest for yield will end – it may even intensify - a factor that underpins future demand for private debt product.

Against that backdrop, at Pemberton we have produced a succession of deals in Germany and the DACH region with a run-rate of about eight deals a year over the period 2017-19. In the 12 months to the end of June 2019 we completed four deals out of a market total (unitranche only) of 37, giving us a 10.8% market share (source: GCA Altium, Midcap Monitor Q2 2019).

Those deals have come from a variety of sectors. We have financed a frozen finger food producer (Frostkrone), a quartz-glass specialist selling into the semiconductor industry based in Eastern Germany (QSIL), a medical equipment business producing pendant carrier systems for operating theatres (Ondal), an IT consulting business focussed on Microsoft Dynamics based ERP and CRM systems (be-terna), and the leading e-commerce retailer of tow bars and related products for passenger cars in Europe (Rameder). Investors welcome sectoral as well as geographical diversification in the asset class.

Reasons to be cheerful

Of course there are clouds on the horizon. There has been a deterioration in GDP performance and outlook, business confidence in August 2019 was at its lowest level for seven years according to the ifo Institute and a common question from investors is how direct lending funds would perform during poor economic performance. In addition, the European private debt market – Germany included - has largely been a post-financial crisis phenomenon and it is still largely untested going through a recessionary environment.

However, at Pemberton we are positive about the outlook and we expect the asset class in Germany to prove its resilience and investors to continue to find value.

As in other jurisdictions, direct lending in Germany benefits from the in-built advantages of the product: a fully-secured, first-lien loan with financial covenants that limit the borrower's overall leverage. The historic loss experience in the sector has been 50bp, and we do not expect that to change.

And as with all lending, credit analysis skills and risk management are important, and we have invested heavily in that area from the outset, with a team of nine credit analysts led by people with a long-term track record and significant restructuring and work-out experience. Those analysts know each of our portfolio companies since we first invested in them and are therefore well prepared to manage any deterioration in performance.

Conclusion

The last five years have seen strong growth in the number of private equity sponsored deals in Germany and an accompanying rise in direct lending. The drivers behind both those trends are well established and unlikely to change. Against that background it is logical to expect more institutional investors to come into the asset class, and the product to go mainstream with other corporates beyond its private equity sponsored heartland. "The direction of travel is very clear" agrees Jürgen Breuer.

A European View

This paper is the first in a series of Pemberton Perspectives that looks at geographies across the region. Each paper has been developed by our experts on the ground across Europe and is designed to give readers an in-depth analysis of Private Debt based on our experiences in the markets we operate.

We would love to hear your opinions. So please feel free to contact our Business Development team with any questions or comments at businessdevelopment@pembertonam.com or +44 (0) 20 7993 9300 with any questions or comments.