PEMBERTON

Private Debt in Germany

A LONG-TERM PARTNER FOR COMPANY GROWTH

GEOGRAPHIC SERIES

Introduction

Germany is the largest economy in Europe and a major market for direct lending. It has become a focus market for private equity given its economic strength and solidity. The country boasts a wealth of well-run, mid-sized companies - increasingly in non-traditional, non-industrial sectors - and a positive attitude towards private equity as creators of operational value and growth. As a result, the market for financing these investments keeps growing and direct lending has been increasing its share of LBO financing for years. Direct lenders' overall market share across all transactions, senior and unitranche rose from zero in 2012 to 62% in Q3 2021[1]. Germany is a key pillar in any pan-European direct lending strategies and has been a stronghold for Pemberton since inception.

November 2021

Why invest in Germany?

Germany is the largest country by population in the EU, with 83.2 million inhabitants as of 2020[2]. It also has the largest economy in Europe, with GDP of €3,368bn in 2020 making it the fourth-largest economy in the World[3].

Following the Global Financial Crisis, the German economy grew steadily from 2009 until the impact of the Covid-19 pandemic in Q1 2020. Like other major economies, the country then suffered the effects of lockdown before recovering from Q3 2020. In Q2 2021 the economy grew by 1.5% on the previous quarter, and by 9.6% on the low point recorded in Q2 2020[4].

The economic outlook for 2H 2021 and into 2022 is for continuing, steady recovery. **The ifo economic institute forecasts 2021 growth of 3.3%, and 4.3% for 2022[5].**

The cornerstone of German economic growth for decades has been the 'Mittelstand', which offers a wealth of well-run, efficient and frequently family-owned businesses with annual sales typically in the range of €100m-500m. Alongside the traditional manufacturing sector, there is also an increasing supply of asset-light companies to invest in, e.g. in Business Services (with IT Services having seen a plethora of buy-and-build strategies in recent years), Software, Communications and Tech.

Plenty of investment opportunities have also opened up in the country's Healthcare and Social Care sectors, with roll-up strategies in ophthalmic, radiology, dentistry and other parts of the medical practices and clinics. There has also been significant private investment in elderly and social care, driven by an ageing society and increasing life expectancy.

As with other major European economies, important decisions lie ahead to maintain Germany's competitiveness on a global scale while managing societal expectations around reconciling growth and ecological sustainability. As one of many illustrations of this challenge, following the decision to abandon nuclear power, Germany already has one of the highest costs of power in Europe, but still wants to run down fossil power production and increase renewable energy significantly. This will require investment in distribution infrastructure, for example to get power generated by wind farms in the north to the rest of the country.

The recent elections mark the end of 16 years under Chancellor Merkel and, for the first time in Germany's post-war history, the need to form a three-party coalition to achieve a majority. Sentiment in the country is divided between those who valued the solidity and calculability of Merkel's steady-hand approach and those who feel the country is in need of more ambitious reform.

"Germany has proven many times that it is capable of reform as and when required," says Jürgen Breuer, Head of DACH at Pemberton. "That ability has been present regardless of the colour of the governing coalition, as shown by the ground-breaking labour market reforms in 2005 under a Social Democrat/Green coalition – arguably an unlikely alliance to bring about such reform. Germany remains well placed to maintain its position as the leading economy in Europe."

> Germany remains well placed to maintain its position as the leading economy in Europe.

1. GCA Altium Midcap Monitor – Q3 2021
2. https://www.statista.com/statistics/672608/development-population-numbers-germany/
3. https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=DE
4. https://www.destatis.de/EN/Press/2021/07/PE21_365_811.html
5. https://www.reuters.com/article/germany-economy-ifo-idUSL5N2NY1JG

The growth of direct lending in Germany

The growth of private equity investment and the declining role of traditional banks have been the main drivers behind the development of private lending in Germany over the past 10 years.

The central role of private equity

We have noticed increased acceptance of private equity investment in Germany in recent years and believe there have been several factors supporting this. First, a generational change in attitudes has reduced the hesitance of founders and family business owners to sell. This has been combined with increasingly global attitudes.

Secondly, the reputation of private equity managers has improved. Many are now seen as having credible investment strategies for operational value creation rather than for financial engineering. They are investing in product development and growth, driving sector and international consolidation via buy-and-build strategies, and increasingly doing all that in a more sustainable way. In many instances the former family owners maintain an equity stake and use the PE firms to drive mutually beneficial value creation.

"Even in secondary or tertiary buyouts – long snubbed as a stop-gap for PE investors to secure an exit – the depth of the PE market provides value-creation levers for the next owner, by growing a business into new geographies or considering add-on acquisitions that may have been too large for the previous owner," Breuer comments.

Finally, 12 years of low interest rates and a lack of yield from traditional savings are causing Germans to wake up to the attractions of private equity as an investment class. This is helped by the arrival of access routes that help bring down the minimum investment of private investors and open up the asset class to a wider audience.

"This is clearly far away from a grass-roots development given the size of the entry ticket, but the returns available for investors in PE funds are mentioned much more in both social and classic media, feeding an interest in the wider public to understand what it is all about," Breuer observes.

Against that positive backdrop, private equity investment in Germany totalled €59.6bn (2016-20[6]). Along with France and Italy, **Germany is one of the leading markets for private equity investment in the EU,** although like them it remains some way behind Europe's leading market: the UK.

"The German private equity scene is larger, deeper, and more diverse than it has ever been," notes Breuer. "Having a team in Germany is a must-have for long-established players, and those that have originated

6. BVK March 2021

Germany remains well placed to maintain its position as the leading economy in Europe.

their success in other parts of Europe will target Germany for expansion at some stage – as seen with FSN Capital, Egeria, Altor and others in recent years".

"And then we have seen many new PE managers set up in Germany, either by professionals who gained a track record at established players, or by people with an entrepreneurial background, to create managers with a German heritage, some of them investing monies of German families," says Nils Weber, Executive Director in Pemberton's DACH origination team in Frankfurt.

Findos, Emeram, Armira and EMH Partners are just a few examples that fit that description.
As elsewhere in Europe, **private equity sponsors account for most direct lending deals.** PE sponsors were behind 90% of Pemberton's German deals up to June 2021. And this trend looks likely to continue. As of August 2021, DACH-based private equity sponsors had US$49.8bn of 'dry powder'[7].

The growth of direct lending in Germany has been accompanied by – and to some extent driven by – the simultaneous decline of traditional bank lending. This is also the case in other European markets, where the impact of Basel III and changing capital adequacy requirements have restricted banks' appetite for mid-market lending, thereby opening up opportunities for direct lenders.

Getting the full debt capacity for a €200m-600m deal from only one partner has proven to be a deciding factor for more and more PE sponsors. This is particularly pronounced in buy-and build situations.

"On another important note, now that the market has finally had the chance to see direct lenders in action throughout a crisis, many PE managers have been impressed with the pragmatism and partnership approach of direct lenders in dealing with the – mostly temporary – Covid impact on portfolio companies. This will reinforce the growing preference for direct lending with sponsors," says Pemberton's Weber.

Among the traditional banks, some lenders have closed their German leveraged finance teams (IKB) or become less active (Société Générale). There is also talk that Cerberus may take over the federal government's stake in Commerzbank, which could potentially bring about further consolidation in the sector[8].

Steady rise of direct lending

There were 375 direct lending deals in Germany up to the end of Q2 2021. That represented 12.2% of all European (including UK) deals to date[9].

Pemberton had completed 34 deals in Germany since inception up to the end of Q2 2021, including add-ons. That accounts for 23% of Pemberton's 147 deals in Europe and shows that **German deals represent a significantly higher share of Pemberton's European deal total than is the case for the overall private debt market**[10].

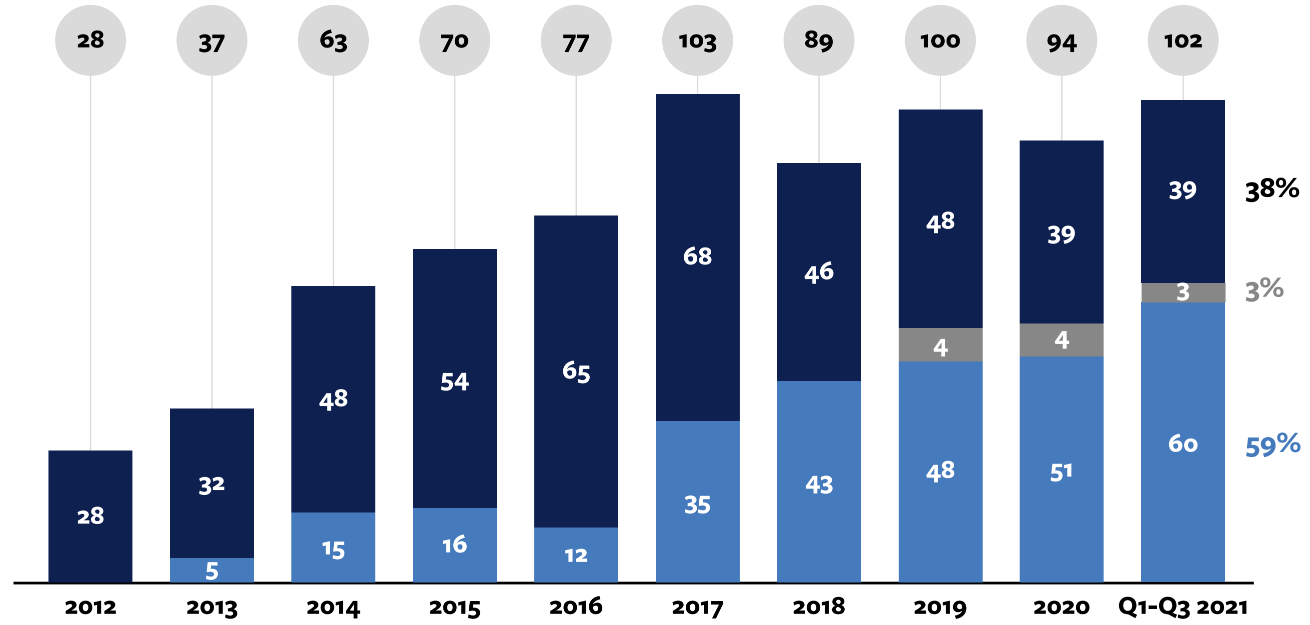
"This pan-European diversification is a result of Pemberton's strong on-the-ground presence and is highly appreciated by our LP base," says Pemberton's Breuer.

Over the last decade debt funds have steadily increased their market share of lending in Germany compared with the traditional banks. **The direct lenders' market share rose from zero in 2012 to 58.5% in 2020, and 62% in Q3 2021**[11].

7. Preqin
8. https://www.sharecast.com/news/market_reports/dj-cerberus-considers-buying-additional-stake-in-commerzbank--handelsblatt--8100410.html
9. Deloitte ALDT Tracker – Q2 2021
10. Deloitte ALDT Tracker – Q2 2021
11. GCA Altium Midcap Monitor – Q3 2021

Figure 1: The growing market share of debt funds in Germany

Total Number of Deals in the German Market (Senior & Unitranche)



Source: GCA Altium MidCap Monitor - Q3 2021

The impact of the pandemic on direct lending deal volumes faded quickly, and after a strong three quarters in 2021 market analysts expect Q4 2021 to see strong demand for direct lending[12]. As of August 2021, Germany-based private lenders had an estimated US$11-17bn to invest[13].

In terms of sectors, **there is currently big demand for exposure to Healthcare and Software/ Technology,** which are perceived as safer. Together they accounted for 60% of direct lending deals in Q3 2021[14]. To put that into perspective, as of 2018 those two sectors only accounted for a combined 29% of deals. However, there is also currently demand from a range of other sectors, including Industrial & Manufacturing, and Consumer.

Viewed by purpose, new financings (primary and secondary) in Germany accounted for a combined 52% of direct lending deals through Q3 2021; refinancing/recapitalisations made up 18%; and add-ons totalled 30% of deals.

The percentage of add-ons has been rising steadily since 2016, when they made up just 9% of financings[15], which is a nice piece of evidence for the value-creation that PE sponsors are driving through buy & build. And as pointed out above, it is a driver of market share for direct lenders, particularly if the additional debt capacity for acquisitions is committed at the outset.

12. GCA Altium Midcap Monitor – Q3 2021
13. Preqin data and assuming an allocation to Germany of 10-15%
14. GCA Altium Midcap Monitor – Q3 2021
15. GCA Altium Midcap Monitor – Q3 2021

At Pemberton, we have been very active in financing buy & build strategies, e.g. for BE-terna, a DPE-owned IT Services group, or for Emeram portfolio company Frostkrone (see case study page 7). In another situation we financed in 2018, our original debt package of c.€50m has grown to more than €250m after we helped finance a large number of acquisitions in three years.

Looking more generally, **direct lending strategies in the market have become more varied,** playing to a range of risk-return profiles and including profiles closer to what banks can do.

For example, the Pemberton Senior Loan strategy finances larger, more conservatively levered companies at lower rates compared to our Mid-Market strategy. The Senior Loan strategy can lend alongside – and pari-passu with – banks, something that is more challenging in the higher-levered Mid-Market strategy. As a result, it opens up opportunities for more co-operation between direct lenders and banks, and helps banks to maintain their place in the corporate relationship.

Another recent development is that certain banks are in a position to take pieces of unitranche financing (i.e. more highly levered) on a pari-passu basis.

Interestingly, large insurance companies are also getting involved in corporate loans. At Pemberton, we have established regular dialogue with some of these as potential partners in our Senior Loan strategy and have already financed a transaction in a trio of a relationship bank, an insurance company and a debt fund

Pemberton's commitment to Germany

Pemberton opened its first continental European office in Frankfurt in early 2015 and the local approach has been one of the firm's key strategic pillars in Germany and other leading European markets, especially during the pandemic. Other direct lenders have recognised the importance of Germany as a direct lending market and have hired resource directed at the country. However, while some have opened or intend to open a local office in Germany, others continue to target the market from London or other centres.

Pemberton has been one of the most active direct lenders in Germany for many years now, as evidenced by the fact that it frequently leads the relevant league tables, which has been the case once again for the LTM period to 30th September 2021[16].

As the list below shows, the platform deals we have financed have been in a range of sectors, but have included a large share of resilient (Healthcare and Food) and asset-light/high growth (Software, Tech, IT Services and Consulting) sectors. And we have brought one of our particular strengths to bear in many of these deals, which is the ability to commit and provide additional capital over a number of years to support buy & build strategies. In total, 37 add-ons were supported for nine of the platforms.

Figure 2: Selected German Pemberton deals[17]

Company	Sector	Sponsor	Notes
Infinigate	Security Software Distribution	Bridgepoint	LBO
WindStar Medical	Consumer OTC Healthcare	Oakley Capital	LBO + add-ons
Aenova	Pharma Contract manufacturing	BC Partners	Refinancing
Frostkrone	Frozen Fingerfood	Emeram	Refinancing + add-ons
BE-terna	IT Services	Deutsche Private Equity	LBO + add-ons
Rameder	Automotive Aftermarket	FSN Capital	LBO + add-ons
Swyx/Enreach	Unified Communication Software	Waterland	LBO + add-ons
QSIL	Fused Quartz materials	Corporate	Refinancing

16. GCA Altium Monitor - Q3 2021
17. Pemberton internal data

CASE STUDY

German finger food goes global

If you walked into any Aldi or Lidl in Germany (indeed elsewhere in the world) and you were set to indulge in some finger food – think mozzarella sticks or chili-cheese nuggets – you would find products from Pemberton portfolio company Frostkrone. Headquartered in Rietberg, Germany, the company has become the category and innovation leader in these products, continuously extending their portfolio with on-trend finger food products since 1997.

Frostkrone sells its products into large food retailers as well as food-service companies, through which those products get onto the menu of leading quick-service restaurant chains. The company's key USP – next to outstanding product quality – is its product innovation culture. That keeps the assortment up to date and provides a steady stream of seasonal product specialties that drive footfall in both retail and restaurants via temporary promotions.

German sponsor Emeram was attracted by these dynamics and, together with Frostkrone's CEO, acquired the business from Ardian in 2017. By late 2018, following initial acquisitions of complementary businesses in France, Emeram sought to expedite international growth with a larger acquisition in the US. Frostkrone already had strong relationships with some European food retailers that were growing their presence in the US, and also with a leading global supplier to the US food service sector, which it sought to capitalise on by establishing local production capacity.

Emeram was looking for a partner capable of refinancing the original deal and providing further capital for both the US acquisition and further international growth. Pemberton was the perfect fit, on the back of our track record of investments in the food sector and supporting buy & build strategies.

We have since supported two further sizeable acquisitions by the company in the UK.

Along with our other food investments, Frostkrone performed well through the pandemic. Its balanced route-to-market approach paid off, as lower sales to the restaurant channel were compensated by buoyant food retail business. Emeram has its eyes set on further growth, which we look forward to supporting.

Contact us

Jürgen Breuer
Head of DACH

juergen.breuer@pembertonam.com
Tel: +49 (0) 69 9760 998 10
Mob: +49 (0) 172 2579 023

Nils Weber
Executive Director, DACH Origination

nils.weber@pembertonam.com
Tel: +49 (0) 69 9760 998 11
Mob: +49 (0) 151 5237 9725

Pemberton Asset Management GmbH
Bockenheimer Landstraße 23, 60325
Frankfurt am Main
Germany

General Enquiries
info@pembertonam.com
Tel: +44 (0)20 7993 9300
www.pembertonam.com