

# Q&A

## Weathering the “perfect storm”

Following an almost doubling of activity in the German small- and mid-cap segment between January and September 2008, the financial crisis finally began to take its toll on the space in the final quarter: **Mareen Goebel** discusses the situation with **Andreas Schober**, vice-chairman of HANNOVER Finanz, who has recently joined EVCA, where he represents the interests of investors in the German Mittelstand

**Q** We have seen the large buyout space in Germany become a shadow of its former self in the last six months, but how is the small- and mid-cap segment faring?

**AS** At the moment there is not a lot of activity across the board, and that includes the small- and mid-cap ranges, which we define as companies with a turnover between €20-200m in Germany. Even at the lower end, there are very few deals being done right now, which is largely due to the expectations of vendors clashing with insecurity on the buy-side as to whether financing will be available. In the economic downturn we are now going through, that creates an unprecedented situation for the industry; something of a perfect storm.

**Q** Is debt liquidity in the small-cap market as much of a concern as in the larger transactions?

**AS** Liquidity is generally tight but the segment benefits from not having to resort to club deals. Those transactions that went through in the last months were typically financed by regional and smaller banks, like a Landesbank such as WestLB or BayernLB, but even they are now rather preoccupied with different problems. Small pockets of liquidity exist and some savings banks are active in the space as well, albeit on a very selective basis at the moment.

**Q** How has the small-cap segment changed in recent years?

**AS** When looked at over the long term, the small-cap market has become more and more active and prominent - I would estimate that the segment has tripled in the last five to six years. It has also become far more professional and there is now an infrastructure in place whereby mediators act as matchmakers. The profile of private equity has also significantly increased – owner families are now more aware of the asset class than they ever were.



Andreas Schober

**Q** What kind of investor are family-owned businesses looking for?

**AS** Vendors in this area of the market are more sentimental than vendors of larger companies, where managers and shareholders are mostly driven by price. The vendors we deal with take other factors into account as well. They are strongly embedded in local communities and tend to look more for sustainable and socially-responsible solutions, the long-term health of the company, and its ability to withstand adverse conditions. Conservative financing and of course, reputation, are crucial factors. Family-owners do distinguish between long-term partners and those that they perceive as asset strippers.

**Q** How do you anticipate the small-cap space developing in the near future?

**AS** There is still a lot of potential and we do anticipate that the market will recover in 2009. In the near term, the decline in the German economy and the massive decreases in companies’ order books in the last two months will create opportunities. We expect to see more companies in need of restructuring, particularly as Mittelstand companies will struggle to recapitalise themselves in the next year. Further opportunities may arise when other private equity investors have lost their stakes in the companies, or when an insolvency adviser is looking for a buyer.

**Q** Do you anticipate larger players becoming active in the lower end of the mid-market?

**AS** Over thirty years, we have seen many new players come and go. Some might succeed in changing their strategy away from the larger mid-market and do deals in the small-cap space, but that requires a quite different team set-up, a different skillset and a strong regional network, which isn’t built overnight. Some larger players might adapt their strategy due to the deal freeze in the other segments and attempt to get into the space. 92% of German companies are family-owned and the vast majority are small businesses, which potentially offers many

hidden jewels and niche market leaders. In addition, Germany’s strong, international suppliers and infrastructure make it a very good place to be.

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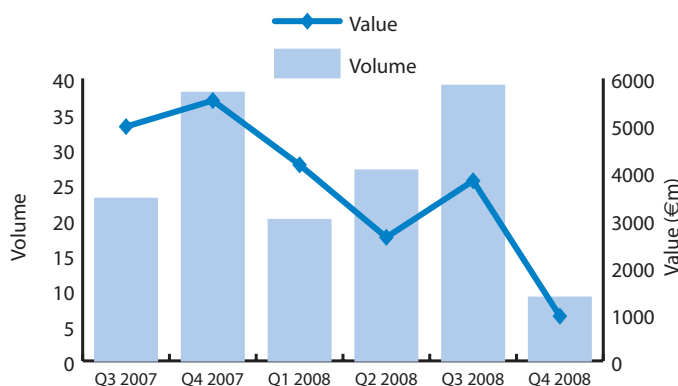
**Q** Are you worried about an increase in competition?

**AS** We expect a similar development to that seen in 2001 and 2002, when many private equity players, having burnt their hands on the new market, quietly expired after failing to raise new funds due to their weak performance. During the boom in 2006 and 2007, many bought companies at 10x EBITDA and will likely fail to get good returns on that money. Indeed over the last five years money was made through a pure trading approach, as company valuations were consistently on the rise. Now, the focus will shift towards real skills of value creation and many newcomers lack these skills. Experienced professionals who have weathered more than one cycle are clearly at an advantage now. ■

**Freeze reaches the Mittelstand**

- With the small- and mid-cap space in Germany having ended 2007 fairly strongly, there was an inevitable decline in the first quarter of 2008, with volume and value dropping by 47% and 25% respectively, from 38 deals worth €5.5bn to just 20 deals worth €4.2bn.
- In the second quarter, activity improved significantly, rising by 35% to 27 deals. However, the value of deals showed a further substantial decline on the Q1 total, falling by 37% to just over €2.6bn, reflecting a slide in average transaction value.
- By the third quarter, as the market slowdown was gathering pace across the rest of Europe, the German mittelstand bucked the trend by recording increases in both volume and value terms. Activity rose by 44% to 39 deals, the largest total seen in more than a year, while value jumped by 46% to €3.8bn.
- The final quarter though, saw a dramatic drop in activity in the space, with just nine deals completed over the three months, worth a collective €950m – down 77% and 75% respectively on the previous quarter.

*Volume and value of small- and lower mid-market buyouts in Germany by quarter, July 2007 - December 2008*



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