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GERMAN PRIVATE EQUITY IS FIGHTING A BATTLE ON SEVERAL FRONTS AND A NUMBER OF DISTURBING TRENDS HAVE EMERGED OVER THE LAST FEW MONTHS THAT COULD SHAPE THE INDUSTRY FOR YEARS TO COME.

MAREEN GOEBEL REPORTS

The classic LBO, previously the industry's bread and butter, has all but vanished in recent months. The reasons are well-reported: The dearth of credit caused by lenders struggling to stay afloat, with many erstwhile promiscuous leverage lenders now concerned with plugging the holes in their own balance sheets.

This has completely redefined the upper limit of what can be done. The industry, which at the height of the boom discussed taking DAX-listed companies private, agrees that the upper limit of deals that can be done presently is set at about €200m – a number previously located at the lower end of the mid-market.

This seismic changes means the industry is experimenting. All-equity deals, historically the domain of restructuring firms, have been done by buyout funds. The most prominent example and one of the biggest transactions in recent months, was BC Partner's acquisition of SGB Group for more than €500m, which was financed with all-equity and a vendor loan.

Mezzanine to the fore

The paltry number of leveraged transactions that are taking place look nothing like they used to. "We are seeing completely different structures," explains Dr Frank Golland of M Cap Finance, a German mezzanine provider. "While the equity

share used to be 20-30%, we are now seeing 50%, with 10-20% mezzanine to fill the gap left by the banks." Banks are unwilling to lend more than around €25m each, which means that club deals – with all the complexities they entail – are now the norm. Hopes that senior lenders might again be able to syndicate loans and the frozen market might thaw have so far been dashed. "The syndicated debt market, as well as the CLO/CDO portfolios, securitised on the capital market, collapsed and will remain shut in the near term," believes Golland.

While European deal levels for the first quarter of 2009 have dropped to the lowest levels since 1996 according to the Private Equity Barometer published by *unquote*”, mezzanine players active in Germany compare the situation with the period of 2003-2004. "We see the same kind of leverage, financing structures and margin as back then," explains Golland.

Mezzanine providers are now keeping very busy reclaiming the space vacated by the banks that had muscled in on their territory with their full-line financing offers in the heady days of 2005-2007. "At the moment, there's no deal being done that doesn't have a mezzanine element," explains Golland, who goes on to outline the current costs of mezzanine. "The pricing hasn't really changed in the last 45 years: 5-6% fix, with 5-6% PIK with an equity kicker, with a total cost of between 15-18%." (*See graphs.*)

THE ROOTS

“CONTRACTS ARE BACK TO PROTECTING BUYERS, AND CREATIVE STRUCTURING OF DEALS IS KEY”

**OTTO HABERSTOCK,
PÖLLATH + PARTNERS**



“The concerns for private equity buyers focus on whether deals make sense even with a higher equity portion, or even pure equity, sometimes combined with the prospect to install a different capital structure including an adequate level of leverage in one to two years,” explains Otto Haberstock of Pöllath + Partner.

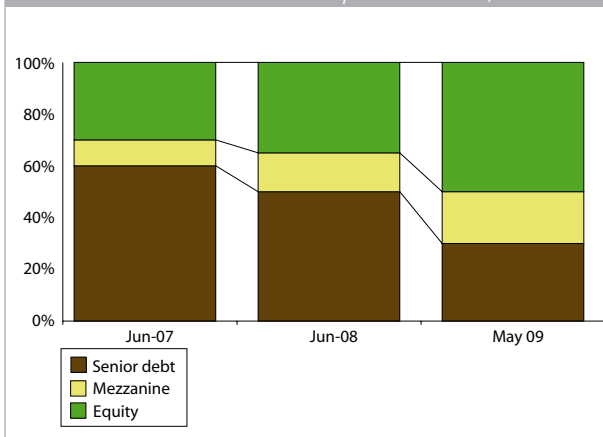
Caveat Emptor

As the German export economy loses steam at an alarming rate, many corporates are divesting non-core assets to be able

to serve existing credit obligations as their cash flows plummet. This is bringing a number of very attractive companies up for sale: The most dramatic case is the crumbling Merckle empire, parts of which are being circled by private equity bidders. In the UK, Lloyds’ buyout arm LDC has purchased two assets recently that are operationally sound but being offloaded by stressed parents.

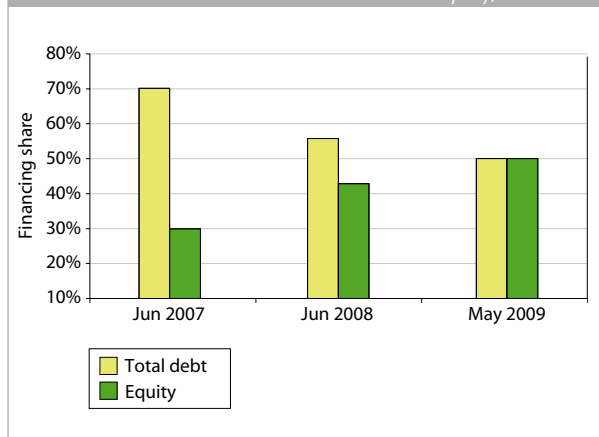
“At the moment nobody sells a business unless they have to, which makes transactions more opportunistic than

Capital structures, 2007-2009



Source: M Cap Finance

Debt to equity, 2007-2009



Source: M Cap Finance

“AT THE MOMENT, THERE’S NO DEAL BEING DONE THAT DOESN’T HAVE A MEZZANINE ELEMENT”
FRANK GOLLAND, M CAP FINANCE



ever,” Haberstock observes. “While we are currently busy with a lot of restructuring-related work, the large wave of M&A transactions triggered by restructuring has not yet manifested. From what we are seeing, many companies are saving themselves from one quarter to the next, hoping for an upturn. But if the situation does not change for the better dramatically, we anticipate a larger wave of deals in the third to fourth quarter, when companies can no longer hold onto unprofitable assets or are ultimately forced to sell to gain liquidity.”

Understandably, acquirers are wary of buying in a falling market, waiting for signs that the bottom has been reached, making the current environment a buyer’s market.

“In terms of transactions’ legal structuring, the state-of-the-art sale and purchase agreements looks nothing like it has for the past years. Locked Box concepts granting the purchaser limited protection against a target company’s inherent risks have been replaced by the traditional long-form agreement, which contains more comprehensive warranties

and indemnities by the seller. The only exception to this rule may be an acquisition after a bankruptcy, where the trustee will typically rather accept a lower price than retaining any exposure,” illustrates Haberstock. “More than ever creative thinking and structuring is required to overcome sellers’ and purchasers’ different views on a business’s true value in such volatile environment. Earn-out, upside and option agreements are frequently used to facilitate transactions that could not otherwise happen.”

New players, old structures

Established senior debt providers are firmly in the corner as smaller and more local players continue to appear on the scene. Smaller transactions are sometimes financed by the target company’s local banks such as Sparkassen and Volksbanken. “They have long-standing relationships with the target and know it intimately without needing a two-hundred-page due diligence report,” explains Haberstock.

The demands of lenders focuses on stricter covenants and closer controlling of the target. It is safe to say covenant-light is firmly

a thing of the past as lenders are learning from the experience of seeing targets financed under such terms go off the rails and their being helpless to intervene. Haberstock concludes: “Lenders are now reserving themselves more power to step in when a target is off-course.” ■

Development of financial structures in the last 12 months						
	Jun-07		Jun-08		May 09	
	x EBITDA	Share (%)	x EBITDA	Share (%)	x EBITDA	Share (%)
Senior debt	6.0	61.9%	3.1	44.3%	2.0	33.3%
Mezzanine capital	0.8	8.2%	0.9	12.9%	1.0	16.7%
Total debt	6.8	70.1%	3.9	55.7%	3.0	50.0%
Equity	2.9	29.9%	3.0	42.9%	3.0	50.0%
Sum	9.7	100.0%	7.0	100.0%	6.0	100.0%

Source: M Cap Finance