

# Raising and Structuring Private Equity Funds in Germany – Impact of Recent Developments

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The November 2008 Private Equity Fund Raising Compendium had still included the statement that up to the end of 2008 the crisis in the international financial markets had not yet a major adverse impact on fundraising in Germany. Despite the fact that the crisis was not caused by the private equity industry, it was not a big surprise that this industry was subsequently hit by the crisis and there was little (practically no) fundraising activity during 2009. But the market is gradually recovering and there has been increasing fundraising activity since the beginning of this year. The following article presents an overview of recent European and domestic developments and their impact on private equity fund structuring in Germany.



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## ECONOMIC ENVIRONMENT

*Buyout funds.* German private equity firms focusing on buyout transactions had completed very successful fund closings during the three-year period from 2004 until the end of 2006. They had anticipated raising their successor funds in 2009 and 2010, but these fundraisings have been postponed because the German buyout market is recovering slowly. Currently, buyout firms focus their activities on improving the capital structure of their acquisition vehicles to overcome the difficulties caused by the mismatch between the initial financial model and the actual performance of portfolio companies. Up to date, the

number of insolvencies of private equity backed buy-out transactions is insignificant in Germany. In almost all critical cases, the terms of the acquisition financing agreements were successfully renegotiated and funds were prepared to increase their equity investment. It is still too early to quantify the potential adverse impact on the total fund performance, though private equity managers anticipate that the performance of those funds that had already invested 50 percent or more of their capital commitments by the end of 2008 will be poor.

*Venture capital funds.* The financing gap for early-stage and start-up companies has been closed through a joint effort of the venture capital industry and the German government. A significant number of seed financing rounds have been completed over the past years with the support of public money, in particular the so-called High-tech Gründerfonds backed by the Federal Ministry for Economic Affairs. While these seed and early-stage investments generally perform well, the German venture capital industry still suffers from the bursting of the dot-com bubble and, as a consequence, struggles to raise funds for providing capital in subsequent financing rounds. But there is an increasing demand for venture capital.

*Expansion capital, mezzanine funds.* Expansion capital and mezzanine funds are probably the “winner” of the current

crisis in the financial markets. Well performing small- and medium-sized companies have a need for equity and equity-related capital in the range of several billion Euros to increase and expand their businesses, and to refinance the equity-related instruments that they issued a couple of years ago which are maturing now. Because banks are unable to satisfy this huge demand for capital the financing gap in this segment can only be closed by the private equity industry.

#### POLITICAL ENVIRONMENT

*Domestic developments.* In October 2009, the two parties forming the new German federal government entered into their coalition agreement (Koalitionsvertrag) setting out the political objectives that shall be reached during the current legislative period. The coalition agreement contains the following statements regarding private equity and venture capital: the government promises to increase state subsidies for entre-preneurs establishing companies as well as for funds focusing on seed and early-stage investments and providing capital for the financing of entrepreneur succession. The existing state programme for seed money (High Tech Gründerfonds) shall be continued as a public-private partnership and commitments of institutional investors to venture capital funds shall be backed by the government through the provision of a guaranty as collateral for a potential loss of capital. The framework for risk capital and private equity capital shall be improved. Innovative start-up companies shall be released from undue bureaucratic burden in connection with their formation. The coalition agreement expressly confirms the government's objective to strengthen the private equity market and to create an attractive environment for private equity firms. The government welcomes foreign investors from all over the world. Because the German private equity market is not

yet “regulated” this segment of the capital markets will be included in the European Directive for Alternative Investment Fund Managers (see below). In this context, the government demands that special features characterising German funds shall also be taken into consideration.

*European developments.* Although following the credit crunch on the international financial markets most of the public focus has been on banks, alternative investment funds, including private equity funds, and their managers have also become the target of political initiatives both in the US and in Europe. On 30 April 2009, the European Commission submitted a first draft of a European directive dealing with alternative investment funds and their managers (the “AIFMD”). At present, only Undertakings for Collective Investment in Transferable Securities (“UCITS”) are regulated on a pan-European basis. Because these funds primarily invest in listed securities, private equity funds and their managers fall outside the scope of application of the European UCITS Directive. Whether private equity firms provide services that are regulated under the European Directive on Markets in Financial Instruments (“MiFiD”) is questionable. While the UK Financial Services Authority has taken the position that MiFiD applies to private equity firms, the German Federal Financial Services Supervisory Authority has presented the contrary view. As a consequence of the current European regulatory patchwork the AIFMD covers all funds that are not UCITS funds and applies to all EU-based fund managers. It can be taken for granted that the AIFMD will be introduced, but the key question is how and when private equity funds and their managers will be regulated. The AIFMD is currently dealt with by the European Council and the European Parliament. It is expected that the final legislation will be agreed at the EU level during the second half of 2010. Because the transition period for implementation at the national level is usually around 18 months, the private equity industry

anticipates that the new regulatory regime will enter into force in the course of 2012. The following briefly summarises the core aspects of the proposals.

*Scope, thresholds.* The AIFMD lays down the rules for the authorisation, ongoing operation and transparency of the managers of alternative investment funds, i.e. any collective investment undertaking. Accordingly, the addressees of the AIFMD are the managers. The AIFMD shall not apply to managers that manage funds with portfolios whose aggregate value does not exceed €100 million (including leverage) or €500 million if two conditions are fulfilled, namely no use of leverage and no redemption rights for the five-year period following the formation of the fund. The Swedish presidency has suggested further important exemptions from the scope of application, but they are politically disputed. Managers that do not exceed the relevant thresholds can elect to be treated as alternative investment fund managers.

*Minimum capital.* Each regulated manager shall have a minimum capital of €125,000 which shall increase up to a cap of €10 million pursuant to a formula depending on the total size of the funds under management. Pursuant to the Swedish presidency proposal, a minimum capital requirement of €50,000 (or €60,000) shall apply to those managers that exclusively manage funds which meet the following criteria, namely no use of leverage, and no redemption rights during the five-year period following the formation of the fund, and make investments and divestments solely on a non-frequent basis.

*Valuation.* The 30 April 2009 draft submitted by the European Commission stipulates that for each fund the manager must appoint an independent valuator to establish the value of the assets acquired by the fund and the value of the units issued by the fund (at least once per year). This requirement has been heavily disputed by the industry, including private equity firms. As

a consequence, the Swedish presidency suggested the following compromise. Managers must ensure that appropriate and consistent valuation procedures are applied, but an independent valuation shall not be required. The member states may require managers to have their valuations externally verified or make them subject to oversight by the depositary (see below).

*Depositary.* Each fund must have an independent depositary which receives all payments made by investors, safekeeps the fund's assets and verifies whether the fund (or its manager on behalf of the fund) has obtained ownership of financial instruments the fund invests in. The depositary shall be liable to the manager and the investors for any losses suffered by them as a result of the depositary's failure to perform its duties. The EU Commission's first draft had included the requirement that the depositary shall be an EU credit institution. The Swedish presidency's proposal still requires an independent, authorised and supervised depositary, but includes financial service providers authorised under MiFiD or legal entities otherwise authorised by the national authorities. In addition, Sweden suggested that the depositary's duties shall be amended and extended. Apart from financial instruments, the depositary shall take into custody other securities as well. The fund's account for payments between investors and the fund can be maintained by a bank other than the depositary and the depositary shall only take care that such account is a segregated one and that all payments are accounted for on such account correctly.

*Transparency.* Each manager is required with respect to each fund to make available to investors and the competent supervisory authority an annual report for each fiscal year containing, among other information, audited financial statements, a report on activities, and a compilation of income and expenditures. Moreover, prior to its investments in the fund each investor shall have access to detailed disclosure relating to the investment policy, fees and expenses, preferential

treatment, liquidity risk management, redemption rights, delegation of functions, identity and duties of external service providers, investor rights should any failure arise, risk profile and risk management.

*Remuneration.* While the EU Commission's first draft dealt with remuneration aspects only in the context of the transparency requirements, the Swedish presidency's proposal contains more substantive rules. The Swedish proposals focus on the effects of remuneration structures on risk management as well as risk-taking behaviour and its control. Accordingly, each fund shall provide for remuneration policies and practices which are consistent with effective risk management. Moreover, the annual report shall disclose the total amount of remuneration actually paid, distinguishing between fixed and variable remuneration, and, where relevant, the total amount of carried interest payments. The annual report shall also disclose on a no-name basis the excess of the total compensation of each member of the manager's board of directors (including carried interest payments) over the average compensation.

*Leverage.* Special disclosure and reporting requirements apply to funds that employ high levels of leverage on a systematic basis. This is deemed to be the case where the combined leverage from all sources exceeds the fund's equity capital in two calendar quarters during the preceding four-quarter period. It appears that only leverage taken directly by a fund shall be included, but leverage at investee level shall not.

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*Controlling positions in portfolio companies.* The AIFMD addresses specific reporting requirements vis-à-vis other shareholders and employee representatives if a fund takes controlling positions in the equity of unlisted portfolio companies. While the EU Commission's first draft defines a controlling position by reference to a 30 percent threshold regarding the voting rights, the Swedish presidency's proposal suggests increasing that threshold to more than 50 percent. Such disclosure requirements are severe and include, among others, rules on the avoidance of potential conflicts of interest between the

manager and the portfolio companies, rules on the external and internal communication of the portfolio company, as well as detailed information about the performance and the business of the portfolio company. These additional reporting requirements have been heavily attacked by the private equity industry, and even the Swedish presidency's compromise proposal is still said to be “over the top”.

*European passport, effective date.* Managers regulated under the AIFMD shall benefit from a European passport regarding their activities in other member states of the European Union and regarding marketing their funds. However, the AIFMD does not grandfather funds that have already been established prior to the effective date of the transposition into national law. Managers that fall within the scope of application of the AIFMD are required to comply with the AIFMD with respect to their existing funds and to submit an application

for authorisation within one year of the deadline for the transition of the AIFMD into national law.

#### IMPACT ON FUND STRUCTURING

*German inefficiencies.* The framework in Germany for private equity funds is still inefficient: management fees are subject to VAT; the requirements for full transparency of private equity funds as laid out in the administrative pronouncement of 16 December 2003 relate to asset management criteria and ignore the fact that private equity is an important instrument for the financing of business undertakings; and, last but not least, the scope of application of the German carried interest legislation is too narrow. As the economic environment in Germany gradually recovers, and after the positive statements in the coalition agreement regarding private equity, the German Private Equity and Venture Capital Association (“BVK”) presently places particular emphasis on the transition of the AIFMD into German domestic law to eliminate the current inefficiencies in the German private equity industry.

The BVK suggests that the AIFMD shall be incorporated into German domestic law by amending the German Investment Fund Act. All alternative investment funds and their managers shall be dealt with in a new “chapter”. Title 1 of this new chapter shall set out the EU harmonised regulatory rules pursuant to the AIFMD and subsequent titles shall address specific provisions relating to certain types of funds, including private equity funds, if and to the extent the AIFMD is silent. As far as private equity funds are concerned, such specific rules should include the following: (i) All funds covered by the new chapter (i.e. all alternative investment funds) qualify as investment funds for the purpose of the exemption of management services from VAT pursuant to the EU VAT rules applicable to investment funds, (ii) Regulated private equity funds are fully transparent for income tax purposes,

(iii) Carried interest payments from regulated private equity funds fall within the scope of legislation of the German carried interest legislation. At this stage, it is still too early to predict whether these political demands will be fulfilled. But statements made by policy makers in parliament indicate that government has realised that the implementation of the AIFMD brings a one-time chance for Germany to create an internationally attractive and competitive environment for private equity in Germany.

*Current fund structures.* Because the inefficiencies as outlined above still characterise the German environment, many German private equity firms establish their new funds in Luxembourg as investment funds under the Luxembourg SICAR regime. In order to achieve full transparency from a German tax perspective they are established as limited partnerships that operate in compliance with the restrictions set forth in the administrative pronouncement of 16 December 2003. This structure should be eligible for an exemption from VAT of the investment services provided by the German private equity firm to the Luxembourg general partner of a regulated Luxembourg fund partnership because under the new business-to-business principle, for VAT purposes, such investment services are deemed to be performed in Luxembourg. They benefit from an exemption from VAT there, because a Luxembourg SICAR is an investment fund. ■

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