Berlin, Germany

Dealing With It

Over the past two years deals have returned to Germany and investors are flooding into the market.

By Maria Jackson

As the biggest economy in Europe, Germany is often used as a barometer for the rest of the continent. Despite recent news headlines heralding the onset of a new regional recession following Germany's surprise 0.2 percent slide in GDP during the second quarter of 2014, the reality is that deals are flowing and the investor mood remains upbeat.

In 2013, M&A deal value in Germany hit $94 billion (€72 billion), which represented the strongest performance by deal value since the $113 billion (€86.2 billion) posted in 2007, according to research from Mergermarket. Importantly, deal activity remained robust in the first half of 2014. Although value dropped on the same half last year, it was only a slight 5.1 percent slip from $43.9 billion (€33.5 billion) to $41.6 billion (€31.8 billion). Most significantly of all, the value of inbound deals jumped by 18.1 percent on the first half of 2013, to $38.3 billion (€29.2 billion).

In terms of the industry drivers, the hottest area was the industrials and chemicals sector, which accounted for 36.2 percent of deal value during the first half of 2013. However, the action is more widely spread than that suggests, particularly as the industrials sector was boosted by a couple of mega deals: namely, Koch Equity Development and Goldman Sach's $2.9 billion acquisition of printing ink maker, Flint Group, and Rolls-Royce's $3.1 billion acquisition of a 50 percent stake in Rolls-Royce Power Systems, formerly Tognum, from Daimler.

"In terms of individual sectors, TMT, pharmaceuticals, medical and biotech dominated, and comprised four out of the five biggest deals of the last quarter," says Georg Seyfarth, co-managing partner of German law firm, Hengeler Mueller. "These sectors are experiencing spikes in activity due to industry specific shifts. In telecommunications, the European Commission is encouraging the extremely fragmented market to consolidate in order to be more competitive."

In short, a strong pipeline is forming across a diverse spread of sectors, and firms are noting that private equity competition is heating up as funds gather to swoop on realistically-priced assets.

"Private equity investors still have a lot of money to invest," says Harald Lindemann, corporate finance partner at Honert + Partner. "Due to the ongoing currency policy of the European Central Bank with the aim to support investments in the Southern European economies, it has become easier for investors to leverage their investments in Germany. In our view, it looks like a perfect investment environment for investors."

LINING UP

Much is being made of the resurgence in European private equity and Germany is attracting a significant piece of that action.

"PE investment has increased quite significantly in recent years; it has gained significant traction since the stagnation occurred in the wake of the financial crisis. Established funds have been more successful in their recent fundraisings and a large volume of capital is available for deals," says Otto Haberstock, corporate finance partner in the Munich office of independent German law firm P+P Pöllath + Partners. "The German market has therefore seen a significant number of transactions being closed by PE houses, including many secondary (tertiary, etc.) transactions. However, the deal flow is still not back to the volumes reached before the financial crisis and competition among PE houses throughout all deal sizes is fierce."

There is no doubt that private equity liquidity in the European market is high. The total value of European PE exits in the first half of 2014 reached $68 billion (€52.8 billion), a 63 percent increase on last year according to the Centre for Management Buyout Research (CMBOR). In addition, research by data provider Preqin suggests that Europe-focused buyout firms have accumulated around $148 billion in dry powder (capital committed to private equity managers for investment). The problem is that demand is outstripping supply.

"In a continuing situation of dry powder and tough competition for attractive targets there is high demand from financial investors, including private equity, infrastructure funds, pension funds, real estate funds, sovereign wealth funds and alternative capital providers," says Frankfurt-based Markus Paul, co-head of the global financial investors group at international law firm Freshfields Bruckhaus Deringer. "Financial investors are responding by broadening their portfolios not only on a regional, but also on a sector level. Freshfields is recognizing an increasing interest among financial investors to invest in regulated industries, where competition for assets – to date – is less intense.

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—GERHARD SCHMIDT, MANAGING PARTNER OF WEIL, GOTSHAL & MANGES' GERMAN OFFICES

Examples include recent investments of private equity in regulated financial services."

This diverging and broadening private equity interest is being reported by law firms across the market. As competition and liquidity continues to increase, moving into new areas of investment is paramount for funds looking to invest their cash.

"As a result of the competitive environment there are a huge number of secondary and tertiary buyouts in the market," says Jochen Tyrolt, M&A partner in the Stuttgart office of full-service German law firm, Gleiss Lutz. "Furthermore, private equity investors are expanding their activities into other areas such as minority investments, real estate transactions, loan portfolios, etc. in order to generate more deal opportunities. They are also more focused on active portfolio management."

Tyrolt also highlights the growth in more club deals structures, where strategic investors are being backed up by private equity investors.

It is also important to note that Germany specifically remains a firm favorite with U.S.-based private equity houses. Although many law firms say that the rise in North American investment is not dramatic, there is no doubt that the participation of U.S. players is increasing.

"Recently, a number of new players have entered the German market (e.g. Centerbridge) or increased their exposure to the German market (e.g. Hellmann Friedman)," says Gerhard Schmidt, managing partner of Weil, Gotshal & Manges' German offices. "In addition, a number of U.S. funds are considering opening offices in Germany where they have not been present with own offices before.

Among Weil, Gotshal & Manges' recent German

deals, Schmidt advised TPG Capital and DLJ Merchant Banking Funds on the sale of an 87.5% share in Grohe Group's parent company, Grohe Group S.à r.l., to Japan-based LIXIL Group. The deal, which closed earlier this year, represents the largest direct investment by a Japanese company in Germany to date. Germany's attractiveness to foreign investors is undoubtedly climbing, but importantly it is not just investors from mature markets that are making moves into the country.

BUILDING BRICS

Germany economic health has long been linked to its vibrant export sector. The country is the third-largest exporter globally and figures from its federal statistics offices revealed that its trade surplus hit around $260 billion in 2013, the biggest surplus in the world. Its focus on diversifying into emerging markets, following the lean years of the financial crisis, has also paid dividends and now nearly 12 percent of Germany's exports go the BRIC (Brazil, Russia, India and China) economies. Those investment relationships have filtered through to other areas of Germany's economy.

"Our clients' emerging markets activities are increasingly influencing our transactional work," says Michael Stobbe, M&A partner in the Berlin office of leading corporate and real estate law firm GSK Stockmann + Kollegen. "In particular, we are seeing deals with German targets having significant production activity in the BRIC countries. In this respect, our work not only requires coordinating legal advice with respect to these jurisdictions but also understanding the economics of these globalized activities of our clients and the target companies."

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In 2012, a team from Hengeler Mueller advised Weichai Power in its strategic partnership with KION Group; Weichai's $998 million acquisition of a minority stake in the private equity-backed industrial truck maker still stands out as the largest Chinese direct investment in Germany to date. The firm says that the increasing flow of inbound and outbound deals involving China is has led it to launch an office in the country.

"The huge potential of China's consumer market makes it one of the top destinations for German exports and a key market for Germany," says Seyfarth. "In order to even better meet the demands of the rapidly developing and increasingly significant Chinese market,

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HARALD LINDEMANN
HONERT + PARTNER

and further enhance existing client relationships with companies located there, Hengeler Mueller is planning to open an office in Shanghai later this year."

It is a sign of the times, according to law firms. It seems that Chinese investors are becoming an increasingly important element in Germany's investment scene.

"Over recent years, Chinese investors have shown very significant interest in making investments in German businesses and/or real estate portfolios. It seems that following the longstanding very intense activity and cooperation of many German companies in China, Chinese business-owners have become increasingly encouraged to make similar investment moves into Germany," says Haberstock. "The robustness of many German businesses, and the economy as a whole even through the crisis years, has created confidence in the solidness of investment into the German market."

As Haberstock goes on to explain, political cooperation has also encouraged stronger investment ties. For example, a new treaty on double taxation was signed between Germany and China in March 2014, which is expected to come into effect in January 2015. Measures such as these should further bolster investment flows between the two countries.

In addition to the BRICs, there are also emerging markets closer to home that have strong investment links with Germany. The country's proximity to Central and Eastern Europe (CEE) marks that region as an important investment destination, particularly Poland and the Czech Republic, which are perceived as being relatively high-growth markets with minimum risk.

"Cross border M&A activity has substantially increased. Notably we advised, for example, Deutsche Telekom on its largest acquisition in recent years, targeting the CEE telecommunication markets by acquiring telecoms service provider GTS Central Europe," says Christian Pleister, co-head of the corporate and M&A practice group at European law firm Noerr, which has a very strong CEE practice. "Another substantial part of our cross border work involves the roll out and equity

financing of e-commerce ventures in emerging markets worldwide by our client Rocket Internet."

However, there is one emerging market that could create a blip in Germany's generally positive investment outlook.

BLACKLIST

The European Union's tightening of economic sanctions against Russia in response to the Ukraine crisis is expected to have significant repercussions for Germany. The country has strong trade links with Russia and food and agricultural imports alone were worth around $2 billion in 2013.

"The most important development will certainly be what influence the sanctions on Russia enacted by the European Union will have on German businesses," says Haberstock. "Business cooperation with Russia has been strong over the last few years and it is very likely that there will be disruption on some level. Given the large diversification of most German businesses, however, the general expectation is that the economy as a whole will only suffer mildly."

However, some firms are already noticing the effects of the West's stand-off with Moscow.

"The first impacts of economic sanctions are already affecting some German businesses. This could be seen in the profit warning from Adidas, because of a weak Russian economy, and the consequential drop of their shares," says Dr. Mathias Schröder, partner in the Munich office of full-service German law firm, Heuking Kühn Lüer Wojtek. "The German car makers, for example Volkswagen, are also affected by a weaker Russian economy through lower car sales. But the impact on the luxury car makers, such as Audi, Mercedes or BMW is not as strong as on the mass manufacturers VW or Opel."

Nevertheless, Schröder believes the overall effect will be a 'damper' rather than a serious shock to the economy. Certainly, the German Government has announced that there are no concerns about market turbulences as a result of the sanctions. However, a recent Deutsche Bank study disagrees: it found that if a broad recession were to hit Russia, German growth could shrink by 0.5 percent.

As Russia-Ukraine peace talks continue, hopefully a solution can be found that will ensure sanctions can be lifted and Germany's deal-making success story can resume. ■

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