Private Equity in Germany – Information for Institutional Investors

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Introduction

Institutional investors dedicate considerable efforts to identifying investment opportunities in asset forms that will offer high returns. However, they do tend to focus mainly on traditional asset forms such as loans, shares, and money market products. The combination of a stock market slump that started in spring 2000 and continued into 2003 and a parallel low interest phase that lasted until 2006, led asset managers from many institutions to increase their search for alternative asset classes.

This occurred even though the stock markets took an upturn in 2005 to mid-2007 and interest rates began to rise again. With experience gained from previous and current downturns, as well as in the currently (2007/08) highly volatile public markets, institutions are striving to develop new investment strategies to offset the drop in returns and volatility as well as contribute to more diversification. As a result, new considerations regarding strategic asset allocation are gaining importance. Moreover, the range of investment areas is expanding to allow for diversification in alternative investments. Private equity is becoming increasingly important in this context as a key alternative asset class, also for German institutions.

When investors are thinking about entering the private equity asset class, they start by looking closely at potential returns and the risk structure (diversification). However, many asset managers find their investment behavior restricted by a lack of transparency, company guidelines or liquidity demands. For many institutional investors, the liquidity of an investment has now become more important than potential returns. Despite the lack of transparency and frequent lack of internal resources, German institutional investors demonstrate far higher awareness of private equity than in the past. Also in terms of organization, many institutions appear to have gone through a substantial learning curve. Nevertheless, this investment segment is still considered to be challenging and in need of explanation. This situation is not helped by the fact that various synonyms are used for this area in the market. It is clearly necessary to define terms.

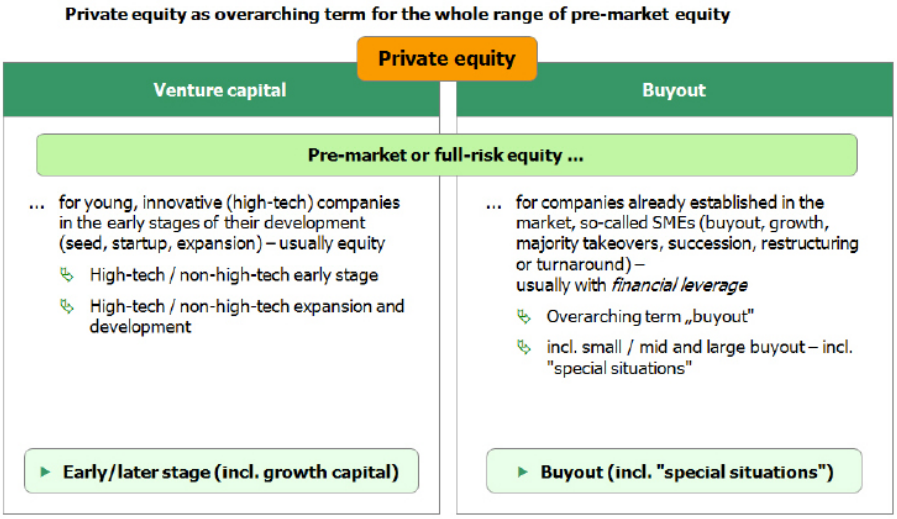
Private Equity as overarching term

As overarching term, private equity describes equity investments in companies not listed on a stock exchange[1]. These types of investments are generally long-term and tend to lack liquidity due to a limited secondary market. Moreover, the private equity market is characterized by very low transparency associated with a greater need for information, or rather (administration) costs than investment in capital markets, for example.

1) This definition differs from the way the term „private equity“ is often used in public discussions, where private equity is often used a as a synonym for the „mega buyout“ segment and does not contain the other private equity segments (the number of mega buyout transactions represent less than 1% of all private equity investments)

The following exhibit reiterates and clarifies how the private equity asset class consists of two main segments: the venture capital segment on the one hand, and the buyout segment on the other (incl. related financing forms such as restructuring or mezzanine). Therefore, the market can be roughly broken down into early phase (venture capital) and late phase (buyout financing) business. These terms do, however, incorporate a variety of different financing reasons, some of which are counter-correlative:

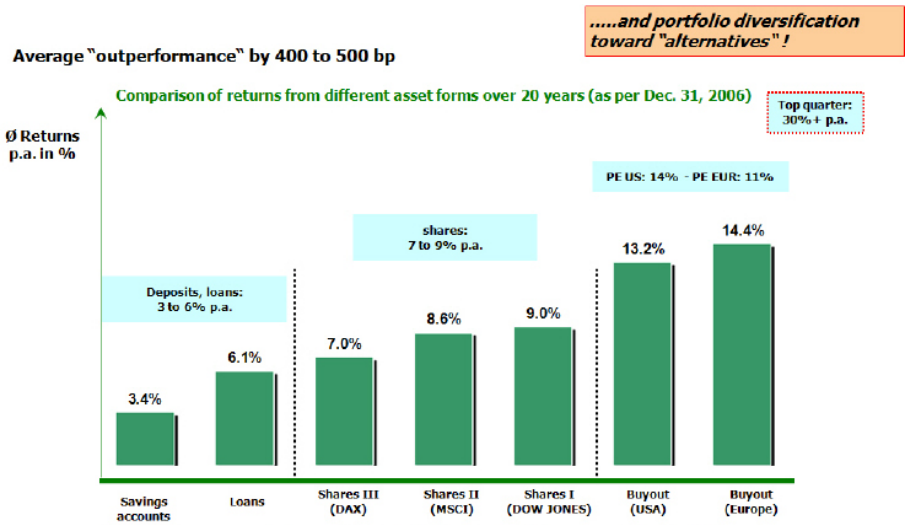
Chart 1: Statistical definitions of Terms



Source: FHP Private Equity Consultants

In the context of increasing diversification and achieving higher returns, interest in private equity has grown steadily. In addition to absolute target returns, institutional investors pursue relative performance, or rather the significance of their private equity engagement – the stock markets generally serve as benchmark here. In the past, private equity mainly achieved the usual target (500 bp over public markets). However, the differences in returns between the best and worst fund managers are far greater in this asset class than in any other. Therefore, private equity entails a selection risk but hardly any market risk.

Chart 2: Why private equity



Comment: average approximate annual returns for historical period of 20 years **as per Dec. 31, 2006**;
Data sources: Thomson Financial / Venture Economics; EVCA; NVCA; Deutsche Bank; Deutsche Bundesbank;

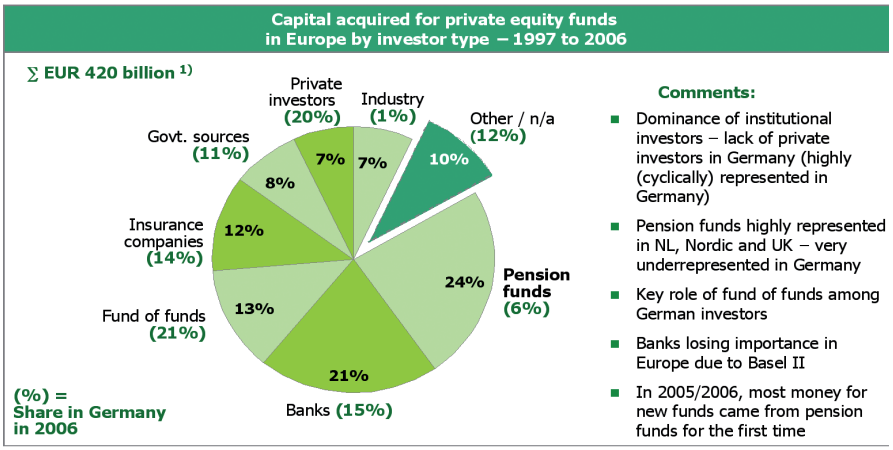
Source: FHP Private Equity Consultants analysis

Heterogeneous investor base

The main investors are banks, pension funds/occupation-related pension plans, and insurance companies. However, other investors include industrial companies, foundations, family offices, private investors, and the Government.

Chart 3: Origin in Capital – Investor base in Europe (Germany) over ten years

Pension funds and banks dominate as capital providers in Europe – differentiated picture in Germany



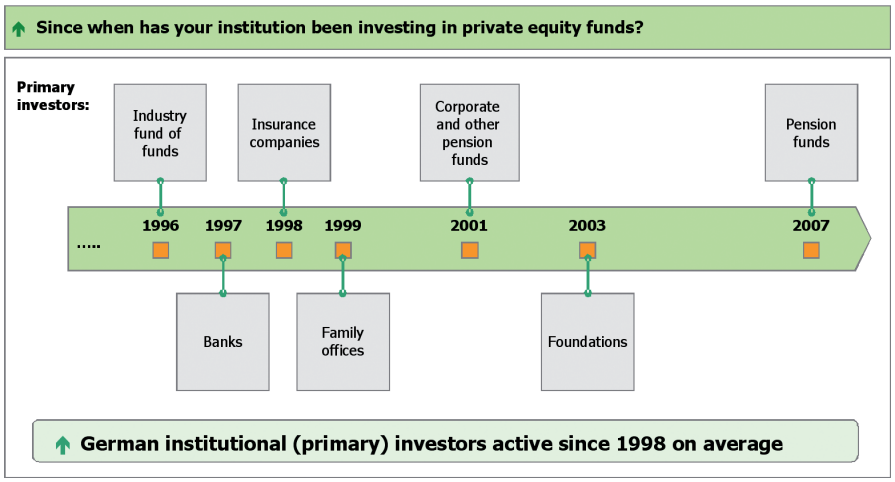
1) incl. capital gains of EUR 26.5 billion
Source: EVCA; BVK; FHP Private Equity Consultants analysis

Besides banks, pension funds are among the leading investors in European private equity funds, with an approximate 50% share of total volume. Quite a way behind, they are followed by fund of funds (as a type of environmental investment for institutional investors) and insurance companies. When analyzing the market by country, it is clear what a major role the banks play in Central European countries such as Germany, France, and Southern European countries like Spain, and Italy. By contrast, in Northern European countries and more Anglo-Saxon countries like the UK and Sweden, pension funds represent the most important source of capital for private equity funds (as is the case in the US). Up to now, pension funds have invested very little in private equity in Germany. At present, German investors‘ average experience amounts to about ten years – when analyzed by investor group, it becomes apparent that insurance companies and banks have more experience but not necessarily a higher allocation. By contrast, the topic is relatively new for foundations and pension funds that did not start operating until 2002. These have the greatest need to catch up. Private equity is encountering an increasingly heterogeneous investor landscape.

Side note An empirical European study conducted by FHP in 2004 highlighted the fact that German investors have less experience compared to their international counter-parts. This is especially true when compared to Anglo-Saxon investors. Investors in Great Britain demonstrate by far the most experience – even Swiss and French investors have had more dealings with and are more open to the topic of private equity.

Chart 4: „German Institutional Investors“ and Private Equity – Background and Facts

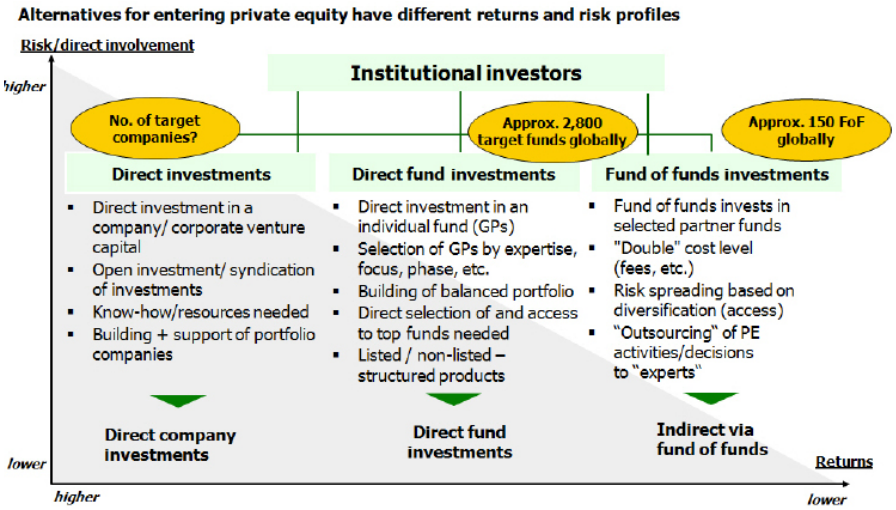
Private equity came late, but is gaining importance among institutional investors



Three Investment options

In principle, investors can choose between three alternatives when designing their investment strategies. Hybrid forms and products are also an option – it is not a question of having a „black & white“ solution here:

Chart 5: Investment behaviour: options



Investors can opt for the most direct variant by identifying and investing in individual companies. Alternatively, they can invest directly in individual funds or choose the indirect variant and invest in fund of funds. Each of these three variants represents a different risk profile, requires varying resources and expertise, and also has different returns potential.

Direct investment in companies

This type of investment provides institutional investors with the most direct way of participating in the private equity asset class. Here, investors put their capital directly into the individual companies and, as is the case with venture capital firms, they assume a direct shareholder role with respect to the target company. This does, however, require entrepreneurial experience, deep know-how in the respective industry, and intensive supervision of the investment. Only very few institutional investors go down this route.

Funds/venture capital firms

Potential investors have the possibility of investing their capital directly in funds. These funds then invest in companies from selected target industries or company phases. Typically, this strategy leads to far greater chance of higher returns than investing in fund of funds with a broader spread of investments, for example. However, it does entail higher risk. This is because the target fund only selects a limited number of companies (10 to 20) and returns therefore depend heavily on the performance of a few companies.

Funds of funds

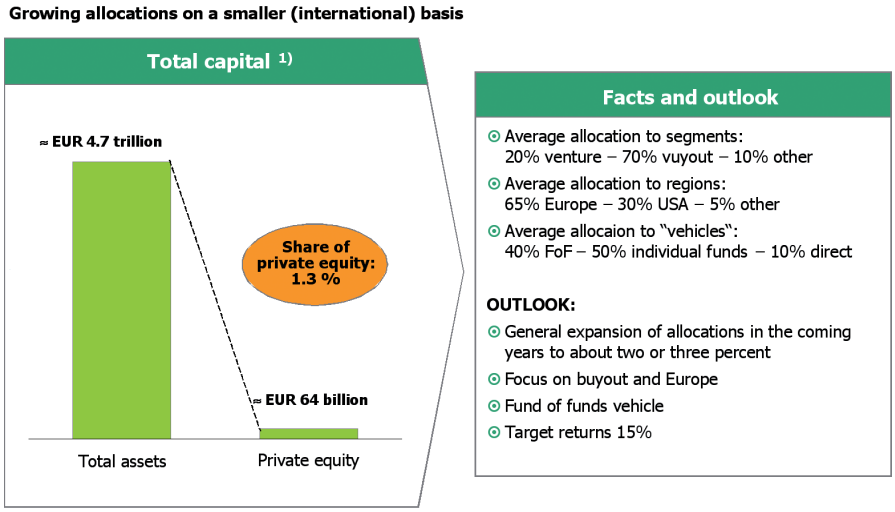
Fund of funds offer investors a third investment option. Especially in the case of a lack of or insufficient internal resources (employees, expertise, and processes), investors tend to invest in one or more fund of funds, thus externalizing fundamental investment decisions (selection of individual funds). Fund of funds invest in the private equity funds they previously analyzed and selected. Since investors are indirectly investing in a number of companies, this provides a broader basis and thus tends to reduce risk; a greater distribution of risk is achieved with a diversified portfolio. Some experienced investors also used the fund of funds variant as a strategic add-on for penetrating

specific niche segments. The „art“ – and thus the success – of successfully managing a fund of funds lies in participating in one of the most successful private equity funds worldwide – the so-called „top quarter“ – to achieve above-average performance, despite a double fees structure.

Allocations of about one percent

According to a current empirical analysis, (Source: Fleischhauer, Hoyer & Partner (FHP) Private Equity Consultants; 2007 for BMWi – see also www.fhpe.de) the 107 institutional (primary) investors surveyed in Germany allocate approximately one percent to the private equity asset class. This figure is based on committed capital.

Chart 6: Institutional Investors in Germany – allocation



1) Excluding fund of funds; Basis: total assets or partly balance sheet totals of banks; share of private equity based on comitted capital
Source: Fleischhauer, Hoyer & Partner (FHP); empirical analysis (2007)- Basis: 107 primary investors

Total assets held by the investors surveyed (107 primary investors) amount to EUR 5 billion – 1.3% of which is committed to private equity. This allocation is very low compared to other countries. Especially considering the fact that only 60/70% of the committed capital will actually be invested. This would therefore put the effective investment rate below one percent. In the next few years, the allocation is expected to increase to two or three percent.
In addition, significant differences can be seen in the allocation. Family offices have a disproportionately high share of private equity. By contrast, many institutions such as insurance companies, pension funds, and banks only have a „micro-allocation“ of maximum one percent. Foundations have played a minor role to date as investors. However, when they do decide to invest in private equity – which involves a great deal of effort – they generally have a somewhat higher private equity allocation. Indirect investments via fund of funds play a key role in private equity allocations of German institutions.
If an institution has invested in private equity, it usually spreads its allocation across different segments for diversification purposes. By far the most capital is committed to buyouts. In terms of geographic allocation, the dominant role of Europe (67%) for German investors becomes apparent compared to the US (30%). This is not surprising based on the proximity to the European market as well as the currency risk associated with dollar investments.

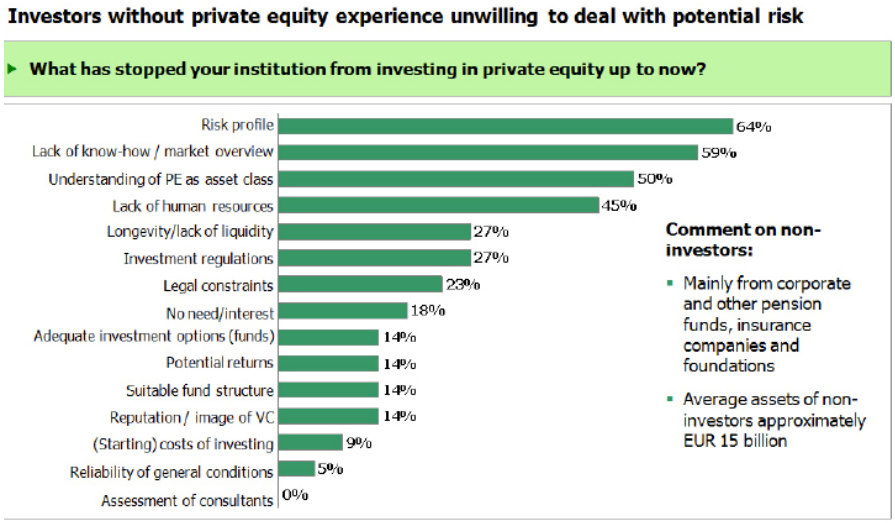
Side note Listed venture capital firms are another investment option. The advantage for investors is that they can find out the share price for selling or buying at any time. From the investor perspective, the limited fungibility of private equity is this transformed into a liquid form of investment. A (share-based) investment is, however, very dependent on the overall stock market situation and less on the actual value of the portfolio. Consequently, investment in listed venture capital firms tend to prove more volatile due to general price fluctuations in the markets.

Private equity as „marginal activity“

Among German institutional investors, PE is a „marginal activity“ that does, however, require considerable effort. Many institutions in the market have hardly any or very little experience with this asset class, or do not have sufficient inhouse resources (comment: BaFin explicitly sets out that investors who want to invest in private equity have to have inhouse expertise – this is often a challenge for smaller institutions). This is also due to the often „subcritical amount“ of assets in the highly heterogeneous German market: Critical mass for assets under management (AuM) is around EUR 1 billion for entering the private equity market.

Moreover, private equity often tends to be associated with high risk, which (still) stops many institutions from investing in this asset class.

Chart 7: Reasons for rejecting Private Equity



Source: Fleischhauer, Hoyer & Partner (FHP); empirical analysis (2007) – Basis: 107 primary investors

Summary

The market for private equity is gaining maturity from both the market and investor perspectives. The private equity asset class is expected to gradually attract a greater number of investors. Nevertheless, this asset class is still a relatively new segment for institutional investors in Germany. German institutions tend to be underinvested in private equity. For many years, they have limited themselves to traditional forms of investment. However, leading institutions or rather potential investors in private equity, are starting to rethink their positions. Contrary to popular belief, the legal conditions do not represent a direct obstacle to increasing investment in private equity. The main barriers are a lack of know-how, or rather a lack of market transparency, a negative image based on its association with high risk as well as limited inhouse resources. There is a huge lack of information regarding private equity. We believe that growing assets among German institutions will lead to greater diversification in portfolios and thus to higher private equity allocations in the coming years. This trend will also be supported by increasing consolidation among small investors to form capital depositaries. Many German institutions are planning to either enter the private equity market or increase their activities there – the potential (investment volume) is high. ■