Chambers
AND PARTNERS

CHAMBERS GLOBAL PRACTICE GUIDES

Private Equity 2022

Definitive global law guides offering comparative analysis from top-ranked lawyers

Germany: Trends & Developments

Peter Memminger, Stephan Boerner and Jonas Schwarz
King & Spalding

practiceguides.chambers.com

Trends and Developments

Contributed by:
Peter Memminger, Stephan Boerner and Jonas Schwarz
King & Spalding **see p.6**

Introduction

The year 2022 has been characterised by significant headwinds for the mergers and acquisitions market in Europe and Germany, which also impacted the private equity market. Amidst the high inflation rate, high energy prices in Germany, which have not been seen in years, and shifts in the global economy caused by the Ukraine conflict, as well as rising global tensions and unstable supply chain as a result of the COVID-19 lockdowns, the private equity market in Germany was actually surprisingly positive in its performance, with the exception of the large buyout market, where a significant decline is evident. It should be noted, however, that the activity in the small and medium-sized segment remained relatively stable and was only in the low double-digit percentage range below its peaks in 2020.

On a deeper level, some segments have suffered greatly from the above-mentioned trends, whereas others could maintain or even increase their numbers and volume of transactions. It is true that valuations declined in general along with the decline in the general stock markets, but since Germany has not been caught up in the special purpose acquisition company (SPAC) wave, valuations of potential targets have also been driven more by fundamentals such as business prospects and research activity of targets than by capital market trends.

Developing Trends in 2023

At a more granular level, what are these trends and developments likely to continue in 2023? These would include declining valuations and a shortage of capital in private equity and, in particular, the venture capital segment, as well as pressure on traditional German assets such as automotive or production due to supply chain issues. It may be common knowledge that energy prices are rising and the general industry trends are evolving, but others such as the increasing impact of regulatory conditions on deal execution are relatively unknown to the broader market.

Declining valuations and shortage of capital

In recent years, quite a number of German start-ups have been successful in achieving unicorn status and raising capital to internationalise their operations, particularly in the software, mobility and consumer sectors. On the back of that wave, the number of VC and growth funds that entered the German market tripled over the last five years, which fuelled further valuations. This trend has stopped and reversed. It has become increasingly difficult to raise funds in that segment, many start-ups have gone out of business or have reduced their operations, thereby negatively impacting the growth equity market as well. While there will always be exceptions, this trend will continue into 2023 and could result in a real market correction.

In line with this, a continuing decline in valuations in the overall private equity market will be seen, as increasing costs negatively impact the profitability of target assets, rising interest rates will make deal financing more expensive, and the overall uncertainty in the market will require a risk premium to be applied to business forecasts.

Niche segments will outperform the general market

As in every downturn, there have been segments that have not been negatively impacted by general trends and which will actually benefit from the overall uncertainty. As a result of ongoing mandates, there are not too many details that can be revealed, however, one can see a significant increase in infrastructure private equity, which will continue due to political decisions taken in Berlin and Brussels. Furthermore, the healthcare segment, with its subsegments and consolidation strategies, has been and will continue to be strong. There is, however, an increasing pushback from politics, government and courts against a further consolidation among doctors and hospitals, as we have observed in our practice in recent months. As such, each bidder is advised to carefully select its advisor in order to ensure that they are aware of these trends, which can vary greatly from one region to another.

Another segment that might still be small overall in total number of deals, but which will continue to grow (at a lower valuation level than one year ago) is the German "deep tech" space (for lack of a better term). It refers to the thousands of small and medium-sized, research-intensive, German companies, often founded only in recent years that focus on inventions in the medical, veterinary, production, energy, recycling, chemical or IT-related arenas. This might come as a surprise, as the overall concern of a "de-industrialisation" of Germany due to macro-economic trends and political decisions are not unfound. However, this research-intensive market segment has grown significantly over the years and is no longer only of interest to strategic buyers, but also to investors who are willing to finance operations prior to significant cash-flow generation from real products.

Convergence of venture capital with traditional private equity

In spite of the negative short-term outlook for capital and valuations, innovation and digitalisation will continue to have an increasingly significant impact throughout all segments of the economy described above, leading to a convergence between venture capital, growth capital and traditional private equity investment. Many established, large asset managers, who traditionally focused solely on large-scale buyouts, now have a fund dedicated to this segment. Meanwhile, successful venture capital funds have been able to raise such substantial amounts of capital that they resemble more and more traditional private equity growth funds, except for their focus on non-majority positions in their target companies (although the rights granted to them contractually often achieve the same). Also, in that context, one should note that consolidation strategies that were previously applied to "traditional" economies are now increasingly being employed in segments such as online market places or IT, and it is becoming evident that the boundaries between traditional fund segments is becoming increasingly flexible as time passes. This trend will continue.

Regulatory scrutiny and ESG

The regulatory environment becomes more and more deal critical and has developed from a niche item in the due diligence exercise ten years ago to a potential deal killer nowadays. The change in the political power in Germany due to last elections, and a continuing worldwide political tension, has accelerated this trend. A takeover of a German robotics company like Kuka by Chinese Midea six years ago would nowadays be blocked by political veto. The underlying concerns have now also expanded into sometimes more remote areas such as basic infrastructure, healthcare, technology or large-scale industry deals as such, and also apply to minority investments. Recently, the government opted to block the acquisition of a minority stake in the Hamburg port by a Chinese company, and politicians stated their opinion on how they would respond to the possibility of Mercedes-Benz being acquired. It is imperative that this trend is taken into account early in the transaction negotiation process and discussed with the political decision makers before transaction rumours make their way into the media.

More importantly, and often overlooked, is the impact that "know your customer" (KYC) requirements and health, safety and environmental regulations have on the deal market today. Over the past 24 months, a number of important EU regulations and German specificities have come into force and will continue to do so in the near future. However, not all operating businesses, let alone funds, are aware of the implications of the changes on their businesses and transactions. It might, for example, mean that during due diligence it turns out that the target asset does not fully comply with all (new) environmental or safety laws, which does not only result in potential losses to the underlying business, but could also pose a significant obstacle to private equity (existing or future) owners who take environmental, social, and governance (ESG) very seriously. ESG requires the adherence to health, safety and environmental guidelines.

Further, certain party transactions have become "undoable" due to new KYC regulations and every market player is well advised to lock into this aspect before significant resources are dedicated to a particular party. If in old times market players might have thought that things are "solvable" and hence can be neglected, they might now be surprised that either notary publics will refrain from notarising transactions if KYC checks have not been performed, or that banks simply keep funds in escrow until they have been able to determine the ultimate beneficial owner in a corporate structure. Furthermore, funds themselves, when fund raising, initiating capital calls, or paying purchase price to sellers, have their own responsibility to determine who their real counterparts are, and non-compliance with that obligation will result in severe fines and damage. There is no doubt that this led, and will continue to lead, to the exit of many potential LPs as investor in funds or of bidders as potential acquirers of assets.

These words suggest that compliance with ESG or EU taxonomy rules will become a crucial factor in the private equity industry, and greenwashing discussions concerning certain public funds will also affect private funds. Ideally, every fund should be prepared to investigate whether its actual activities align with its public announcements, let alone what is legally required.

More transaction and investor related disputes

Unstable times mean that buyers who thought to have struck a fair deal four months ago might want to get out of a deal before closing because the business outlook has worsened. It has already happened in 2008 and 2009, during the COVID-19 crisis, and has begun to occur now as well. Even if buyers do not wish to take such drastic measures, they are more carefully investigating whether claims may be made for indemnity or guarantee breaches. The expectation is that the number of such claims will increase in the next 12 to 18 months.

In addition to this "normal" development that occurs in every downturn, another development that is relatively new and results from the high valuation growth of start-ups in 2019–2021, namely, down rounds and the issues that accompany them. In a down round, capital is raised at a valuation lower than the valuation applied in the previous financing round, and because of the hype in the start-up space in the last 24 months, investors often forgot to demand traditional devices which would have protected them from the diluting impact such down rounds have on their existing ownership in a start-up, both from a legal and more importantly from an economic standpoint. When this is combined with the fact that fresh capital seeks to be prioritised in the capital structure, and the founders realising that their ownership stake may be of no value if all liquidation preferences of investors must be satisfied first, then there is a perfect storm of misaligned interests in such down round financings. If the expectations of declining valuations prove correct, more of these disputes will be seen in the next 12–18 months.

Carve-outs and pick-up of large-volume buyout deals

It may come as a surprise due to the existing slowdown in large buyouts and the macroeconomic and political circumstances described above, but predictions are for an increase in the deal flow of large buyouts in 2023 in a particular segment of that market, namely carve-outs from large industrial players. Increasing margin pressure and rising interest rates are causing headaches to many CEOs and CFOs of strategic players, who must adapt their businesses to new supply chain reality, energy efficiency targets and new industry innovations at the same time. Declining capital market valuations and intense debt financing restrictions will restrict the amount of capital available to them from traditional financing sources. This will result in an increasing level of carve-outs by these players to large buyout funds, who have a large amount of unallocated capital and remember how they have acquired these assets that later generated the highest returns to them during times such as these.

Therefore, a number of larger carve-outs could be seen in the next 12–18 months.

PIPE transactions and taking privates

As a result of decreasing valuations in public equities, a substantial increase in minority investments by private equity into publicly listed companies (PIPEs), or even the taking private of listed companies by private equity funds with knowledge in that area, is on the cards. This is an area which has been traditionally en voque when valuations on listed markets decline and this firm has already advised on the first of these types of transaction in 2002. In recent months an increasing number of these transactions has been apparent. The legal framework upon which these transactions occur is much different from that of a traditional buyout or private financing round and the selection of an experienced advisor becomes even more relevant, as violations of applicable laws could result in substantial fines and even loss of voting rights. But there is a strong interest for listed companies to entertain discussions with interested investors to strengthen their capital base, which will grow even further when the financial results of listed companies come under pressure and debt financing sources become even more restrictive.

King & Spalding is an international law firm with more than 130 years of service that represents a broad array of clients, including half of the Fortune Global 100, with 1,200 lawyers across 23 offices in the USA, Europe, the Middle East and Asia. Located in key financial and commercial centres around the globe, King & Spalding's Private Equity team helps clients execute the investment, M&A and financing transactions that are integral to private equity investment and exit strategies. The firm's Private Equity practice is well-versed in fund formation, mergers and acquisitions, acquisition finance, compliance issues, securities offerings, tax, and other related issues and offers deep experience in industry sectors such as energy, healthcare, life sciences, real estate and technology.

Authors

Peter Memminger is partner in King & Spalding's Frankfurt office and heads its M&A/Private Equity practice in Germany. He focuses on M&A, corporate, and litigation work on behalf of private equity funds, family offices and large corporates across various industries. Peter Memminger helps clients with a broad range of domestic and cross-border transactions including (public) M&A, restructuring, insolvency and ESG matters. He also has extensive experience with representing clients in litigation matters arising out of his corporate work and, on behalf of clients, has handled some of the largest corporate disputes in Germany to date.

Stephan Boerner is a counsel in King & Spalding's Frankfurt office and member of the firm's M&A/Private Equity practice. He focuses on M&A, corporate, and litigation work on behalf of private equity funds, family offices and large corporates. Stephan Boerner helps clients with a broad range of domestic and global transactions and represents them in related corporate litigation. His practice also focuses on data privacy and compliance issues.

Jonas Schwarz is a counsel in King & Spalding's Frankfurt office and member of the firm's Private Equity practice. His practice focuses on M&A and complex and high-profile domestic and cross-border restructuring and insolvency matters and other situations involving financially distressed businesses. Jonas Schwarz has extensive experience in advising debtor companies/managers, creditors, shareholders and investors on a broad range of crisis and insolvency matters as well as on financial restructurings – both within and outside of insolvency proceedings.

King & Spalding

TaunusTurm
Taunustor 1
60311
Frankfurt am Main
Germany

Tel: +49 69 257 811 000
Email: pmemminger@kslaw.com
Web: www.kslaw.com

CHAMBERS GLOBAL PRACTICE GUIDES

Chambers Global Practice Guides bring you up-to-date, expert legal commentary on the main practice areas from around the globe. Focusing on the practical legal issues affecting businesses, the guides enable readers to compare legislation and procedure and read trend forecasts from legal experts from across key jurisdictions.

To find out more information about how we select contributors, email Katie.Burrington@chambers.com