

Weekly Report

Fear of financial investors unjustified

In the midst of the international financial crisis, the German federal government passed the Risk Limitation Act in autumn 2007. In spring 2008 the Bundestag has finally decided on the law. The domestic private equity/buyout providers, which have not previously been subject to banking supervision, are among the main addressees of the act. Among others, "objectionable macroeconomic activities of financial investors" are to be hindered or prevented, without simultaneously "impairing efficient financial and corporate transactions". In short, the regulation of activities is intended to have a stabilizing effect in the midst of turbulent times.

Private equity funds can particularly be regarded as a supplement to the traditional instruments of corporate financing. In a study recently presented by DIW Berlin, it was determined that private equity funds generally do not swarm in on German companies "like locusts". Their macroeconomic significance has so far tended to be minor. An expansion of commitment by private equity funds would be welcomed. Particularly SMEs can profit from it.

Private equity funds and hedge funds are frequently grouped under the umbrella term of "financial investors" in this country, also in the Risk Limitation Act. For both types of funds, intensive monitoring is envisaged, equally by the Deutsche Bundesbank and the Federal Financial Supervisory Authority (BaFin).

Private equity investors are primarily active on the market for debt-financed corporate acquisitions (leverage buy-outs).¹ The necessary equity capital for these acquisitions is provided by the buy-out funds and—to a lesser extent—also the future management of the acquired companies.² The debt capital generally comes from a syndicate comprised of banks and increasingly also institutional investors. After conclusion of the acquisition, the different risk-bearing loan tranches are passed on to the participating investors and, in some cases, also to the market.³ The share of debt capital in the total acquisition price generally fluctuates between 60% and

¹ The focus of a study by DIW Berlin is on first-round buy-outs, cf. Schäfer, D., Fisher, A.: Die Bedeutung von Buy-Outs/Ins für unternehmerische Effizienz, Effektivität und Corporate Governance. DIW Berlin: Politikberatung kompakt 38, 2008, www.diw.de/documents/publikationen/73/78948/diwkompakt_2008-038.pdf.

² European Commission: Report of the Alternative Investment Expert Group—Developing European Private Equity. 2006.

³ European Central Bank: Large Banks and Private Equity-Sponsored Leveraged Buyouts in the EU. 2007, www.ecb.int/pub/pdf/other/largebanksandprivateequity200704en.pdf.

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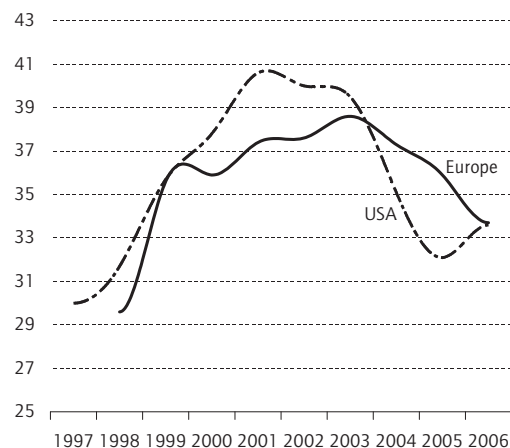
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Corporate finance

Figure 1

Average equity capital ratio of mainly debt-capital-financed corporate acquisitions

In percent



Source: Axelson, U., Jenkinson, T., Strömberg, P., Weisbach, M. S.: Leverage and Pricing in Buy-Outs: An Empirical Analysis. University of Illinois, 2007. **DIW Berlin 2008**

80% (Figure 1).⁴ The aim of the fund is to generate a high return. The investment horizon is usually limited to several years.

In contrast to buy-out funds, hedge funds are generally aimed at the utilization of volatilities in mature debt capital and equity capital markets. One of the better-known varieties amongst the extensive range of hedge fund strategies is to search out undervalued equity capital.⁵ In order to immediately be able to take advantage of price changes, the investment horizon of hedge funds is usually for a shorter term than for buy-out funds. Furthermore, in contrast to buy-out funds, hedge funds mainly appear as “shareholder activists”, when the price of the target company can be changed to the profit-making direction in the short term. Hedge funds also incur debt at the fund level while, for buy-out funds, the debt is occurred at the level of the target company, and loans are secured directly with the available assets.

In 2005, the total funding originating from Germany for buy-out funds amounted to 4.5 billion euro. On an international scale, this sum is low.

In spite of this, only two-thirds (2.9 billion euro) were also managed in Germany. In contrast, British

⁴ However, historical buy-outs in the USA were also carried out at the end of the 1980s with debt capital portions of more than 90%.

⁵ Schäfer, D.: Hedge-Fonds—Eine gute Anlageform? Weekly Report of DIW Berlin No. 32/2004.

managers manage more than double the funds on the British Isles, at 45.6 billion euro (Figure 2). A similar picture emerges in 2006. Germany is therefore an exporter and Great Britain is an importer of buy-out funds.

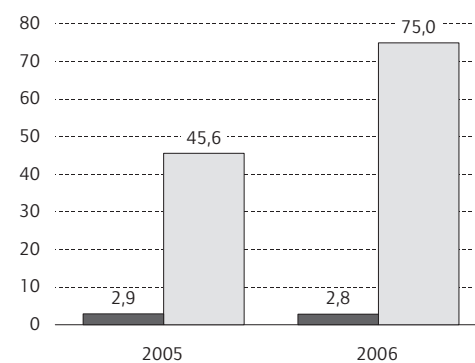
It is not very likely that the reason for this net out-flow of funds is a lack of worthwhile investment opportunities in Germany. This conclusion is, at least, apparent from a simultaneous glance at the investments (Figure 3). Only 50% of the total funds invested (7.2 billion euro in 2006) by buy-out funds in Germany came from domestic buy-out funds. The total investments in Great Britain amounted to 25.5 billion euro (2006), resp. 11.9 billion euro (2005). However, in 2005 and 2006, British fund managers invested a total of 23.8 billion euro (200% of the total investments in Britain), resp. 40.9 billion euro (174% of the total investments in Great Britain).

Figure 2

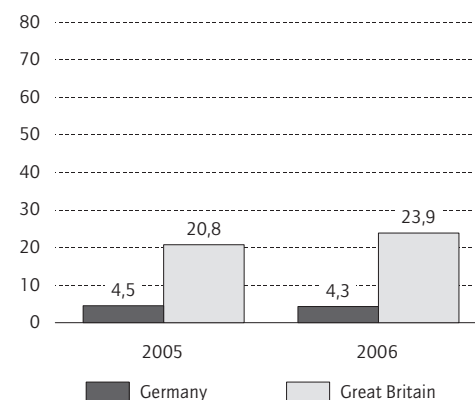
Funds raised for buy-out funds in Germany and Great Britain

In Euro billions

According to domicile of management



According to origin of funds



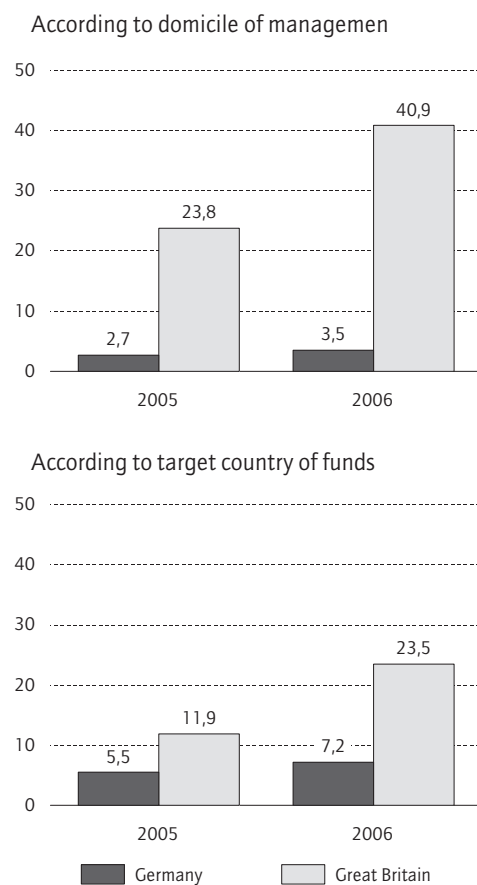
Source: EVCA Barometer.

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Figure 3

Invested funds from buy-out funds in Germany and Great Britain

In Euro billions



Source: EVCA Barometer.

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While Germany is obviously primarily interesting as an investment country, Great Britain appears to be particularly attractive as a financial centre.

Buy-Outs in Germany are increasing

Within a few years, buy-outs have risen to become the most important segment in the private equity sector in Germany and Europe. In 2006, 75% of private equity fundraising and 70.7% of investments were attributed to the buy-out sector.⁶

According to information from the Centre for Management Buy-Out Research (CMBOR), in 2006, financial investors acquired companies at a value of 21.6 billion euro.⁷ The transaction volume grew by around two-thirds, compared with 2005. The

previous highest number of 155 transactions was achieved in 2006; this means an increase of 25%. A good fifth of the continental European buy-outs were realized in Germany in 2006. The number of buy-outs was significantly higher in Great Britain during the same year, at a total of 676; this was nearly the same amount as for the rest of Europe.

This market is still underdeveloped in Germany, measured on the basis of economic power. If the buy-out volume of Great Britain and Germany (Figure 4) is compared, it becomes clear that the German market is lagging behind.

Inflows of equity capital and debt capital from buy-outs

With equity capital, companies not only “insure” themselves against liquidity and income risks. This financing mode is also a “door-opener” for debt capital, in times of internal ratings for companies by commercial banks (Basel II). In Germany, equity capital is scarcer than in other countries. Market capitalization lies behind Great Britain, the USA and even behind France (Figure 5). Among other things, the German financial system is also described as being particularly bank-centered for this reason. With low significance of market equity capital, off-market investment financing is becoming all the more important; a possibly existing equity capital gap could be closed with this. Private equity funds are one of the few available sources for off-market equity capital.

The ability of private equity funds to activate a great deal of debt capital for the acquisition of a target company, in addition to equity capital, has had a strong influence on promoting the negative image of financial investors among the German public. However, the inherent idea of equity capital as a “good” and debt capital as a “bad” form of financing is not justified from the financial point of view. If the debt capital interest rate is below the expected total return, a higher debt ratio causes the equity ratio to rise. For tax reasons, it is also attractive to work with a high portion of debt capital. For this reason, the equity ratios are also low with German sole proprietorships and private companies, and these ratios only provide a limited indication of assets and available reserves (additional contributions) for eliminating a debt crisis.⁸

Not least, debt capital plays a significant part in corporate management. Jensen describes high debt

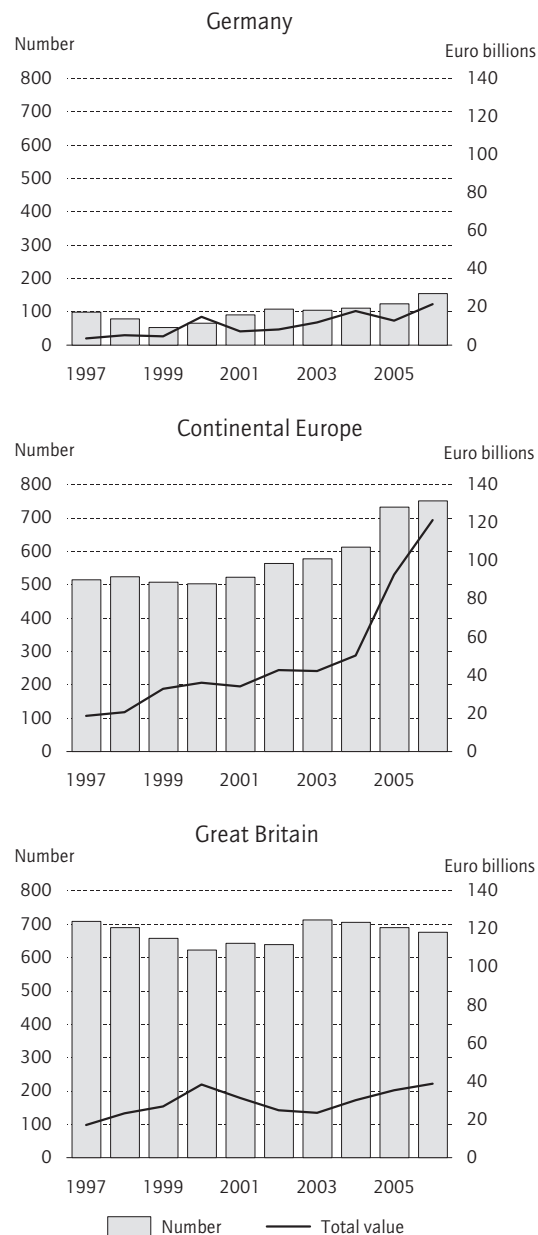
⁶ European Private Equity & Venture Capital Association (EVCA): Jahrbücher.

⁷ CMBOR: European Management Buy-outs Jan-Dec 2006.

⁸ Deutsche Bundesbank: Monthly Report December 2006—Zur wirtschaftlichen Situation kleiner und mittlerer Unternehmen in Deutschland seit 1997. Frankfurt 2006.

Figure 4

Number and total value of companies acquired in Germany by buy-out funds



Source: CMBOR.

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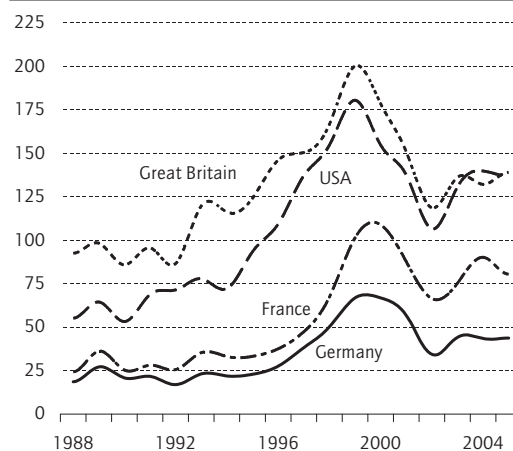
as a “carrot and stick” strategy. It also permits the concentration of property and therefore a comparably high participation by management. The latter guarantees high performance incentives (“carrots”). At the same time, the high debt and the inherent threat of rapidly losing your own position through insolvency, with poor performance, is like a hard sanction mechanism (“stick”).⁹

⁹ Jensen, M. C.: Agency Cost Of Free Cash Flow, Corporate Finance, and Takeovers. American Economic Review 76, 1986, 323–29.

Figure 5

Market capitalization¹ in selected countries

Share of gross domestic product in percent

¹ Aggregated market value of listed companies.

Source: World Development Indicators.

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On the debit side of high debt is primarily the risk of insolvency. However, the willingness of private equity funds is presumably high for preventing pure liquidity-related insolvencies of buy-outs by providing additional equity capital. On the one hand, in the case of insolvency, own return on investment is wasted. On the other hand, private equity companies rely on establishing their reputation as buyers of companies and reliable contractual partners of the banks.

However, it has to be noted that corporate insolvencies are a normal part of business activity and therefore also a normal part of the buy-out market. Indications of “excessive” insolvency risk of buy-outs are not identifiable so far, despite several bad investments (e.g. Bundesdruckerei), which have been publicised.

Reasons for the creation of a buy-out market

The reasons for the creation of buy-out markets extend from increased options for eliminating so-called family “cluster risks” through improved corporate governance, as well as realization of specialization advantages (das Wort simpler wurde entfernt), to the point of reducing financing limitations.

Family “cluster risks”

For various reasons, family-owned companies in particular do not have the option available to them

of spreading assets. External financing limitations and stock market access, which is frequently not available to small and medium-sized companies, force entrepreneur families not only to concentrate on their personal manpower, but also on personal assets in their own company. A well-functioning buy-out market opens up opportunities for family-owned companies to bring their risk preferences and their financial investment into harmony and eliminate the family cluster risk through a partial or complete sale.

The number of sales of family-owned and other private sole proprietorships, as a proportion of buy-out funds in 2006 and their high market share, show that demand apparently exists for this financing instrument in Germany (table). This is indicated by the fact that, according to the CMBOR, the typical SMW sales below 10 million euro have also reached a new record level, with 87 buy-outs.

Improved corporate governance

Buy-outs play a different role when listed companies are involved, with shares that are widely spread. The anonymity of listed equity capital weakens the incentive to control management, as only the active investor bears the costs of control, but earnings benefit everyone. Therefore, the management can also pursue personal goals, such as aiming for power, income and prestige, to the detriment of the shareholders. Against this background, the US economist, Michael Jensen, interprets the buy-out transactions, aimed at owner concentration and direct investment by management, as an instrument for reinstating the unity of ownership and control.¹⁰

Advantages of specialization

In addition to a lack of incentive for control, the efficiency brakes in a large company frequently also include the coexistence of several subsidiaries. If lack of synergy effects and strong competition force management to return to the core business, “remote group units” are cut off from internal capital market and company resources. This results in an incentive for parent and subsidiary companies to initiate a buy-out and realize specialization advantages.¹¹

¹⁰ Jensen, M. C.: Eclipse of the Public Corporation. Harvard Business Review, 1989, revised 1997; Jensen, M. C.: The Modern Industrial Revolution: Exit and the Failure of Internal Control Systems. Journal of Finance 48, 1993, 831–80.

¹¹ Working Group “Financing” of the Schmalenbach-Gesellschaft für Betriebswirtschaft e.V.: Eine empirische Untersuchung zur Veräußerung von Konzernteilen an Private-Equity-Investoren. Zeitschrift für betriebswirtschaftliche Forschung 58, 2006, 235–264.

Table

Buy-Outs/Buy-Ins in Germany, according to origin

Sale by ...	2002	2003	2004	2005	2006
Number					
Family-owned or private company	19	9	14	27	38
Foreign parent company	18	16	17	24	17
Domestic parent company	47	42	49	48	53
Privatization	0	0	0	0	1
Reorganization/insolvency	15	12	5	5	3
Buy-out fund ¹	2	14	18	12	31
Others	1	3	1	3	1
Unknown	6	9	7	5	11
Total	108	105	111	124	155
Shares in percent					
Family-owned or private companies	17.6	8.6	12.6	21.8	24.5
Foreign parent company	16.7	15.2	15.3	19.4	11.0
Domestic parent company	43.5	40.0	44.1	38.7	34.2
Privatization	0.0	0.0	0.0	0.0	0.6
Reorganization/insolvency	13.9	11.4	4.5	4.0	1.9
Buy-out fund ¹	1.9	13.3	16.2	9.7	20.0
Others	0.9	2.9	0.9	2.4	0.6
Unknown	5.6	8.6	6.3	4.0	7.1

¹ Onward sale of a previous buy-out to a buy-out fund

Quellen: CMBOR/Barclays Private Equity/Deloitte.

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Reduction of financing limitations

Asymmetric information between entrepreneurs and capital investors and behavior risks limit the financing opportunities for companies. This can result in rationing by lenders—or as regards listing in an illiquid stock market segment—by the capital market.¹² Companies that are owned privately and by families are regarded as being particularly intransparent for a potential lender or shareholder and therefore tend to be limited in terms of financing. Buy-out funds can alleviate this. Off-market equity capital is suitable for strengthening the companies’ assets.

Furthermore, due to close links with the credit industry, buy-out specialists are often in a position of being able to activate additional debt capital.¹³

Effects of buy-outs—Experiences in the USA

The available findings on leveraged buy-outs (LBO) are mainly based on US data and, therefore, on the historical precursors to the most recent wave of LBOs. In the USA, between 1981 and 1989, buy-out companies purchased more than 2540 listed companies, with a market value of 297 billion US dollars. LBOs represented 7.5% of all takeovers and 17% of the transaction volume, in terms of value. In

¹² Stiglitz, J. E., Weiss, A.: Credit Rationing in Markets with Imperfect Information. American Economic Review 71, 1981, 393–410.

¹³ European Central Bank: Large Banks ..., a. a. O.

the peak year of 1988, 410 LBOs were carried out at a total value of 18 billion US dollars.

In connection with these acquisitions, the findings range from above-average price gains for the existing shareholders of around 42% after takeover offers by buy-out companies to a 30% increase in the return on sales to a productivity increase for buy-out companies lying above the corresponding industry average.¹⁴ With LBOs carried out in the late 1980s, above-average financial crises frequently occurred later. However, the consequences of these insolvencies for the owners were contained, so that a debate took place in economic research regarding so-called “strategic insolvencies”.¹⁵

Efficiency gains compared with pure asset shifting

The LBOs of the 1980s were also controversial in the USA. The greatest resistance to mainly debt-financed corporate acquisitions came from the managers of large companies, the unions and from politics.¹⁶ As proponents of restrictive regulation of LBOs, they assess the asset gains of the owners as “too expensively purchased”, with the losses of other actors who are associated with the company. Central points of controversy were effects on employment and wage level, losses for the previous creditors and potential tax losses for the treasury.

The theory of “too expensively purchased” asset gains in case of the owners was not able to be empirically confirmed. If the reduction of jobs could be proven in the studies, this tended to relate to oversized administrative areas, but not production areas. If debt capital devaluation took place, this remained limited to previous owners, without protective clauses, in the loan agreements.¹⁷ A portion of the LBO-induced value gains were, in fact, able to be attributed to tax savings.¹⁸ However, overall, a positive tax effect was assumed—among other

¹⁴ Kaplan, S.: The Effects of Management Buyouts on Operating Performance and Value. *Journal of Financial Economics* 24, 1989, 217–254; Smart, S. B., Waldfogel, J.: Measuring the Effect of Restructuring on Corporate Performance: The Case of Management Buyouts. *The Review of Economics and Statistics* 76, 1994, 503–511; Lichtenberg, F. R., Siegel, D. S.: The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior. *Journal of Financial Economics* 27, 1990, 165–194.

¹⁵ Cf. Schäfer, D.: Restructuring Know-How and Collateral. *Kredit und Kapital* 35, 2002, 572–594.

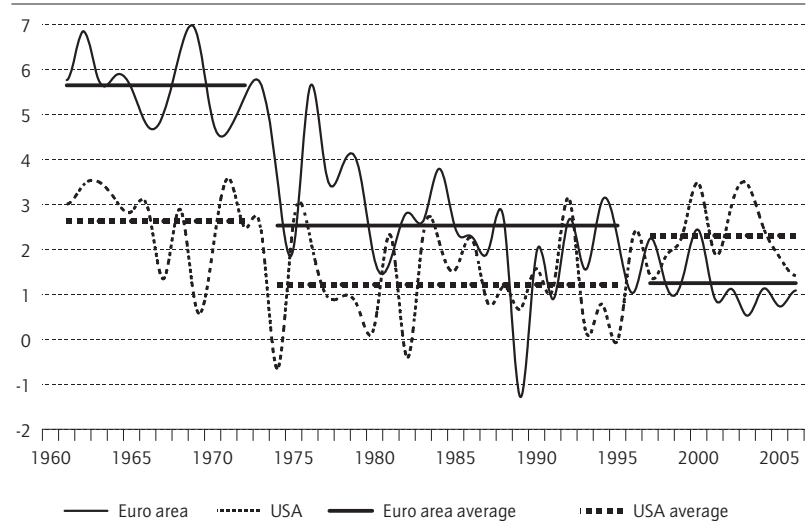
¹⁶ Jensen, M. C.: Corporate Control and the Politics of Finance. *Journal of Applied Corporate Finance* 4, 1991, 13–33.

¹⁷ Asquith, P., Wizman, T.: Event Risk, Wealth Redistribution, and its Return to Existing Bondholders in Corporate Buyouts. *Journal of Financial Economics*, 1990, 195–213; Palepu, K. G.: Consequences of Leveraged Buyouts. *Journal of Financial Economics* 27, 1990, 247–262.

¹⁸ Kaplan, S.: Management Buyouts: Evidence on Taxes as a Source of Value. *The Journal of Finance* 44, No. 3, Papers and Proceedings of the Forty-Eighth Annual Meeting of the American Finance Association, New York, 1989, 611–632.

Figure 6

Productivity growth in the USA and in the euro area In percent



Euro area average 1961–1973, 1974–1995 and 1996–2006.

Source: Groningen Growth and Development Centre and the Conference Board, Total Economy Database, January 2007, www.ggd.net. DIW Berlin 2008

things, due to additional capital gains taxes with the previous shareholders and taxes on extra interest income with regard to the lenders.¹⁹

At the beginning of the 1990s, it already became clear that important macroeconomic indicators in the US economy, such as labour costs, capital employment, wage development, the unemployment rate and expenditures on research and development had developed positively in the 1980s. A comparison of the development of work productivity in the USA and in the euro area supports the theory that no negative economic effects have resulted from the restructuring wave of the 1980s, which wereas mainly supported by LBOs (Figure 6).²⁰ In contrast, in the euro area, where such restructuring has not yet taken place, a comparable effect cannot be recognized.

More recent findings

When drawing upon the more recent findings, these confirm a positive effect of LBO activity on the share price and the productivity of the affected companies.²¹ In contrast, signs of effects on employment

¹⁹ Jensen, M. C., Kaplan S., Stiglin, L.: Effects of LBOs on Tax Revenues of the US Treasury. *Tax Notes* 42, 1989, 727–33.

²⁰ Wiersema, M. F., Porter-Liebeskind, J.: The Effects of Leveraged Buyouts on Corporate Growth and Diversification in Large Firms. *Strategic Management Journal* 16, 1995, 447–460.

²¹ Harris, R., Siegel, D. S., Wright, M.: Assessing the Impact of Manage-

development in connection with LBOs are rare. However, in a British-Dutch comparative study regarding the effects of LBOs on the employees, positive effects were found in both countries on advanced training, participation of the employees in business activities, employment and wage levels and on employee participation.²²

Conclusion

Buy-outs by financial investors have become the most important segment of the private equity sector in Germany in recent years. Two drivers are assumed for these trends, with respect to supply and demand: On the one hand, efficiency advantages result from the restructuring of affected companies, on the other hand, demand for innovative financial instruments can be assumed. Both aspects have a positive effect on the “coming together” of company buyers and sellers. These statements are compatible with the majority of the findings of relevant empirical economic research.

Without bank loans and liquid bond markets, buy-outs are not conceivable. The current liquidity crisis in the banking sector and the quasi collapse of the market for credit sales therefore also leave traces in the private equity sector and tend to have a restrictive effect. Clear legal regulations that do not impair the market are all the more important.

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²² Bruining, H., Boselie, P., Wright, M., Bacon, N.: The Impact of Business Ownership Change on Employee Relations: Buy-outs in the UK and the Netherlands. *ERIM Report Series Research in Management*, 2004.