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SIGNIFICANCE OF PRIVATE EQUITY INVESTMENTS, ESPECIALLY FOR SMEs- BLESSING OR CURSE?

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Prof. Dr. Markus Peskes, Fabian Tang Zheng¹

Abstract

Although fallen into disrepute Corporate financing in the form of private equity has developed into a billion-dollar industry. Private equity arose from the need for alternative financing options and has had a long lasting impact on the economy and society. Companies of this sector, which is often described as non-transparent, regularly make headlines because of leveraged buy-outs (LBOs).

This multifaceted industry provides various forms of equity capital outside regulated capital markets and should be viewed in a more differentiated manner, especially considering its growing significance for SMEs. The peculiarities of private equity extend beyond just conceptual delineation and its structures, reaching into the methods aimed at achieving excess returns over the public market.

This excess return is offset by a range of value enhancement methods and private equity undoubtedly can exert significant influence on companies. Therefore, a holistic view of this industry seems warranted.

Accordingly, this research paper examines private equity investments focusing on the mid-market in terms of their sustainable value contributions for investors and companies. It explores whether private equity is more of a blessing or a curse especially for SMEs.

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1. Initial situation

The omnipresent problem of succession means that shareholders want to sell their company due to a lack of a successor within the family, but often cannot find a suitable buyer. There can be various reasons for this. Starting with the fact that the market is too small to find suitable strategic investors, other investors have too little capital for a takeover or are even afraid of exploiting information relevant to competition. Regulatory changes and capital regulations according to Basel I-IV also restrict the possibility of borrowing, which is why private equity financing is becoming increasingly popular in the mid-market.² While private equity companies initially concentrated on large transactions with a transaction volume of several hundred million euros, SMEs have now also become an extremely attractive field of investment.³

This is also reflected in the development of private equity investment sums. According to the Federal Association of German Corporations, private equity investments (LBOs) in Germany in 2022 were almost three times as high as in 2015.⁴ However, this trend has been declining since the second half of 2022 according to the Private Equity Trend Report 2024 of PwC.⁵ Against this backdrop, the following section will examine the extent to which private equity transactions can achieve actual added value for investors in terms of their returns and for companies in terms of their sustainable, ongoing profitability. The focus here is on companies in the mid-market, as these account for a significant proportion of all companies and employees in Germany and represent an extremely attractive investment object for private equity investors in terms of value levers.⁶

This research paper starts with the causes of the rise of the private equity sector. The challenges of corporate financing are then explained and a conceptual distinction is made between private equity in the broader and narrower sense. For a better understanding of the attractiveness of the private equity sector, the structures of such funds and their return potential compared to the stock market are shown, as well as the value drivers for investors and companies. These mainly include leveraged buy-out, management incentivization, operational engineering, network and know-how transfer, buy & build strategy, multiple arbitrages and finally ESG criteria. The case of Grohe AG serves as a practical case. Finally, the development of portfolio companies in the hands of private equity companies is examined holistically on the basis of various studies and an outlook on the future development of the private equity sector is given in the conclusion.

² See Thum, Timmreck, Keul (2008), Prologue

³ See Böhm (2020), p. 229

⁴ See BVK (ed.) (2024): The BVK has published its annual statistics for 2023, URL: <https://www.cfh.de/bvk-jahresstatistik-2023-zum-deutschen-beteiligungsmarkt/>

⁵ See PwC Germany (2024) Private Equity Trend Report 2024, URL: <https://www.pwc.de/de/private-equity/private-equity-trend-report.html>

⁶ See IfM-Bonn (ed.) (n.d.): Mittelstand im Einzelnen, URL: <https://www.ifm-bonn.org/statistiken/mittelstand-im-einzelnen>

2. Rise of private equity financing

2.1 The challenge of corporate financing

3.35 million companies or 99.3% of all businesses in Germany, according to the German Institute for SME Research, are SMEs and nearly 54.4% of all employees in Germany work in SMEs, and 70.6% of all apprentices are trained in SMEs.^{7,8}

In addition to these quantitative factors, it also makes sense to include qualitative distinguishing features in the categorization of SMEs. SMEs are primarily characterized by the unity of ownership and performance. The company is generally owned by two natural persons or their family members who own at least 50% of the company shares.⁹

The mid-market faces a wide variety of challenges when it comes to raising capital. These can be categorized into company-related and market-related problem areas. The market-related challenge lies in information asymmetry. Decision-relevant information is much more difficult to obtain than in larger companies. In the context of corporate management, detailed financial capital, financial and liquidity planning is also often dispensed with. Another challenge in raising capital is that these companies are often specialized and less diversified in terms of business areas, customer and supplier relationships. Other reasons may include a lack of understanding of business management and a "master of the house" mentality.¹⁰

These more difficult financing conditions lead to higher risks on the part of lenders, which - as an expression of the default risk - results in higher interest rates for debt financing. This jeopardizes the already difficult financial planning of SMEs, particularly with regard to traditional bank financing. However, regulatory provisions such as Basel I-IV also ensure that banks have become and must be more cautious in their lending. The mandatory deposit of liable equity capital of 8% in relation to the total loan amount of the banks, stricter credit checks and expanded internal audit systems are intended to promote bank stabilization through these prescribed regulations.^{11,12}

Micro-enterprises and innovative companies as well as start-ups in particular face particular challenges when it comes to raising capital in the form of external financing, as demonstrated by an empirical analysis by the Institute for SME Research.¹³ This is due to the aforementioned causes, such as company size and the resulting lack of

⁷ See E.g. IfM-Bonn (ed.) (n.d.): Mittelstand im Einzelnen, URL: <https://www.ifm-bonn.org/statistiken/mittelstand-im-einzelnen>;

⁸ See Peskes, Steinmetz (2021): Strategic instruments of value-oriented corporate management for SMEs in the Future – Implications of the Covid-19 pandemic, URL: <https://www.econstor.eu/handle/10419/238746>

⁹ See May-Strobl; Welter (2016), p. 3

¹⁰ See Becker, Schulte-Krumpen, Graneß (2011), p. 23 ff.

¹¹ See e.g. Federal Ministry of Finance (ed.) (n.d.): Basel II & III, URL: https://www.bundesfinanzministerium.de/Content/DE/Glossary/entries/B/001_Basel_II.html?view=renderHelp

¹² Koch, Stefan; Schneider, Roland; Schneider, Sebastian; Schröck Gerhard (2017): Bringing Basel IV into focus, URL: <https://www.mckinsey.com/capabilities/risk-and-resilience/our-insights/bringing-basel-iv-into-focus>

¹³ See IfM-Bonn (ed.), Butkowski, Hoffmann, Nielen, Schröder (2019), p. 34 ff.

diversification, immature organizational professionalism and planning uncertainty, which results in high interest costs. In principle, a high level of debt results in high direct costs in the form of interest and repayment. Equity capital, on the other hand, provides support in the event of temporary liquidity bottlenecks, strengthens creditworthiness and reduces the risk of insolvency.¹⁴ The benefits of financing with equity or debt capital must therefore be weighed up properly.

2.2 Definition, types and differentiation of private equity

Private Equity

Private equity in the broader sense stands for pre-IPO private equity capital, which is collected in a pot to acquire stakes in companies. The investors are often institutional investors such as pension funds, insurance companies, banks and sovereign wealth funds.¹⁵ In this respect, private equity in the broadest sense is a generic term for corporate financing for private and therefore unlisted companies. The counterpart to this is the public market, such as the stock exchange. A distinction is made here between the sub-categories of the private equity forms venture capital and private equity, which is explained in more detail below.¹⁶

Based on the consolidation of various definitions, Becker, Schulte-Krumpen and Graneß describe private equity in the broad sense as follows

- "Provision of equity [...] for the financing of non-issuable or listed companies for a limited period [...]"
- Possibility of exerting influence through information, control and co-decision rights as well as active entrepreneurial supervision and support [...]"
- With the aim of increasing the value of the company [...]"¹⁷

Private equity¹⁸ in the narrow sense is characterized by the fact that the aim is to exert entrepreneurial influence on the investee company. In order to achieve this, the level of participation is often over 40% and individual investments - depending on the size of the fund - exceed €100 million. This acquisition investment comprises equity and debt capital, known in the industry jargon as a leveraged buy-out (LBO). The time frame for private equity investments is limited, as the duration of the private equity fund is generally limited to 4 to 7 years. During this period, the investment must be liquidated again in order to service the investors. The aim of the investment is to exercise active control through

¹⁴ See Ifo Institute (ed.), Peichl, Sauer, Lautenbacher, Rumscheidt (2021), p. 1

¹⁵ See Hofmann (2018), "Die guten Heuschrecken", in: Süddeutsche Zeitung, URL: <https://www.sueddeutsche.de/wirtschaft/finanzinvestoren-die-guten-heuschrecken-1.4237136>

¹⁶ See Thum, Timmreck, Keul (2008), p. 11

¹⁷ See Becker, Schulte-Krumpen, Graneß (2011), p. 34 ff.

¹⁸ In the following, private equity is generally used in the narrow sense.

securitized voting rights in order to increase operating profitability and achieve a corresponding return when the investment is liquidated.¹⁹ Various levers are used for this purpose, which are explained in more detail in the third chapter.

Venture Capital

Venture capital bears the distinction to private equity in its name. As a sub-sector of private equity in the broader sense, venture capital focuses on riskier early-stage financing. Venture capital funds therefore finance the business idea, start-up, market entry and expansion phases. In contrast to private equity funds, which mainly invest in established companies, venture capital funds tend to focus on young and innovative companies with extraordinary growth potential. However, small companies or newly established start-ups have a very high risk of failure. Private equity therefore tends to describe investments in later-stage companies and venture capital in early-stage companies.²⁰

Schefczyk describes further characteristics of venture capital funds.²¹ In contrast to private equity, these funds strive for a minority shareholding in order to maintain autonomy and the entrepreneurial spirit. The investment period is 5 to 10 years, as many of these companies are not expected to generate either a positive cash flow or a positive business result in the first few years. Nevertheless, the venture capital fund is given co-determination and control rights so that it can contribute its expertise and exert a positive influence on the company.²²

One example of these commitments is the Berlin-based venture capital company (VC) Earlybird, which invested 150 million USD in the German air-taxi start-up Lilium together with other investors in July 2023.²³

¹⁹ See Thum, Timmreck, Keul (2008), p. 13 ff.

²⁰ See Gündel, Katzorke (2007), p. 29

²¹ See Schefczyk (2006), p. 10

²² See also Gulliver, John; Jiang, Wie (2020): The Impact of Private Equity Buyouts on Productivity and Jobs. Committee on Capital Markets Regulation, 2020, Available at SSRN: <https://ssrn.com/abstract=3672264>; Verbouw, Jeroen; Meuleman, Miguel; Manigart, Sophie (2021): The Real Effects of Private Equity Buyouts: A Meta-Analysis, in: Proceedings, in: Academy of Management Annual Meeting. 2021, p. 2 ff.

²³ See Globenewswire (2024): Lilium Announces Planned Participation in Upcoming First Quarter 2024 Investor Events, URL: <https://www.wallstreet-online.de/nachricht/17695857-lilium-announces-planned-participation-upcoming-first-quarter-2024-investor-events>; o.V. (2023): Lilium raises 150 million - Alpine White gets 3.75 million - Floy receives 3.4 million, URL: <https://www.deutsche-startups.de/2023/07/14/dealmonitor-lilium>

In summary, the two forms of financing are compared below:

	Private equity in the narrow sense	Venture Capital
Targeted companies	Established companies with stable cash flows, mature products and growth potential	Young, innovative and fast-growing companies (start-ups)
Management support from investors	High, but dependent on the size of the company	Very high
Duration of shareholder-participation	3 to 7 years	5 to 10 years
Type of participation	Majority shareholding	Minority shareholding
Risk	Manageable	High
Phase of the Company	Maturity phase	Early phase
Motives for financing	Expansion, buy-outs, spin-offs...	First Stage, Series A, Series B, Seed...
Goal	Financing with assumption of control, but dependent on the size of the company in order to implement operational improvements	Financing without assumption of control to ensure autonomy

Figure 1: Distinction between private equity in the narrow sense and venture capital²⁴

Family Offices

In addition to traditional private equity funds, there are also so-called family offices. These differ from traditional private equity funds in terms of their structure and investor universe. Family offices manage the assets of one or more entrepreneurial families and have an average holding period of 19 years. The long-term holding period - often spanning generations - means that family offices have a different approach to managing and investing in their portfolio companies. In addition to return targets, qualitative objectives such as the reputation of the entrepreneurial family and the preservation of jobs often play a role here.²⁵

Another distinguishing feature from private equity is the will to actively shape the company. Entrepreneurial families want to combine their strengths with the financial goals of the company. The aim is to combine the investment opportunities and benefits of private equity, which is why it is also referred to as "impact investing". This means that they also invest in blockchain or the ecological timber industry, for example, in order to have a positive influence on future trends.²⁶

²⁴ See Thum, Timmreck, Keul (2008), p. 16

²⁵ See Hofmann (2018), Die guten Heuschrecken, in: Süddeutsche Zeitung, URL: <https://www.sueddeutsche.de/wirtschaft/finanzinvestoren-die-guten-heuschrecken-1.4237136>

²⁶ See PwC (ed.) (2018): European Private Business Survey 2018, URL: <https://www.pwc.de/de/mittelstand.html>

Hedgefonds

Finally, there are hedge funds, which are investment vehicles that use various strategies to invest in a wide range of assets. Professional investment managers have various strategies to reduce volatility and risk while generating positive returns regardless of market movements. As the name suggests, these funds hedge their investments and can also include very aggressive investment strategies such as short-selling or trading financial derivatives due to their high flexibility. This gives hedge funds the opportunity to realize positive returns in both rising and falling markets. However, this highly speculative investment opportunity is only available to a limited number of investors who must meet a number of criteria.²⁷

Hedge funds therefore represent a significantly riskier investment than traditional private equity investments. The initially mentioned question of blessing or curse therefore refers not only to private equity, but also to hedge funds.²⁸

2.3 Structure of private equity funds

The private equity sector owes its increasing popularity and rapid growth to limited partnerships, among other things. Private equity funds are structured in such a way that they have limited partners (LP) and general partners (GP). The LPs assume the role of investors in the fund, while GPs form the investment team. This serves to safeguard equal interests, as the GPs also invest their own capital in addition to their own operating activities. The profit, in this case the carried interest of the GP, depends on the performance of the investment company. This must exceed a certain hurdle, i.e. a profit threshold, in order to be paid out as a profit share for the GP. Equal interests are also created when the GP invests its own capital in the fund, which is often between 1 and 5 % of the total fund volume. This also pursues the goal of achieving a corresponding return on the invested capital. This increases the attractiveness of private equity funds, as it ensures that the GP is aiming for a higher return than investment alternatives such as public equity funds or ETFs. In addition to the carried interest, the investment team also receives a management fee of 2 to 3 % of the fund volume annually to cover operating costs such as salaries, office supplies, rent, etc.²⁹

²⁷ See Baker, Filbeck (2017), p. 1

²⁸ See (n.d.) (2005): "Wen die SPD wohl gemeint, aber nicht nannte", in: Frankfurter Allgemeine Zeitung, URL: <https://www.faz.net/aktuell/wirtschaft/hedge-fonds-wen-die-spd-wohl-meinte-aber-nicht-nannte-1228870.html>

²⁹ See Thum, Timmreck, Keul (2008), p. 3

The following chart illustrates the relationship between investors in the private equity fund, the private equity company and the portfolio companies.

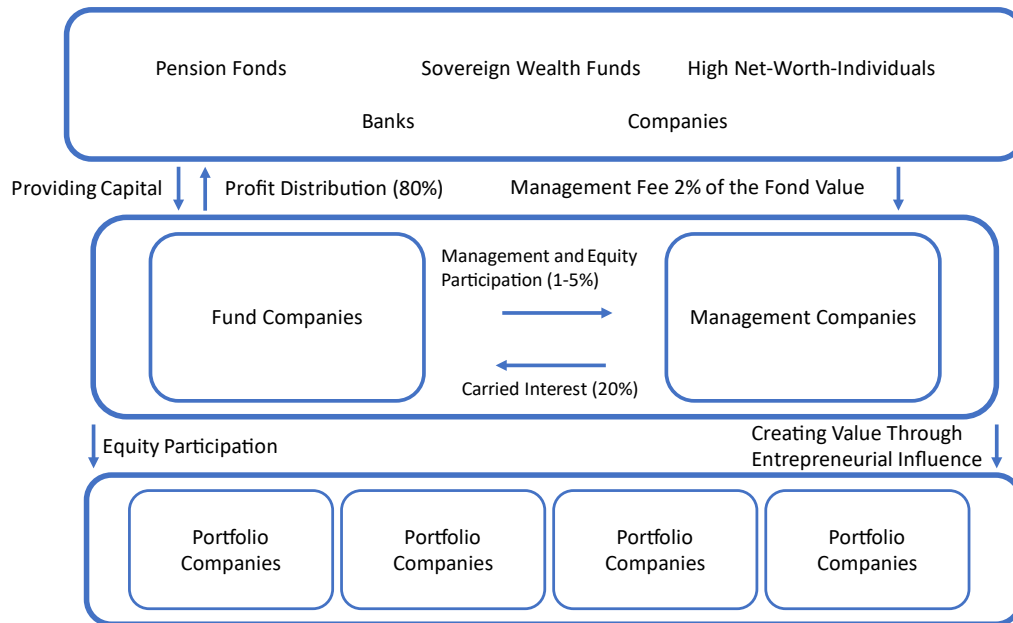


Figure 2: Structure of private equity funds³⁰

2.4 Return on private equity funds

As previously mentioned, private equity investments have grown rapidly in recent years, although it is important to clarify what makes private equity investments so attractive, apart from the fact that they serve as a diversification opportunity for investors alongside existing investments. As the following chart shows, buy-out funds, i.e. private equity funds that specialize in the majority takeover of companies, generated a considerable return between 2000 and 2019. These annual returns were over 15% in the median and even around 20% in the upper quartile. Even the lower quartile managed to achieve a return close to 10%.

³⁰ Based on Becker, Schulte-Krumpen, Graneß (2011), p. 51

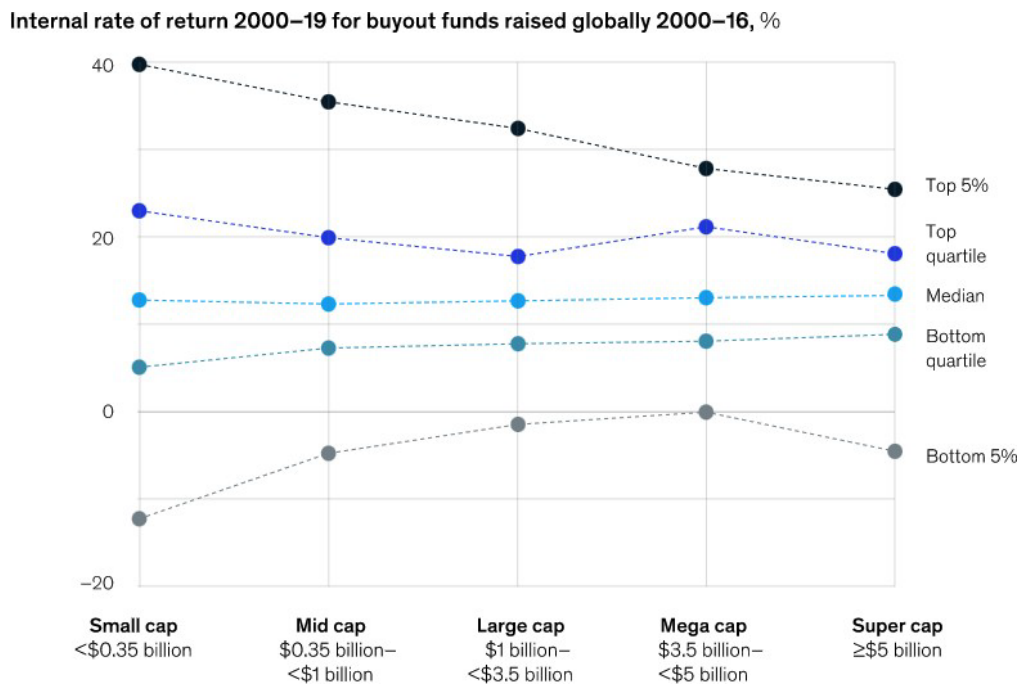


Figure 3: IRR³¹ of private equity buyout funds from 2000–2019³²

In comparison, the German stock market (DAX) is characterized by an annual average return of 5% to a maximum of 11% over a similar period.³³ However, unlike other asset classes, private equity is associated with a significantly higher risk. Due to the increased default risk, the lower transparency and the illiquidity of such investments compared to the equity market, a higher return profile is also expected, assuming a positive correlation between return and risk.³⁴ This raises the question of the value drivers that make such returns possible and the extent to which companies benefit from private equity financing.

³¹ The internal rate of return (IRR) describes the discount rate of the cash flows so that the net present value is zero.

³² McKinsey (ed.) (2022): Private Markets Annual Review, URL: <https://www.mckinsey.de/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review>

³³ See Börse.de (ed.) (n.d.): Dax Renditedreieck, URL: <https://www.boerse.de/renditedreieck/Dax/DE0008469008>

³⁴ See Gündel, Katzorke (2007), p. 236

3. Value drivers for companies and investors

3.1 Leveraged Buy-Out

Private equity investments are often characterized by the purchase of a company through a leveraged buy-out. This means that the takeover - or at least a large minority share - is financed to a significant extent by borrowed capital as a means of maximizing returns through the leverage effect. This often evokes associations with private equity as a curse, in which the company in question collapses under the high interest and repayment burdens of debt capital and the financial investor pulls away with huge profits. Against the background of existing capital protection regulations, however, this idea is absurd. Nor would a 'collapse' of the company be an ideal starting point for selling the company on at a profit.

Private equity companies use the company's cash flows to repay debt so that the interest burden is lower and the company value increases as a result, as shown in the chart below. Thus, an additional objective of the financial investor is to ensure the liquidity of the company.

	Without leverage	With leverage
Purchase for 100		
Enterprise value	100	100
Indebtedness		-50
Value of equity	100	50
Sale for 150		
Enterprise value	150	150
Indebtedness		-50
Value of equity	150	100
% increase in value	50%	100%
Sale for 75		
Enterprise value	75	75
Indebtedness		-50
Value of equity	75	25
% increase in value	-25%	-50%

Figure 4: The leverage effect³⁵

It can also be seen that the leverage effect can have both positive and negative effects on profitability, depending on whether the company is sold at a profit or not.³⁶ The leveraged buy-out therefore serves to maximize the return on equity. However, this is only achieved if the total return on capital, consisting of return on debt and return on equity, is higher than the return on debt.³⁷

³⁵ Based on Thum, Timmreck, Keul (2008), p. 87 ff.

³⁶ See Thum, Timmreck, Keul (2008), p. 87 ff.

³⁷ See Gündel, Katzorke (2007), p. 23

3.2 Management Incentivization

A leveraged buy-out implies that a majority stake in the company is acquired; however, a 100% takeover is rarely the aim. This is due to the fact that structures - such as those found in private equity funds - must be created that satisfy the interests of all parties involved. This is done by incentivizing the most important players in such a deal: the employees. Employee and management incentives are standard in private equity investments. These ensure that the workforce remains motivated and stands by the company even in crisis situations. This ensures a personal and professional bond between employees and the company. There are various forms of employee incentives: these can be additional salary payments if certain key operating figures or sales targets of the company are achieved. Incentives can also be created through share options, where employees become company owners on a pro rata basis and thus participate in the company's equity.

These incentives in the form of equity investments are available to management and key employees in particular. The aim is to prevent them from switching to a competitor, but at the same time to increase their willingness to perform. Employees who do not have a key function in the company are given less consideration in the form of equity participation, but are rather encouraged through bonus payments.³⁸

3.3 Operational Engineering

Management incentivization is a foundation for partnership.³⁹ While value creation in earlier years was still achieved through financial engineering and multiple arbitrages, operational engineering is becoming increasingly important for maximizing returns. BCG found that value generation through operational engineering amounted to 18% in the 1980s, while in 2012 it already accounted for 48% of total value creation. The repayment of liabilities as part of leveraged buy-outs, as described above, has only contributed 13% to value creation since the 2012s. Multiple arbitrages, on the other hand, are increasing its share of value creation, as can be seen in the following chart and later.

³⁸ See Thum, Timmreck, Keul (2008), p. 119

³⁹ See *ibid.* p. 104

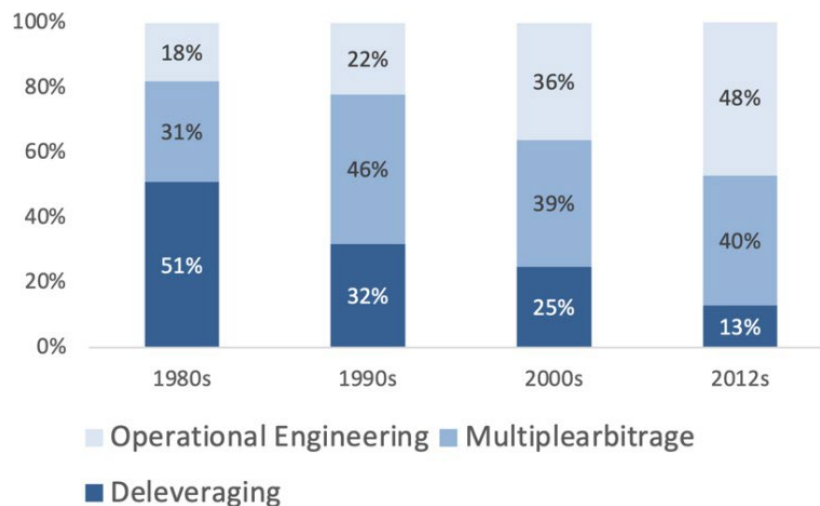


Figure 5: Influence of value enhancement levers in PE investments⁴⁰

There are numerous ways to achieve operational value creation within a company. These include strategies that influence the "top line" and "bottom line" of a company. The top line refers to the first item on the income statement in accordance with Section 275 of the German Commercial Code (HGB), while the bottom line focuses on EBITDA⁴¹ or the annual result with a view to cost-cutting potential. Strategies that affect sales growth can be, for example, M&A activity⁴², geographic expansion, driven product innovation, strategic account management, increased cross-selling, more efficient pricing, realigned marketing strategies or service optimization. Cost reduction measures ideally lead to a reduction in overhead costs, more efficient production, outsourcing or optimized purchasing strategies. BCG found through interviews with private equity firms that M&A and geographic expansion are the most popular top-line strategies and outsourcing, overhead cost reduction and optimized sourcing strategies are the most popular cost reduction strategies.⁴³

Operational interventions can also affect the financial and asset structure of the company. A portion of operational value enhancement involves financial engineering, such as through more efficient management of working capital. Positions such as liabilities from deliveries and services (L/L), inventories, and receivables from L/L often experience significant fluctuations, leading to high volatility in liquid assets. These fluctuations can be countered through active and more efficient cash management, as well as appropriate accounts receivable and accounts payable management, to reduce working capital and

⁴⁰ See Brigl, Jansen, Schwetzler, Hammer, Hinrichs, Schmundt (2012), "How Private Equity Firms Fuel Next-Level Value Creation", URL: <https://www.bcg.com/de-de/publications/2016/private-equity-power-of-buy-build>

⁴¹ Earnings before interest, taxes, depreciation and amortization

⁴² Mergers & Acquisition

⁴³ See Brigl, Nowotnik, Pelisari, Rose, Zwillenberg (2012), p. 19

strengthen internal financing capacity.⁴⁴

In addition, private equity companies rely on their specialized employees, who often have a background in investment banking. Their experience, negotiating skills and relationships with banks ensure that they can raise debt capital for their portfolio companies on favorable terms. After the takeover, private equity firms support their clients in raising new loans, issuing corporate bonds, refinancing debt capital, but also in IPOs or capital increases on the stock exchange and the sale of shares on favorable terms.⁴⁵

3.4 Network and know-how transfer

As previously stated, private equity investors have numerous levers at their disposal to increase productivity and profitability. In order to secure influence, for example, an advisory board is set up at a GmbH or KG, which has control and participation rights comparable to those of the supervisory board of an AG. The private equity company's own employees or external experts are appointed to the advisory board to advise or otherwise support the top management,⁴⁶ whereby the support depends on the investors, the company's stage of development and future strategic goals can vary greatly. In addition to know-how transfers, the private equity firm can make its extensive network available to the company.⁴⁷

Private equity companies can, for example, use their expertise from many years of transaction experience in an internationalization strategy by acquiring companies abroad. At the same time, their network gives them easier access to bankers and therefore to suitable investment targets. Strategic advisors and industry experts can also be called upon as part of the transaction. This leads to the realization that one of the greatest indirect and informal levers is the network and know-how of the financial investor, which contributes latent added value in all areas.⁴⁸

3.5 Multiple arbitrages and buy & build strategy

Various valuation methods can be distinguished in the context of company valuation, one of which is the multiples valuation. This involves using historical or planned key financial figures and then applying a multiplier to them, which depends on many factors such as size, profitability and industry. In practice, multipliers are often applied to the KPIs sales,

⁴⁴ See Thum, Timmreck, Kedddul (2008), p. 101

⁴⁵ See Barth (2021), p. 38

⁴⁶ See Thum, Timmreck, Keul (2008), p. 118 ff.

⁴⁷ See Gündel, Katzorke (2007), p. 36

⁴⁸ See Pindur (2006), p. 88

EBITDA⁴⁹ or EBIT.⁵⁰ In this context, multiple arbitrages means buying a company at a lower multiple than selling it later. This is achieved through the aforementioned bundle of measures on the part of the equity investment companies with the aim of maximizing returns, in particular through the use of economies of scale and scope.

Another prominent option for multiple arbitrages is the so-called 'buy & build' strategy, which can be applied regardless of positive trends such as GDP growth or falling interest rates⁵¹ This strategy aims to buy smaller companies that have a lower multiple than the parent company. This is done under the premise of identity or at least similarity in terms of 'customers, products and services. Buy-and-build also follows the logic that the group as a whole is worth more than the sum of the individual companies. This is achieved by exploiting synergies to reduce costs and maximize sales. The added value therefore arises from operational efficiency and the development of a platform, which is valued at a higher multiplier than its individual parts due to its size.⁵²

3.6 ESG

ESG, i.e. Environmental, Social and Governance,^{53,54} is now well established in the private equity landscape. Over 81% of the limited and general partners surveyed by auditors PwC stated that they have a sustainable investment policy and that ESG reporting has been established at the same time. The driver of such a development is the risk management of investments, as regulatory requirements are playing an increasingly important role. However, corporate governance and pressure from limited partners, i.e. investors, also play a major role here. ESG factors can play an important role in this context can be integrated in various ways: Screening of companies, investment decisions, board discussions, reporting, but also operationally in the portfolio company. The topic of ESG is particularly important in due diligence, as there is an increased focus on the risks of corruption or bribery in this area.⁵⁵

In a survey conducted by management consultants Bain & Company, 93% of limited partners stated that they would forego an investment opportunity if it entailed an ESG risk. 50% of respondents stated that the introduction of ESG guidelines would result in better performance.⁵⁶ This is supported by an analysis of the performance of 745

⁴⁹ Earnings Before Interest, Taxes, Depreciation and Amortization

⁵⁰ See Gündel, Katzorke (2007), p. 181 ff.

⁵¹ See Bayaz (2014), p. 78 ff.

⁵² See MacArthur, Rainey, Dessard (2019), p. 37 ff.

⁵³ ESGVolution (n.d.), ESG Ecological, social and corporate strategy information as additional indicators for economic success, URL: <https://www.esgvolution.com/de/esg>

⁵⁴ Haber, Stephen et. al: What Shareholders Do Fund Managers Represent?, URL: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4267270

⁵⁵ See Jackson-Moore, Case, Bobin, Janssen (2019), p. 9 ff.

⁵⁶ See Bain (ed.) (n.d.): ESG in Private Equity, URL: <https://www.bain.com/industry-expertise/private-equity/esg-in-private-equity>

sustainability funds conducted by Morningstar Research, which found that they performed significantly better than non-ESG funds over a period of up to 10 years.⁵⁷ The asset management company Blackrock also stated that its ESG funds beat the corresponding benchmark in 2020.⁵⁸ ESG criteria are therefore not only a value driver in the private equity sector, but also an opportunity to help shape the future of tomorrow.

4. Influence of private equity on companies

4.1 The case of Grohe AG

Background to the Grohe company

The Grohe case is one of the most prominent private equity takeovers: it was and still is associated with the bad image of private equity companies as a curse.

Grohe is a German armatures manufacturer based in the Sauerland region, with a history dating back to 1936. In the private equity context, however, the story begins in 1998 - the year in which the British financial investor BC Partners bought the company for 900 million euros and delisted it from the stock exchange. However, the Grohe case only became known through derogatory statements of the German politician Müntefering in 2005, when BC Partners sold the manufacturer of sanitary products, whose headquarters were located in Müntefering's neighboring constituency, to the financial investors Texas Pacific Group (TPG) and the investment arm of the Swiss bank Credit Suisse. Both financial investors carried out a leveraged buy-out, purchasing the company for 1.5 billion euros and loading the company with high debts of 1.1 billion euros, which caused an annual interest burden of 80 million euros.

As a result, the company had to take restructuring measures and mandated the consulting firm McKinsey, which proposed a significant reduction in jobs, which was then implemented. In 2015, Grohe was then sold by the financial investors to a Japanese group called Lixil for three billion euros. At the time, this transaction was also the largest Japanese acquisition in Germany of all time. As a result of the acquisition, the world's largest faucet manufacturer was created with a total turnover of 4 billion euros. Shortly after the acquisition, Grohe's subsidiary, Jiyou AG, filed for insolvency, which took investors by surprise.⁵⁹

⁵⁷ See Bioy (2021), 2020: A year of records for European sustainability funds, URL: <https://www.morningstar.de/en/news/209654/2020-ein-jahr-der-rekorde-f%C3%BCr-europ%C3%A4ische-nachhaltigkeitsfonds.aspx>

⁵⁸ See Blackrock (ed.) (2022): Larry Fink's letter to CEOs: The Power of Capitalism, URL: <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

⁵⁹ See Fritz (2016): A lot of investors' money sunk, URL: <https://www.wiwo.de/finanzen/boerse/grohe-viel-geld-der-investoren-versenkt/13045506.html>; Köhn (2005): Der Fall Grohe liefert für Zündstoff, URL: <https://www.faz.net/aktuell/wirtschaft/sanitaer-der-fall-grohe-liefer-zuendstoff-1115783-p2.html>

The development of Grohe AG

The added value for the financial investors through the transactions with Grohe was given to the extent that the sellers of the company were able to achieve a sales value that was significantly higher than the investment.

The parameters turnover, EBITDA and number of employees are used to analyze the holistic added value for the company. Turnover reflects the growth of the company; EBITDA shows the profitability of the company and the number of employees represents a qualitative parameter. For this analysis, all publicly available consolidated financial statements of Grohe AG dating back to 2005 will be used. Although this does not allow a statement to be made about the development of Grohe before the job cuts, it does allow a basic statement to be made about the development in the years in the hands of the financial investors, as the following figure shows:

Consolidated financial statements of Grohe AG after acquisition of TPG and Credit Suisse											
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	CAGR
Sales	865	939	940	964	783	932	972	1021	1046	1116	2,90%
EBITDS	-52	18	57	21	96	109	107	116	114	142	29,50%
Employees	5834	5338	5071	4973	4552	5037	5245	5312	5563	5732	-0,20%

Figure 6: Development of Grohe AG⁶⁰⁶¹

It should be expressly mentioned in this evaluation that not all annual financial statements are publicly available, which limits their informative value. However, it can be seen that turnover grew continuously by an average of 2.9% per year and was therefore slightly above the level of inflation. The number of employees was initially reduced over the years - this change was slightly above the inflation level - but had almost reached the initial level again in the year of the sale.

However, the enormous increase in the company's profitability is particularly striking. This was calculated from 2006 onwards, as the starting year has a negative value. With an annual increase in profitability of 29.5%, the financial investors managed to achieve an EBITDA margin of 12.7%, although it was still negative at the beginning. The company's higher profitability is not only more attractive to potential buyers, but also implies advantages for the company itself, as new cash flows from operating activities are generated every year.

⁶⁰ Own representation

⁶¹ See consolidated financial statements of Grohe AG from 2005 to 2014

4.2 Holistic development of SME companies

While increases in operating performance are common with private equity investments, as an increase in profitability can be observed in almost all cases, parameters such as an increase in sales growth and employment are less self-evident.⁶² This would also appear counter-intuitive in the context of the question if private equity companies are a blessing or a curse.

Scheuplein's study, which analyzed over 100 private equity-controlled SMEs in Germany, came to the conclusion that these companies performed slightly better than the control sample in terms of sales growth. In contrast, platform companies that were subject to a buy-and-build strategy recorded a four-fold growth in turnover.⁶³

Private equity companies are also significant from a macroeconomic perspective in several respects. The additional inflow of capital enables companies to sustainably increase their R&D efforts in order to remain fit for the future and, for example, to develop further patents, which ultimately represent an innovation KPI. The productivity of companies is also promoted through optimized resource allocation. This in turn leads to greater competitiveness of companies at national and international level. Ultimately, this also generates an increase in gross domestic product.⁶⁴

Another study by auditors KPMG and the Finnish Venture Capital Association Pääomasijoittajat found that companies held by buyout investors have a five-year sales CAGR⁶⁵ that is significantly higher than that of the peer group of independent companies, i.e. without investor participation. The mirror-image CAGR of personnel growth also exceeds the comparison group by around three times.⁶⁶ Sales growth is often only accompanied by additional staff. Some of the additional personnel are taken on as part of acquisitions, but a large proportion also includes organic growth in personnel. It should be noted in this context that private equity companies make a pre-selection in order to achieve maximum increases in returns and invest specifically in companies with higher performance than their peers.

The German Private Equity and Venture Capital Association (BVK) and the Institute for SME Research (Ifm Bonn) have excluded the effects of buy-and-build strategies for a focused look at the organic growth of companies. Over a period of 3 years, companies with equity financing showed a total personnel growth of 13 %, while the comparison group only grew by 1 % in terms of personnel. In the three-year turnover analysis, the overall growth of companies with equity financing was 8 percentage points higher than

⁶² See Kaplan, Strömberg (2009), p. 133

⁶³ See Scheuplein (2020), p. 24

⁶⁴ See o.V. (2013): Exploring the impact of private equity on economic growth in Europe, p. 50 ff.

⁶⁵ See *ibid.*

⁶⁶ See Santavirta, Koivula, Vesterinen (2021), p. 7 ff.

the comparison group.⁶⁷ This development can presumably also be attributed to the fact that many SMEs are family-run and presumably did not have a financial investor as an owner before the acquisition of financial investors. This means that investors have several levers for increasing the value of the company, which in turn makes it easier to increase returns.

The debate concerning the role of private equity companies suggests that companies do not necessarily benefit from financial investors and, using Grohe as an example, companies or parts of companies can also slide into insolvency. In comparison, however, there are also turnaround or distressed investment hypotheses for private equity companies, in which they buy up companies at risk of insolvency. Such investments are usually made by financial investors, as some niche funds have specialized exclusively in such situations. In this constellation, the company can only emerge from a crisis if it has a clear strategy and a plan of action that has been worked out together with the investors.

In such situations, an external management team often invests to help lead the turnaround. Analogous to the debate, one can discuss whether private equity is not the worse evil for companies in such a situation. Thum, Timmreck and Keul, on the other hand, describe a private equity investment in a company that is at risk of insolvency as advantageous, as there are incentive structures in place for the company, investors and management to work together to free it from insolvency and make it profitable again. In contrast to lenders, investors benefit from the long-term prospects of success, but also bear a higher entrepreneurial risk.⁶⁸

⁶⁷ See BVK (ed.) (n.d.): Analyse der Entwicklung beteiligungsfinanzierter Unternehmen, p. 10 ff.

⁶⁸ See Thum, Timmreck, Keul (2008), p. 118 ff.

5. Concluding remarks

The importance of private equity financing, particularly in the SME sector, has undoubtedly increased in recent years. Externally financed takeovers, management incentivization, operational engineering, network and know-how support, multiple arbitrages and the emerging ESG topic are key value drivers for companies and investors, as the value creation for both parties is very closely intertwined.⁶⁹

In the case of Grohe AG profitability was significantly improved, at least during the involvement of TPG and Credit Suisse, thus opening the door to growth. The question of whether private equity investments lead to higher value creation in SMEs for companies and investors can therefore be answered in the affirmative. Studies also confirm that investment companies should not be defined as curse per se, as the interests of investors and companies are closely intertwined and investors' profits are measured by the strength of the company and its market value, which should be higher than the initial purchase price.⁷⁰

Various current trends are likely to further increase the importance of the private equity industry, particularly for SMEs. These include the constant desire on the part of companies for more ESG-compliant investments, especially in SMEs, where this topic has played a rather subordinate role to date. Many SMEs are also increasingly confronted with succession issues, ever-expanding regulatory problems, e.g. based on Basel I-IV and other laws, as well as the challenges of inflation, the shortage of skilled workers, rising production costs and investment pressure as part of the digital transformation. All of these challenges will lead to increased add-on acquisitions across all industries.

In this respect, the image that private equity companies only focus on large institutional investors, such as pension funds, sovereign wealth funds, insurance companies, banks and high-net-worth individuals, where they can create added value, can be considered outdated. Due to the attractive returns, the private equity market in this segment will naturally experience further growth. In addition, this sector is also opening up to private investors, in particular SMEs, which represent an increasingly attractive investment object.

⁶⁹ See Achleitner, Ann-Kristin; Herman, Kerry; Lerner, Josh; Lutz, Eva (2010): Family Business and Private Equity: Conflict or Collaboration? The Case of Messer Griesheim, p. 25; Lahmann, Alexander; Stranz, Wiebke Velamuri, Vivek K. (2017): Value creation in SME private equity buy-outs, Qualitative Research in Financial Markets, Emerald Group Publishing Limited, vol. 9(1), pages 2-33, February. URL: <https://ideas.repec.org/a/eme/qrfmmp/qrfm-01-2016-0004.html>

⁷⁰ See BVK (ed.) (n.d.): Why are private equity companies referred to as locusts?, URL: <https://www.bvkap.de/beteiligungskapital/fragen-antworten/wieso-werden-private-equity-gesellschaften-als-heuschrecken>

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