German Private Equity: A Sitting DACH?

2023 was, broadly speaking, not a great year for private equity. A lot of money has been raised, and against the present backdrop of weak deal flow, most of it is looking for a home in all the same places. So, in typical Alvine fashion, we took a considered pause and reflected on where a less saturated place to invest might be in 2024.

When it comes to European private equity, it's probably fair to say that the UK and the Nordics have been the standout geographies. The Scandinavians have (in typical fashion) excelled at presenting themselves as adept and discerning investor, and their economies have been suitably strong. The UK has, despite its challenges, maintained a deep and amenable market for private equity, underpinned by an entrepreneurial spirit and the powerhouse that is London. Some of the other markets, such as Spain, Italy, Benelux etc can be accessed through focused funds, but often comprise part of a Pan-European strategy.

So, what about Germany?

Germany has had its challenges, however, for as long as I have been alive, the country has been associated with success, growth, and exports. In recent times, certain policy errors have cast doubt on their immediate future, but the prevailing notion has always been, and still is for that matter, that Made in Germany means good quality. Furthermore, never write them off, for they always seem to bounce back.

The reason for this is primarily due to one prevailing characteristic of the Germany economy: the existence of the Mittelstand - otherwise known as the backbone of the Germany economy. The contingent of small to medium sized businesses characterised by their "razor thin focus" and ability "to do one thing really well." (*Lessons from Germany's Midsize Giants, Simon Hermann, Harvard Business Review, 1992*). These businesses have more than often been owned and operated by a single family, with management passed down through generations. Put simply, these are incredibly attractive businesses.

So why then has private equity historically lacked penetration in the region, certainly in contrast to other western economies; and why does that create an opportunity? In the third of our series of 'Thought Pieces' on interesting areas within alternative investments, we take a closer look at the German Mittelstand, and explore why now may be the right time to take a closer look.

First things first: What is the Mittelstand?

The Mittelstand lacks a commonly observed definition, so at the risk of repeating the above, it makes sense to offer some definitions and examples.

In terms of size, we are looking at the German Lower Middle-Market/ Mid-Market:

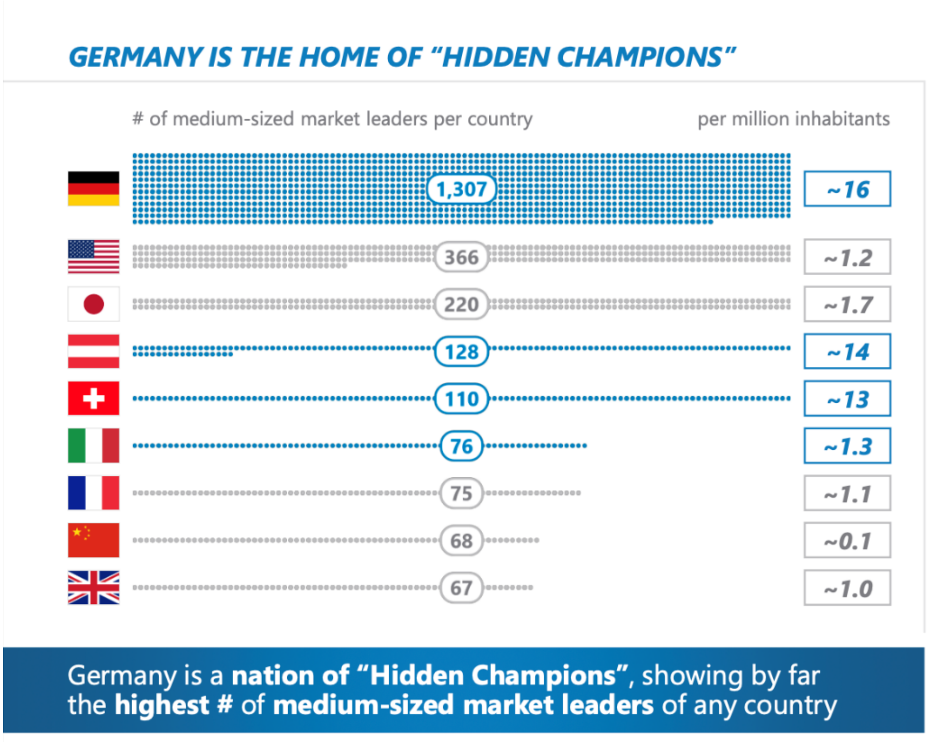
"Based on the definition provided among others by the Institut für Mittelstandsforschung in Bonn (IfM): enterprises with up to 500 employees and an annual turnover of no more than €50 million are considered to be an SME"

Of course, many of Germany's most successful companies can trace their roots to the Mittelstand but may have since outgrown that label. In these cases, companies are keen to retain their status as Mittelstand because of the association with quality. This can tend to drive confusion.

That is why the following qualitative factors are so important:

- **Unity of ownership and management**
  These are family run businesses owned and operated by the families who founded them. In some cases, these can stretch back hundreds of years. These families are totally liable for the decisions they make and feel a familial attachment to their workforce. They are therefore minded to make very long term decisions and act in a conservative fashion to safeguard their assets and employees.

- **"Hidden champions"**
  To use a term coined by Simon Herman who wrote a fantastically interesting book on the concept, these businesses are obviously successful, yet tend to operate behind a curtain of apparent secrecy. This is understandable. Why (particularly if you only do one thing) do you really want to raise awareness of that process or give anyone else the faintest inkling of how to do it? To coin a quote borrowed from an excellent article by Harvard Business School when interviewing the CEO of an unnamed welding business: "We are not interested in revealing our successful strategies and helping those who have been inert during recent years."



Information taken from *The Hidden Champions: Lessons from 500 of the World's Best Unknown Companies*, Hermann Simon, 1996

- **Nestled in the foothills.**
  Germany is a large and decentralised country. This can be challenging when organising a roadshow for GPs, however it does serve to create a strong interdependence between employer and employee. For example, a Mittelstand company may be based in a tiny little town in the countryside yet be generating hundreds of millions in revenue. It is not unknown for close to the entire working population of the town to be in employment for the business. In some instances, you can even find the town square named after the local business. In essence, the business needs the employees, and they need the business. Life without either would be economically unviable and unthinkable.

- **Modest.**
  When Michael Lewis describes the recruitment process in *Liars Poker,* he writes about meeting dapper gentleman in impeccable blue suits adorned with expensive Rolexes and Ferragamo ties. He thinks to himself: "wow, this is what success must look like" before realising these are just the sales guys and the people with the real money don't need to bother with a suit… and it's a bit like that here. Overall, as an outsider, you would have no idea that the slightly dishevelled looking man is the CEO and fifth generation family owner; and that's by design. Because when you are very well-off and most of your town work for you, it's best not to flaunt it in their face.

- **Conservative.**
  German attitudes towards debt are sceptical at the government level so it is therefore unsurprising that this would persist at the company level. Founding families are reticent to over encumber their business for future generations or leave themselves exposed to unexpected movements in rates.

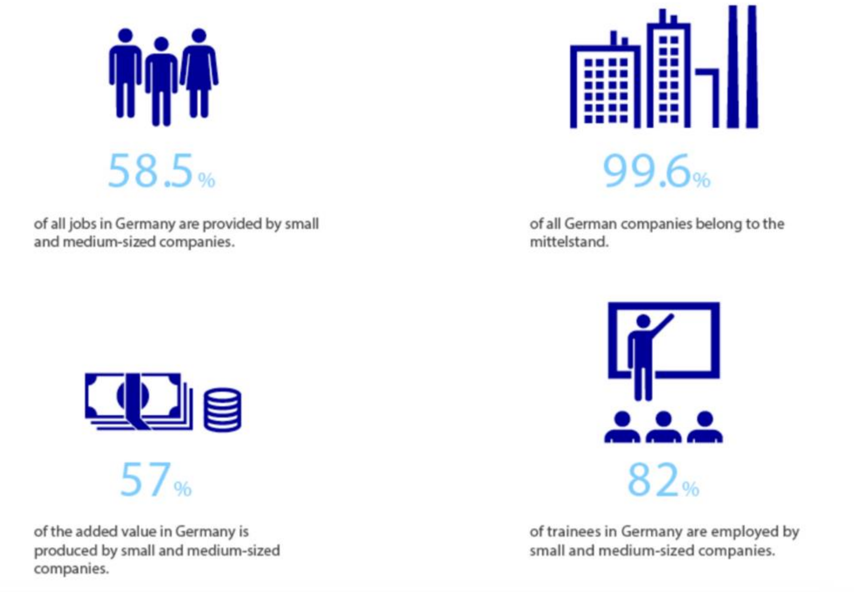
- **Niche.**
  They do one thing, and one thing very well. These companies are 1, 2 or 3 in the world at what they do.

- **Innovative.**
  Much like receiving a deadline for this newsletter, there's nothing like a little panic to drive productivity and innovation. Given the concentrated product offering at many of these companies, the fear of obsolescence has often driven some quite staggering innovation, as companies make use of their significant manufacturing capabilities to pivot product type in times of change or stress.

Examples

1. **Flexi**, founded in 1972, are the number one manufacturer or dog leads worldwide and pioneered the retractable dog lead. They are based in based in the small town of Bargteheide, just North of Hamburg, and employ 300 people there.
2. **Koenig & Mayer**, founded in 1949, are the number one manufacturer of microphone/ music stands for musicians and have a strong association with quality. They are based in Wertheim south of Frankfurt and again employ 300 people. Currently in their third generation.
3. The Harvard Business Review write in their insightful article, *Lesson's from Germany's Midsize Giants*, about a company called **Körber/Hauni** who were/are the world's dominant producer of cigarette machines with 90% market share. In the 90s, rightly identifying a health-related threat to their business, they pivoted and founded a subsidiary which pioneered a breakthrough innovation: a machine called Oxygen Selector PRO2-VITAL that produces oxygen from normal air. I always thought irony was lost on the Germans…

In terms of importance….



Source: Deutsche Boerse Group website: What Drives the Mittelstand

Why don't they like private equity?

25 years ago, Germany was (once again) in tight spot. Holger Schmieding had just labelled the country 'the sick man of Europe' and Gerhard Schroeder was intent on administering some medicine. His government were pushing through unpopular yet necessary reforms to bring in foreign capital to revive an economy which had been blighted by the costs of reunification, sky-high labour costs and an overly generous welfare system. Banks and financial institutions, which had up until now, maintained supportive yet loss making holdings bolted for the door as soon as they were able. 'Anglo-Saxon' private equity funds, never keen to waste a good crisis, identified an opportunity and made themselves right at home.

Unsurprisingly, Franz Munterfering of the left-leaning SPD in Germany, took up issue with this. In 2005 he declared in (no uncertain terms) that he was not a fan of Anglo-Saxon private equity funds, in a beautiful quote, in which the accuracy of the metaphoric imagery has ensured it has remained a mainstay in political discourse for decades:

"We must help companies acting in the interest of their future and the future of their employees against irresponsible locust swarms, who measure success in quarterly intervals, suck off substance and let companies die once they have eaten them bare...

Mother nature never fails to deliver when it comes to capitalist comparisons, does it?

I suppose the criticism derives from the respective contrast in intended (or rather conceited) ownership objectives and duration. Private Equity is supposed to be one of, if not the longest-term investments, but as someone who professionally raises funds within this industry, I can offer some first-hand observations. Yes… sometimes:

- GPs do generate 'shareholder' value through leverage, financial engineering, cost cutting, and yes this does not make them (and crucially, the seller) entirely popular with their employees or customers.

- GPs can be more short term minded than their 10yr structure would suggest, particularly when thinking about raising their next fund…. It is not uncommon for a manager to sell prize/ top performing assets after 2-3 years, in order to realise a gain to facilitate more effective marketing for the next vintage. This is called 'picking the daisies'.

These two points serve as an anathema to a long-term minded family owner.

The crux of the matter is that if a business has been in your family for generations and most of the town work for you, the optics associated with selling that business may be confused at best. Further compounding that doubt is the eventuality that the counterpart with whom you have transacted may then proceed to sack most of the workforce and move production to a cheaper part of the world, effectively rendering your town unemployed (and unhappy). Worse still, they then sell the company to an even more faceless entity within 2yrs, and a once loved and cherished company becomes another spoke in the wheel of a senseless and unfeeling capitalism. Remember, these are the kind of business owners who drink in the local beer hall and eat in the local café. Entertaining these conversations has historically been heavily frowned upon.

So why now?

Germany is, not for the first time, facing a few challenges. The purpose of this piece is not to overwhelm you with negativity (if you want that, please go and read The Economist's recent article: *The Germany economy: from European leader to laggard 17/08/23* or *Germany was worst-performing major economy last year*, Financial Times 16/01/23) but rather to make the point that the Mittelstand will prove to be resilient in the face of these issues. When writing this piece, I was fortunate to speak with Holger Schmieding, one of Germany's most renowned (and historically accurate) economists, who was adamant on this point and would strongly urge everyone who has an interest in Germany to spend some time reading his recent punchy and upbeat piece: "*The German economy: what is the problem?*" available on the Berenberg website where he serves as the Chief Economist.

The issues Germany faces would require more than a fleeting summary but for the sake of clarity (and brevity), let us boil them down to following:

- Overexposure to exports to China.
- Overreliance on Russian gas to fuel manufacturing
- Overly bureaucratic policy making
- Aging population

These are serious issues bred through the complacency of success however it is important to understand that Germany is now taking significant steps to address them, and crucially, is in an excellent fiscal position to do so. Moreover, all agree that something needs to be done. Gone are the days of obstruction from the mainstream centre-left that we saw during the early days of Schroeders' tenure: the last time that Germany identified and overcame significant challenges.

As we must acknowledge, betting against Germany's ability to overcome challenges has not been a winning strategy in modern history. And it is here that we return to the premise of this piece: the Mittelstand has weathered every single storm.

I was keen to understand the reason behind this resilience and was particularly drawn to a certain phrase Holger had used in his piece; namely, that the German Mittelstand was one of the greatest 'search engines' for innovation ever devised. He unpacked this by explaining that German family owners are completely and utterly obsessed with their niche, constantly speaking with one another, and spending countless sleepless nights worrying about threats to their business or product. Compounding this angst, they feel a uniquely paternal/ maternal affiliation to their workforce for reasons explained above. If we consider that there are anywhere from tens of thousands to hundreds of thousands of German Mittelstand companies, all interacting with one another, we can begin to understand the Mittelstand almost as a type of organism, or a brain, constantly scouring for innovation and solving problems. In times of hardship, these conversations occur more frequently, and innovation accelerates.

At the same time, we are transitioning towards a new generation of family owner; one which is more global and open towards 'Anglo-Saxon' practices. Unlike their parents who were born, raised and importantly remained in the local community- their children are more likely compelled to live abroad or in a more urban environment. Deriving from affluent families, they have likely spent significant time in the US, London or Asia. As they come to take the reins, it is our firmly held view, that they will be far more open to external sources of capital (and advice), so long as certain cultural and legacy related issues are suitably addressed.

The recent Viessman deal is a fantastic example of this shifting dynamic, and you can read an excellent account of the transaction in a recent FT article: *German anxiety stoked by US group's bid for family-owned Viessmann (05/05/23).*

Viessman is a heating pump manufacturer founded in 1917, based in Allendorf, which has been in the Viessman family for four generations. Allendorf is a small German village of 6000 people wherein most of the town work for Viessman. Recently the Inflation Reduction Act in the US has provided generous subsidies for domestic manufacturing and installation of heat pumps. Similarly, the German government, as part of its big green push, has approved a bill that bans new oil and gas heating systems from 2024, whilst also offering subsidies and exemptions to support the transition. The confluence of these factors made Viessman extremely attractive to its US competitor, Carrier, who recently purchased the company in 12bn EUR cash and stock deal.

At that price, I would argue that even the most staunchly conservative Mittelstand owner would have found themselves at the negotiating table. Furthermore, Max Viessman will join the board of Carrier and the Viessman family will become a significant shareholder in Carrier engendering the notion of 'Partnership'. Nevertheless, the terms of the deal make for interesting reading, and reflect the underlying concerns of Mittelstand sellers:

"*The company said Carrier had agreed to maintain the Allendorf headquarters for at least 10 years and to keep all German manufacturing and research and development sites for at least five years. Lay-offs for operational reasons would not take place for at least three years, Viessmann added."*

Clearly, the family feel a sense of duty to their employees (or have been well advised). That said, the most interesting part of the article came towards the end:

"The waitress at the café in Allendorf agreed the recent succession had changed things. "I've had the elder Mr Viessmann here as a customer, Mrs Viessmann also comes in here — but you don't see the younger ones that often," she said. "There's a new generation coming and they have a different road map." The same thing happened when Martin Viessmann took over from his father in the 1990s, she added. "After that, the two [generations] did not have much to do with each other any longer."

I have a feeling we will be seeing more and more high-quality Germany companies up for sale in the coming years.

What's the best way to access?

Although I feel the medium to long-term trend suggests a shifting attitude towards third-party capital, the bar is still extremely high for transactions to take place, and the purchasing entity will have to differentiate themselves from the crowd in order to find deals and complete them.

We have spent the past few months speaking with German LPs and GPs to unearth exactly what it is sellers are looking for in a Mittelstand partner. Below a few key qualities:

- **Part of the club**
  Are they transacting with someone who innately understands their issues? Even more compelling: are they dealing with someone who has been through the same process before, or comes from a Mittelstand family? As discussed, these families speak with one another constantly… a good word goes a long way.

  In the same vein, what is their LP base like? If there are German families in there, that would suggest they are doing something right, and the connectivity that brings in terms of deal flow and access can make all the difference.

- **Long-term mindset**
  How effectively is the GP able to demonstrate their intent to partner for the long term? Effective techniques abound but one innovation we have been following very closely is the innovation of long-term/ evergreen vehicles. 12, 15 or evergreen vehicles seem to appeal to family sellers because they feel as if their legacy is going into a suitable home. This also gives the GP time and flexibility to focus on multiple expansion.

  Further, attitudes towards debt reveal a lot about the mindset of the buyer. German owners are likely to be suspicious of a track record which owes a significant proportion of its return profile to leverage.

- **Focus**
  As we would argue for pretty much any private equity fund, focus, whether it be sector-driven or geographic, is crucial here. Someone who focuses purely on the Mittelstand will be able to source deals more effectively and imbue their strategy with the culture required to build successful partnerships with German entrepreneurs. In this sense, pan-European funds with an outpost in Munich just don't quite cut it, and are probably too big to be accessing the 'real' Mittelstand anyway.

- **Strong operator**
  You will need to demonstrate to someone with (you would hope) the greatest understanding of their own product in the world, that you can add value and understand their industry. They are engaging with you because they need help to take it to the next level, or they are looking for a conscientious owner as part of a transition. Track record and sophistication of team and set up are important here.

Conclusion

And there we have it, the German Mittelstand… an incredibly resilient and attractive marketplace with high and often invisible barriers to entry. It is our view that attitudes towards private equity are becoming more friendly and a new generation of family owners will be more willing to engage. Certain cultural sensibilities and practices will not only have to be observed but innately understood to drive deals to completion and accordingly a successful investor will have to combine family attitudes with institutional practices. We feel this creates an opportunity and warrants Germany a considered look as investors assess their pipeline for 2024.