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Level headed

Market conditions may have improved, but discipline is more important than ever

LP Q&As

Investors share their views on performance, activity levels & pricing

Debt

Banks are back but dealflow is lacking, says SEB's Stuart Hewer

Data commentary

Germany shines again in large-cap space





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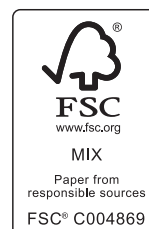
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Navigating a challenging market

Despite significant amounts of dry powder and a very favourable financing environment, German buyout dealflow has remained consistent in recent months. Can local players pick up the pace while remaining disciplined? **Greg Gille** reports

THE CONSISTENCY in numbers is certainly befitting the nation's reputation for precision engineering: with roughly 22 private equity-backed buyouts in the first halves of both 2012 and 2013, and in the region of 35 transactions in each second half, according to *unquote* data, German dealflow has remained eerily consistent in the past couple of years. Overall value did display peaks and troughs though, as is expected in a market where one or two mega-buyouts can significantly affect a quarter's total.

The first half of 2014 stuck firmly to the tried-and-true formula, with *unquote* recording 25 LBOs worth an estimated £7.5bn between January and June. While this dip in volume compared to the previous six months (33 deals) is not out of character for the country, it jars with the recovery witnessed in other European markets in H1 2014, such as France and the Nordic region.

But it is also at odds with the market conditions prevalent in the first half of the year, widely regarded as significantly improved compared with most of 2013. On the one hand,

strong investor appetite resulted in healthy amounts of capital being injected into funds targeting Germany in the past 24 months – with GPs such as Aflum, Triton, Quadriga and Steadfast all closing vehicles in the first half of 2013.

On top of the dry powder available, access to cheaper, more plentiful financing options improved consistently in recent months, as was witnessed across Europe. The market still benefits from strong, established German banks – and from many foreign banks that consider Germany as their second core market – which in turn drives liquidity and favourable terms. Alternative lenders also made their mark, especially in transactions benefiting from higher leverage or non-amortising solutions.

Dry powder and debt financing indicators may very much be in the green, but the level of private equity penetration in Germany remains low compared to other European markets, as evidenced by the number of deals completed so far this year. “There is clearly a lot of money chasing relatively few deals, and especially fewer high-quality deals,” sums up Jörg Rockenhäuser, the head of Permira's Frankfurt office.



“There is clearly a lot of money chasing relatively few deals, and especially fewer high-quality deals”

Jörg Rockenhäuser,
Permira

Large-cap pull

The first few months of 2014 (and especially the second quarter) have not been without their more positive points though. Markus Ehrler, a partner at debt advisory firm Marlborough Partners, notes that while overall activity has been lacklustre so far this year, the upper end of the market is looking more promising: “New-money activity has been slightly subdued so far this year and we did see a few processes starting but not going through, mainly on the back of pricing expectations that were just too high,” he says. “We are seeing a little bit more

M&A coming through now, which is an encouraging sign. This is mainly at the larger end of the spectrum and not so much in the mid-market though.”

Headline statistics indeed hide the fact that one of the market segments in Germany has fared particularly well so far this year. The number of buyouts valued at more than €500m doubled between H2 2013 and H1 2014, settling at six deals worth an overall €5.9bn. This resulted in Germany being home to a third of European transactions in that range, surpassed only by France with eight.

Some of the most high-profile transactions completed in Germany so far this year included Triton buying the heat exchanger business of GEA Group for an enterprise value of approximately €1.3bn – a deal backed by €775m of high-yield bonds. Meanwhile, Bridgepoint sold speciality chemicals company Clariant Acetyl Building Blocks to Permira, reaping a 2.4x money multiple. Deal value was understood to be in excess of €800m, equating to an entry multiple of around 8.5x EBITDA.

Although the Clariant deal was sourced from another GP, Permira's Rockenhäuser points to another positive development in recent months: “Primary dealflow has been stronger this year. And this should continue in the coming weeks as the current market is simply very attractive for corporates looking to divest divisions, with plenty of exit options available.” However, it is not all roses: “The issue with some of the big corporate spin-offs is that they tend to be long, complicated processes and that can lead to sub-optimal prices. Looking at the ones done in 2014, we think that a couple of them have been too expensive.”

The virtue of discipline

The issue of pricing is one that often arises in conversations with local private equity professionals – perhaps unsurprisingly given the supply/demand imbalance evident in the market, which fuels a flight-to-quality syndrome. “The material difference this year is that we continue to see very high price levels – arguably higher than before the crisis, which is not yet the case in the rest of Europe,” says Rockenhäuser. “Of course, it depends on the asset, but looking at LCD data, entry multiples stood at around 8.4x in 2006-2007, while now we are seeing peaks at 9-9.5x. One thing to bear in mind though is that the picture is quite lumpy, since there aren't a great number of deals, so



“It is wise to pay top prices for top assets – even through a downturn, the best companies will keep their intrinsic value”

Markus Ehrler,
Marlborough Partners

this can be easily distorted by one or two large deals.”

As is usually the case, high valuations are initially the preserve of top-quality businesses; as this goes on and sought-after targets rarefy, less attractive deals manage to slip through and command high prices as well. “The most successful PE guys will be the disciplined buyers,” warns Marlborough's Ehrler. “It is wise to pay top prices for top assets – even through a downturn, the best companies will keep their intrinsic value. Problems arise when buyers are willing to pay similar prices for less attractive assets.”

The debate around investment discipline is compounded by the supply/demand imbalance also witnessed when it comes to acquisition finance. With hefty debt packages swiftly arranged for the most high-profile deals, and borrowers benefiting from increasingly friendly terms, is the market back to the bad old pre-crisis habits?

Ehrler acknowledges that the wider European debate around the sustainability of such a lending environment has also reached Germany, but notes the consensus is that comparing the current situation to pre-crisis excesses is not yet entirely relevant: “We are looking at debt packages flirting with the 6-7x EBITDA mark, which is almost on par with pre-crisis levels, but the pricing and coverage ratios are different. Most borrowers have more headroom now.”

Still, discipline is set to remain very much on the mind of savvy investors, with their sights set firmly on future returns rather than getting money quickly out of the door or over-relying on the favourable lending environment. Rockenhäuser expects the trends witnessed so far in 2014 to continue as the year draws to a close, but warns against complacency: “Nothing should critically change as long as the debt markets remain as they are. But these times of favourable borrowing conditions are not easy times for private equity. Every cycle brings its challenges but the availability of cheap debt often leads to higher prices and you have to be very disciplined in such markets.” ■

SEB acquisition finance executive
Stuart Hewer says that banks are back
in the game but face limited dealflow

Debt seeking deals



Stuart Hewer, SEB

"It has been surprising how few banks have exited the market despite Basel III and the financial crisis"

What is your view on dealflow in Germany at present?

Currently, there is more activity in the small- to mid-cap segment compared to the large-cap space, but in terms of primary dealflow, there is a supply/demand imbalance: banks are still quite hungry for deals, and a lot of funds have been raised and are looking to put money to work, but there are just not enough deals coming in to meet demand.

What does this imply for lenders?

Firstly, with the scarcity of deals in Germany and Europe in general, lenders are keen to complete the ones that are there, so they offer more aggressive terms and leverage to sponsors. The market becomes more borrower-friendly, particularly at the larger end of the spectrum. Secondly, the debt funds in particular, with a drive to invest raised capital, will go out looking for deals and will move away from typical LBOs to sponsorless transactions.

This is combined with the general need for banks within Germany and Europe to deleverage. Some banks will need to accelerate a downsizing of their balance sheet, particularly in light of a full implementation of Basel III and the results of the ECB Asset Quality Review.

Who is managing to lend in this environment?

It has been surprising how few banks have exited the market despite Basel III and the financial crisis. Some banks have changed their strategy, and most (SEB being a notable exception) stayed on the side-lines at the height of the recession, but most have come back to the market and started lending again.

Debt fund activity is also more limited than I would have expected. Banks are not just giving up and passing the cup to the debt funds, and I think

sponsors remain comfortable with the bank loan product.

There are areas where we have seen increased debt fund activity, though. These deals seem to fall into the space where leverage is higher than a senior debt structure. Besides, debt funds typically have a higher risk appetite and are able to offer more flexible documentation in respect to covenants and repayments, and they are potentially less bound by credit policies than banks. Maybe these types of deals will increase, but at the moment it is limited largely to outlier deals where banks would struggle to offer what the sponsors want.

Recent figures suggest Germany's macro environment is suffering due to political headwinds. How will this impact lending into private equity?

There is a general feeling of heightened uncertainty resulting from geopolitical risks and reduced growth in certain emerging markets, and this comes together with government policies from the grand coalition that seem more left-leaning than some anticipated. Some of this softness had already been priced into deals, and private equity transactions tend to be concentrated in more resilient sectors so are slightly buffered from headwinds at the moment.

Beyond this, I think it is difficult to align macroeconomic indicators and market activity, as they have decoupled. Market activity is sustained at the moment by central bank intervention, masking the real fragility of the recovery. This is one of the many reasons we at SEB retain some healthy scepticism on some of the valuations and leverage levels we are starting to see. Having said that, we remain very active in the market and are still financing an impressive volume of strong deals. ■



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SEB

Sluggish yet sanguine

WEGA senior investment manager Sven Berthold lauds German optimism, staying power and consistent historical performance, despite the current dip in activity



Sven Berthold,
WEGA

How much confidence is there in the German market at present?

Confidence is fairly high at this point. The economy has done well in recent years, companies have recovered from their lows and profits are above pre-crisis levels. The quality of dealflow is good, albeit not abundant, and we have seen an increase in recent months. GPs have seen strong fundraisings and deal financing is available at attractive conditions. As well as this, transaction volume for buyouts is up compared to the first half of 2013. And all of this seems to be confirmed by the BVK Sentiment Index, which is at levels unseen over the past 10 years, bar during 2006-2007 and briefly in 2011.

What is the outlook for a German GP wishing to raise funds in the current environment?

Generally speaking, the current fundraising environment is bifurcated. It's very accommodating for GPs with good track records but less high-performing groups can take a long time to raise capital.

For LPs, the task of securing allocation with very good GPs is not easy – I'd say there is a

fight for allocation going on. LPs need to be proactive and position themselves very early in the fundraising cycle in order to secure their commitments. This is very similar to the 2005-2007 period. The strong performance shown by Germany and German GPs during the financial crisis means the country is an attractive destination for capital. But as most German GPs focus on the smaller Mittelstand, fund sizes aren't that large and they don't increase that much from fund

to fund either. Demand outstrips supply and the very strong and fast fundraisings of some German GPs recently confirms this in my eyes.

What do the criteria for your fund manager selection look like? Have they changed?

We have always emphasised investing with experienced teams with robust track records, who seek value creation through growth and/or operational change as the main value drivers. Rather than the selection criteria changing, we have seen more pronounced shifts in our strategic allocation to private equity strategies and buyout fund size segments. Venture capital investments have been phased out, giving more room to special situation and turnaround funds in our portfolio.

Furthermore, while 10 years ago we had started shifting into the small-cap space and emphasised this part of the market, today we target a more equally balanced mix of large-cap, mid-cap and small-cap funds.

How have the German fund managers that you have invested in fared?

Interestingly, in IRR terms, three of our top 10 best performing fund investments since inception are Germany-based. However, this statistic needs to be relativised as some of the commitments were made in some very good vintage years. If we benchmarked the German funds we committed to against their European vintage peers, I'd say the performance is good, but not great. This observation is very much in line with all the other available data on German private equity performance relative to other European countries. Returns have been fairly homogenous in my mind, too. In the past, one might have said that performance has been somewhat boring, but today one would say that returns have been robust over time – an attractive feature in the eyes of many LPs! ■

"In IRR terms, three of our top 10 best performing fund investments since inception are Germany-based"

3i partner **Peter Wirtz** celebrates the lucrative exits high valuations have kindled, but bemoans the lack of reasonably priced assets

Money for nothing



Peter Wirtz, 3i

What is your current view of the DACH market?

At the moment I think it's rather quiet. There's a bit of a summertime lull and not a lot is going on. The main issue is the assets that have been sold in the past six months were quite expensive and received very healthy valuations. I think that's where we are at the moment: there's a lot of money available but not a lot of assets around.

How is this playing out at 3i?

Like most of our competitors, we would like to do more deals. We are finding it difficult to find good targets with attractive valuations, because valuations are generally pretty high and robust. It helps with the exits though – we sold Hilite two months ago in a very attractive M&A market. It was bought by a Chinese trade buyer and I think there was a lot of confidence and money out there that allowed us to run a competitive process and achieve a good price. This could help in the future too as, with a portfolio as big as 3i's, we are always looking at selling businesses.

“If you compare Germany to France today, it really has gained in competitiveness. So we have strong hopes for the current vintage”

How do you view the recent decline in Germany's GDP?

In principle, the German economy is still pretty robust. You don't really see the impact of being 0.2% down in just one quarter's results; you shouldn't put too much weight on it. Here in Germany we expect

to grow between 1.5-2% this year and this is pretty good compared to European standards. The UK is probably growing faster than that but there are a lot of countries who are not seeing such rates of growth. All in all, I think we are looking at a robust macroeconomic landscape.

What about the debt financing available in Germany?

There are a lot of players outside the traditional sources from whom you can get money. I think really there's just a lot of money out there in different asset classes trying to get a return and the debt market remains pretty buoyant and strong as well.

With regards to the main lenders in the space, DZ Bank, IKB and Commerzbank have all been pretty active in the alternative lending space.

Does German private equity still tend to rely mainly on banks or are alternative lenders getting a look in?

I can't speak for everybody, but at 3i we have tended – so far – to stick with the traditional lenders. If you do traditional deals – nothing too fancy – then in my opinion you are best placed with them. And we have known them and worked with them for many years.

There is nothing wrong with the alternative providers but, at 3i, we see no necessity to work with them. We are, of course, open to new offerings in the marketplace but so far traditional lenders fully satisfy our needs.

What would you like to see happen in the German market?

Perhaps more quality dealflow – good, interesting, primary dealflow. ■

Dealflow dallying

Akina Partners principal Christian Böhler talks about the effect of low deal activity on the volatile German market



Christian Böhler,
Akina Partners

“The DACH region has been a solid midfielder in terms of performance compared to other European markets”

How much confidence is there in the German market at present?

In the broader European context, international investors are deploying money into Europe, and Germany is still one of the first choices for investment. Macro-wise, the German-speaking region is very solid; there's a good forecast, unemployment rates are low and you have a lot of market-leading companies and technologies in the country. It's also still seeing positive growth compared to peripheral Europe.

But looking at private equity specifically – I think the picture is less positive for Germany. It is still lacking in terms of private equity penetration and deal-making is behind the most mature markets, which are the UK, France, Scandinavia and Benelux.

Has the German buyout market fully recovered from the financial crisis?

Deal activity has been remarkably flat in German-speaking Europe since the crisis. For example, we currently have about 100-120 private equity deals per year in Germany; before the financial crisis that was more than 200. Ten years ago people thought Germany was going to pick up but it never has. And if I look at German players I see the usual suspects – the number of players has been at a relatively stable 80-100 in the last 5-10 years.

What is the outlook for a GP wishing to raise funds in the current environment?

About 30% of GPs raise funds relatively easily in a short space of time; the top ones are even oversubscribed. The middle segment, which comprises 30-40% of GPs, are able to raise money but it takes a long time – more than a year in most cases – and they typically don't reach their target size, maybe raising 60-

90%. It's not an easy fundraise. The last third struggle heavily, fail completely or take a huge amount of time, say two years.

How have the German fund managers that you have invested in fared?

We have been investors in the DACH region for around 15 years and have invested with a sizable number of fund managers, in various strategies and deal size brackets. On average, the DACH region has been a solid midfielder in terms of performance compared to other European markets. It is better than the performance we have seen in peripheral Europe – the south and CEE – but is probably lower than the best-performing markets like Scandinavia and Benelux.

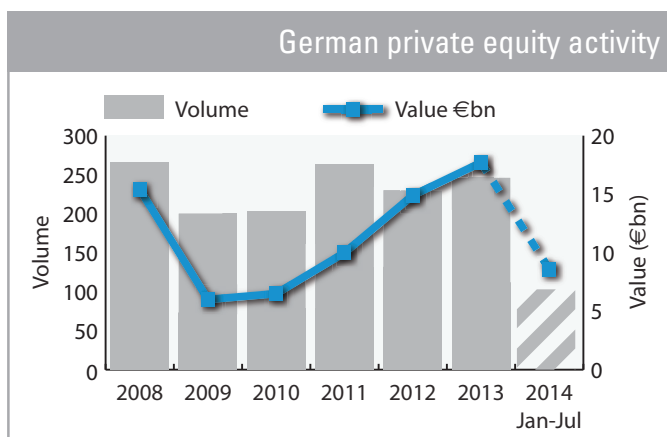
The difference between fund managers also seems to be higher than in other large markets like France and the UK; given the less mature experience curve, some groups had to learn lessons first, such as entering the leverage trap pre-financial crisis or fine-tuning their financial engineering skills in general. In addition, the German economy is more cyclical given its strong export and manufacturing base; this is consequently mirrored in underlying fund returns.

Have any of the German managers you are invested in requested fund extensions given the lack of dealflow in the country?

We have seen that quite regularly in the last four to five years. This is a consequence not only of a lack of quality dealflow but also of funds being raised that are too large. We therefore place a strong focus on fund size during due diligence and, in case of doubt regarding deployment capacity and ability, we have no qualms about declining what looks to be an attractive investment opportunity. ■

STATISTICAL COMMENTARY

By Vidur Sachdeva



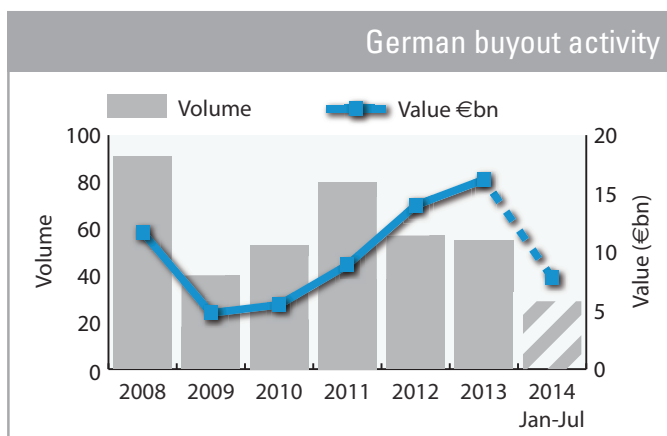
Rise to the challenge

German private equity activity was solid during 2013 due to sizable deals during the first half of the year – 246 transactions worth €17.7bn were recorded, marking an improvement of 16 investments and €2.8bn from 2012. If the late rise in aggregate deal volume during the second half of 2013 is an indication of how things might progress during the remainder of 2014, year-end figures should level last year's total. Total deal value also looks set to exceed 2013's aggregate – and if it does, it would be the sixth consecutive year in which an improvement in total deal size is reported. All this however depends on whether the supply of attractive investment opportunities can pick up, as pointed out by several market players in this report.



Bigger slice of the pie

Germany's dealflow remained stable at around 15% of overall European activity in 2013. However, a relative slowdown in French dealflow meant that for the first time in several years Germany overtook France volume-wise by a 9% margin. The German industry ended the year in second place with the UK at the top of the league table volume-wise. However, aggregate deal value in Germany has dramatically outpaced Europe at large. Germany has more than doubled its share of the value pie from 8% in 2011 to 17% in 2013. With three €1bn+ buyouts recorded during the second quarter of 2014, Germany strengthened this trend even further in 2014 – accounting for €1 out of every €5 invested in Europe during the period from January to July.

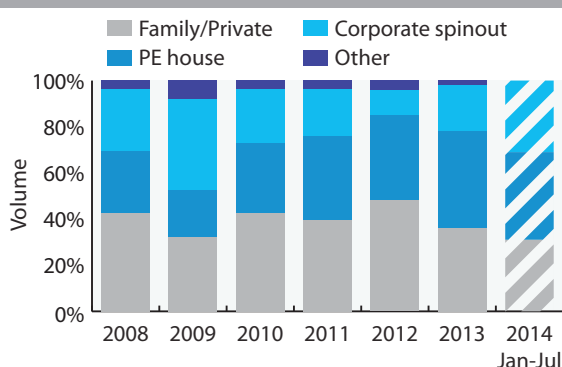


Mittelstand-still

Contrary to expectations, buyout volume in the Mittelstand has been disappointing since the end of 2011 – shedding a different light on the rise in overall private equity dealflow (see previous chart). As a result, the strong recovery that marked the 2009-2011 period took a sharp turn for the worse in 2012 when Germany's aggregate buyout volume declined by 29%. Exacerbating the situation further, even fewer buyouts were recorded in 2013 and 2014 (Jan-Jul). However, total deal values tell a different story, rising for the fourth consecutive year in 2013 and more than tripling since 2009. The prospect of concluding 2014 near 2013 values seems likely as deals worth €8bn were recorded by the end of July. This surge in German buyout size does challenge the UK's long-standing reputation as the largest European buyout market (value-wise).

Source: unquote data

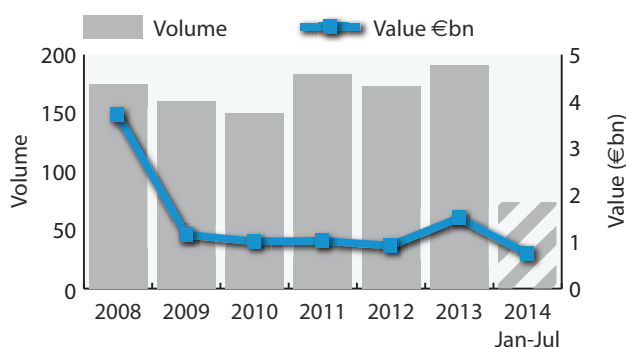
German dealflow by vendor type



Primary concerns

The post-financial crisis German market has seen a significant shift in the sourcing department. The number of deals sourced from family/private investors declined by 38% from 2010-2013 – and year-end 2014 estimates are set to decline further. Similarly, corporate spin-offs were down 32% between 2010-2013. As noted by Permira's Jörg Rockenhäuser (*see page 2*), perhaps 2014 might be a better year for corporate spin-offs – the number of deals sourced from these vendors during the first seven months already equals 82% of 2013's year-end level. On the other hand, it has been an altogether different story for deals sourced from other private equity houses – aggregate volume and values have steadily recovered since the crisis, surpassing 2008 levels.

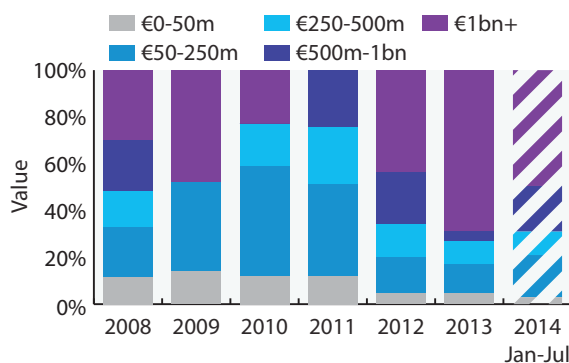
German early-stage & expansion deals



Stunted growth

Last year saw early-stage and growth capital investments sustain a trajectory of solid recovery volume-wise. Investment volume exceeded 2008 levels by 9% (+18 deals, 191 in total). Since the financial crisis, aggregate deal volume had declined to 150 deals in 2010 but has grown steadily since then. However, barring a boost in deal volume during the second half of 2014, year-end estimates are likely to fall short of the 2013 level as total deal volume from January 2014 to July 2014 represents only 38% of the aggregate deal volume seen last year. Total deal values also increased during 2013, jumping by an impressive 64% relative to 2012 (from €920m to €1.5bn). Furthermore, it seems likely aggregate deal value in 2014 will match 2013 estimates.

German deals by size range

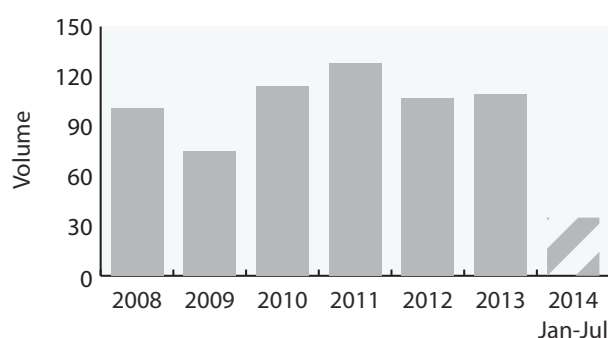


Mecca of the mega-deal

Deals valued at less than €50m accounted for only 5% of total deal value during 2013, down from 12% in 2008. Similarly, deals in the mid- and large-cap segments (€50m-€1b) have also declined from 58% of all transactions value-wise to 26% in that same period. On the other hand, €1bn+ deals have risen from 30% in 2008 to 69% in 2013. This year is so far seeing an easing of this trend to some extent with aggregate deal value split 50/50 between €1bn+ deals and mid-market deals. The shift to larger deals was also witnessed in volume terms, albeit to a lesser extent. €1bn+ deals have risen from 2.5% to 10% of total deal numbers between 2009-2014; small deals have declined from 68% to 31%. Five of the 10 largest European buyouts from January 2013 – July 2014 were done in Germany – more than any other country.

Source: unquote® data

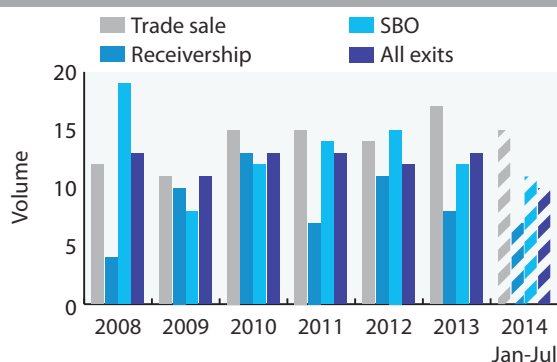
Volume of German exits



Know your exits

German exit volume has witnessed its fair share of volatility over the last few years. After declining by 25% from 2008-2009, the number of exits recovered dramatically over the following three years – rising by more than 71% from 2009-2011. However, hopes of a sustained recovery did not last long as 2012 witnessed a 20% decline. Last year did not prove to be much of an improvement either – only 2 more exits were recorded in 2013 compared with 2012. This year could see the aggregate volume of divestments drop even further, as only 35 exits were registered in H1 2014. That said, exits in the German industrial sector are the only exception to this trend. Divestment volume in this sector has grown dramatically, up 153% between 2009-2013.

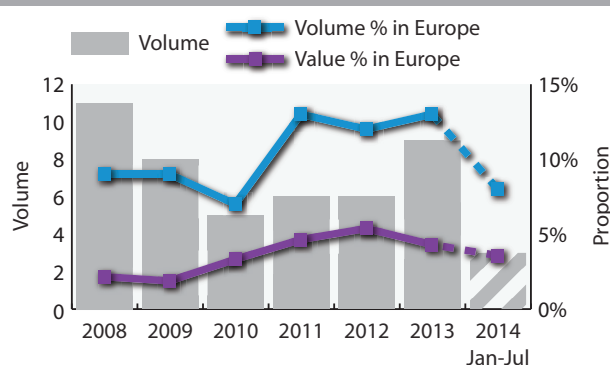
German exits as percentage of European total



Tricks of the trade sale

German businesses have become increasingly attractive to strategic buyers. German trade sales accounted for 17% of Europe's total exit volume in 2013 before declining (modestly) to 15% in H1 2014. This still compares somewhat favourably to the 14% recorded in 2012. The exit route was yet again the most preferred in the country, accounting for 43% of all German exits in 2013. On the other hand, trade sales in Europe at large accounted for 38% of the total exit volume in the continent. The €2.3bn sale of KKR's ingredients provider Wild Flavors to Archer Daniels Midland has been the largest German trade sale in 2014 so far – it was also the second largest trade sale in all of Europe. Overall, Germany's share of total exits in Europe has remained relatively stable over the years, fluctuating between 11% and 13%.

German private equity funds reaching final close



Money in the bank

The number and aggregate size of funds closed in Germany have recovered steadily since the financial crisis. After the nadir of 2010 when five funds were closed, 2013 saw fund closes returning to 2009 levels with eight final closes. Meanwhile, overall commitments more than tripled from 2009-2013 (€613m to €2bn). However, year-end 2014 numbers are likely to be relatively disappointing value-wise – only three fund closes amounting to a combined €646m were recorded by the end of July. Germany's share of the total number of funds closed in Europe declined from 13% in 2013 to 8% in H1 2014. The decline in Germany's share coincided with a surge in France and Norway's share of the total European fundraising volume.

Source: unquote data

Top 10 German deals 2014 (Jan-Sept)

Deal name	Deal date	Deal value (€m)	Sector	Equity
Minimax	Jun 2014	1,370	Electronic & electrical equipment	Intermediate Capital Group
GEA heat exchanger business	Apr 2014	1,300	Industrial engineering	Triton Advisers
Mauser	May 2014	1,200	General industrials	Clayton Dubilier & Rice
CABB International	Apr 2014	800 est	Chemicals	Permira
Alstom auxiliary components business	Apr 2014	730	Electricity	Triton Advisers
GHD GesundHeits Deutschland	Jun 2014	500 est	Healthcare equipment & services	Nordic Capital
Delivery Hero	Sep 2014	267	Software & computer services	Insight Venture Partners, Kite Ventures, Vostok Nafta Investment
ASK Chemicals	Apr 2014	257	Chemicals	Rhone Capital
Schleich	May 2014	220	Leisure goods	Ardian
Performance Interactive Alliance	Mar 2014	150-250 est	Media	Equistone Partners Europe

Source: unquote™ data

Top 10 German exits 2014 (Jan-Sept)

Deal name	Deal date	Deal value (€m)	Sector	Vendor
Rudolf Wild & Co	Jul 2014	2,300	Food producers	KKR
Minimax	Jun 2014	1,300	Support services	IK Investment Partners
ProSiebenSat.1 Media	Jan 2014	1,260	Media	KKR, Permira
Versatel Deutschland	Sep 2014	1,250	Telecommunications	KKR
Mauser	May 2014	1,200	General industrials	Dubai International Capital
CABB International	Apr 2014	800 est	Chemicals	Bridgepoint
Deutsche Annington Immobilien	May 2014	585	Real estate investment & services	Terra Firma
GHD GesundHeits Deutschland	Jun 2014	500 est	Healthcare equipment & services	IK Investment Partners
Stabilus	May 2014	490	Automobiles & parts	Triton Advisers
Vinnolit/Vintron	May 2014	490	Chemicals	Advent, M2 Capital Management

Source: unquote™ data

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