Angie in Wonderland: Assessing Foreign Direct Investment and Private Equity in Germany for 2005

Thumbs up for the latest and very promising figures for capital flows into Germany: Europe's export champion is back in the focus of investors again, and 2005 saw rebounding investment activity and the greatly discussed increasing investment from PE. If the interest rates do not rise considerably, foreign private equity corporations will continue to invest in Germany. The reasons for their investment also lie in the improved efficiency of German enterprises and their better market position. Thus, German companies are moving ahead in international competitiveness compared to other European industrial powerhouses in costs per unit, to name just one indicative figure. The unit costs are up only in finance and other services (at 108 compared to 100 in 2000); in manufacturing, they were at 92 (compared to 100 in 2000) in Q2 (having fallen steadily from 2001 onwards).

Foreign net capital investment grew by €285.7bn up until October 2005, mostly from EU countries, but only €19bn was transferred as FDI. In the strong years of FDI – such as in 2002 – they made up a quarter of the investment total. Portfolio investment represents the lump sum of this huge amount, totalling €186.6bn or 65%. The cross-border credit activity is also quite considerable at €89.5bn or 31%, mostly in short-term credits.

The capital flows from the UK stood at €300bn in October 2005, which corresponds by and large to the years before – €267bn in portfolio investment and €37.2bn in mostly short-term credits. Nevertheless, according to the Pink Book, more than portfolio or direct investment, 75% of UK securities owned in Germany were other investments, i.e. trade credit, loans, or currency and deposits.

British direct investment in Germany looks less promising this year with a capital drain of €4bn for Q1-3 with €1.15bn accounting for non-reinvested earnings. The positive sum of €2.6bn in reinvested earnings could not offset the general withdrawal of invested capital. The widely-discussed law introduced in 2004, which redefined corporation tax deductions for capital costs of national or international holdings, gets all the blame for this general development of funds migration. The law states that equity capital has to be at least 40% (previously 25%) and leads to increased fund flows into German subsidiaries to reach that level. So, in October 2005 €6.3bn was invested in Germany – €3.5bn as inter-company loans and €2.7 as equity capital. This financial restructuring process from credit-based finance to equity-based finance has been increasing for years.

According to a very recent study on private equity activity in Germany, published by Ernst & Young in December last year, PE transactions rose from 113 in 2004 to 133 in 2005 – a dazzling 18% with a total investment sum bigger than ever before, reaching €29.5bn or 26% more than the year before. And this figure only reflects the 48% or so of transactions with published values; the other half remains hidden from the general public. Experts assume that many small-volume transactions by German funds remain undisclosed. The UK was the top PE investor in Germany in 2005. With regard to the lamentable locust debate, it would seem appropriate to look at a more comprehensive picture below.

In 2005, one in four (leveraged) buy-outs was PE-driven. More and more of them were secondary buy-outs, which means that they pass from one PE ownership to another. Later than the UK and the US, Germany is in this period of transition in company finance. Traditionally, companies in Germany were debt-financed which resulted in close ties between the respective merchant bank and the German SME. The advantage of this system was relatively low costs compared to equity-based finance, and a long-term relationship that guaranteed sustainable growth and liquidity. For a number of reasons, this old system is being replaced by equity-based company finance well-known in Anglo-Saxon business culture. For one thing, Basel II regulations on debt-equity ratios and the resulting interest based on risk assessment. Furthermore, the globalised competition and consequential consolidation in the financial services changed the cost structure of German banks and made cross-border investment more interesting and profitable.

When assessing the influence of PE in any economy, Hamlet may be of help: "There is nothing either good or bad, but thinking makes it so." So, in times of transition, politicians, employees, managers or consultants may be lured into qualifying the unknown and complex as good or bad. One thing, however, is clear: The plethora of defensive statements and the massive publication of data corroborating the positive effects of PE is remarkable, and seems to indicate how difficult it is here for PE to assert itself.

All publications in this area prove that PE capital increased employment in all areas but one – companies that have to restructure. In a recent study by the EVCA (European Private Equity & Venture Capital Association) the employment effects of their dealings provide evidence contrary to the locust theorists: average employment in PE fostered companies has grown by 5.4% from 2000 – 2004. In other listed companies, the EU growth rate totalled a mere 0.7%.

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It is futile to try and whitewash the black sheep in the market. Some instances seem to indicate that the respective PE could have done more or better, mostly in the field of employment. There are negative examples, though, mostly from the US, and most of those companies refused to take part in the EVCA study. The so-called "black sheep" took over Grohe, MTU Aero Engines, and Edscha (in whose case we do not get any financial data available after the business year 2003-4, acquired in January 2003 offering a 7% premium to shareholders).

Last year's publication mentioned DNICK Ltd (now DNICK Holding plc) as an example of British FDI in Germany. The company, formerly Deutsche Nickel AG, had been in troubled water with the prospect of insolvency and a break-up in December 2005. Because of the new structure and the British headquarters, 900 of 1100 workers remained employed and only one of the various companies, Eurocoin, had to shut down. This example may serve as a case-in-point that investors, of course, seek their return on investment, but they also guarantee the continuation of those formerly struggling companies. None of these or other investments, however, remain unattacked by the employees of the respective companies, individual shareholders or medium-sized investment funds (e.g. the Niedersächsischer Aktienclub GbR).

Rates of return, turnover (an average of 10% not including the dazzling seed and start-up growth rates) and gearing is better with PE capital involved. The gearing of normal companies is at 18%; those of PE-owned or part-owned companies is between 28 and 30%, guaranteeing better ranking under the Basel II regulations and sustainable growth. Available capital is limited, with banks as external fund providers showing the tremendous advantage of PE companies as both company owners and providers of capital.

There are diverging strategic assessments of PE investment when it comes to the time factor. Whereas a recent study by Ernst & Young assumes the reduction of the length between investment and divestment or exit, proposing 18 months to two years maximum, a study by PwC and the BVK (German Private Equity and Venture Capital Association) stresses the validity of the findings in academic literature that a period PE involvement between four and seven years seems more appropriate. Since those studies do not provide any details and little independent research has been done – and considering the short history of PE investment in Germany – both may be right in their assessment.

The upshot of an assessment based on the little we know so far about PE investment is not a mixed picture. The influence on the economy is largely positive, and expecting profits on the part of the participating investor groups is not disgraceful. In fact, some are just realising another positive effect; namely that Gordon Gekko may have spoken the very truth in the film Wall Street when he said, "Greed is good …Greed is right …Greed works". To demonstrate this point, consider instances like William Ackman from Pershing Square Capital Management putting pressure on McDonald's, suggesting that they were not using their assets to the best advantage of the shareholders. Or Jerome York, an adviser to Kirk Kerkorian, suggesting that pay cuts for the management and the shareholders (intended to get GM back on track) will be beneficial to everyone in the end, because they attack mismanagement that no one dared to criticise before. The corporate world is also in a period of transition and stakeholders have just begun to realise that.