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GERMANY

The funding gap facing German PE

Worried that its venture capital market is lagging its European neighbours, the German government is doing all it can to provide more start-up support, says Andreas Rodin of P+P Pöllath + Partners

***Rodin**: Germany's exit environment is regarded as 'difficult' by investors*

After a record year in 2017, it is perhaps no surprise that the private equity market took a breather in Germany in 2018. But the main talking point was not the dip in fundraising, but on where that capital is being invested – in particular the lack of venture capital for start-ups. There was also a heated debate in Germany about exit-related issues, especially what happens when a tech company falls into foreign hands.

That coupled with some pressing tax issues, notably proposals for tax relief for R&D expenses and an ongoing discussion over whether VAT should be levied on the management of private equity funds, made it a busy 12 months in the German private equity market.

After a record 2017, fundraising fell back in Germany last year, according to the 2018 report from the German Private Equity and Venture Capital Association (BVK) released in February. Fundraising dropped by 11 percent from €3.08 billion in 2017 to €2.74 billion in 2018. Venture capital fundraising was down 24 percent to €1.227 billion; buyout fundraising fell 20 percent to €826 million; and growth capital/mezzanine funds raised €395 million, down 11 percent.

The BVK figures are the most comprehensive data on the German private equity market, as they are derived from the European Data Cooperative – a non-commercial joint pan-European platform that covers leading European private equity associations including Invest Europe. EDC is the single data entry point for the members of the participating private equity associations and applies a standardised methodology thereby generating consistent, robust and comparable market data for the different regions in Europe.

The BVK's breakdown of investor groups via their commitments in 2018 shows that public sector bodies contributed 45 percent of the capital, pension funds (mostly non-German) 12 percent, family offices (mostly German) 9 percent, foundations and academic endowments (mostly non-German) 7 percent and insurance companies 3 percent. German investors represented 46 percent of the total, investors from elsewhere in Europe 31 percent and non-European investors 23 percent.

The total amount invested in 2018 in German portfolio companies fell by 18 percent from €11.68 billion in 2017 to €9.57 billion in 2018, according to the BVK figures. There was, however, a slight increase in the total number of German portfolio companies backed by private equity and venture capital from 1,197 in 2017 to 1,222 in 2018.

Buyout investments represented 70 percent of the total amount invested, growth capital 16 percent and venture capital 14 percent. But 55 percent of all portfolio companies received venture capital, against 33 percent for growth capital. Only 12 percent were the subject of a buyout transaction. This discrepancy between the amount invested and the number of portfolio companies that receive the different types of capital continues to be a characteristic of the German private equity market.

The data is categorised into corporate sectors, where there are also notable differences between value invested and the number of investments. For example, the business-to-business sector received 24 percent of total investment but only accounted for 18 percent in terms of the number of portfolio companies invested in. Companies engaged in information, computer and electronic technologies also received

24 percent of all investment, but accounted for 32 percent of the portfolio companies; biotech companies accounted for 16 percent of investment and 13 percent of the portfolio companies; companies focusing on energy and environmental technologies had 16 percent of the investment value but just 3 percent of the total number of portfolio companies.

There is a similar picture when the data is split by sales volume. Seven percent was invested in companies with total sales of up to €1 million, but these firms represented 53 percent of all the portfolio companies; 6 percent of capital went to companies with sales of €1 million-€10 million, but this represented 26 percent of portfolio companies; 29 percent was invested in companies with total sales of €10 million-€50 million, representing 13 percent of portfolio companies; 24 percent was invested in companies with sales of €50 million-€100 million but this went to only 3 percent of portfolio companies. So it goes on: 18 percent was invested in companies with total sales of €100 million-€250 million, but this was just 3 percent of the portfolio companies; 16 percent was invested in companies with sales of €250 million-€500 million, representing only 2 percent of the total number of portfolio companies.

The same is true when company size is broken down by workforce size: 4 percent of the total was invested in companies with up to 19 employees, but this represented 42 percent of the total number of portfolio companies; 15 percent was invested in companies with up to 99 employees representing 35 percent of the total number of portfolio companies; 36 percent was invested in companies with up to 499 employees representing 18 percent of all portfolio companies; 10 percent was invested in companies with up to 999 employees, representing 3 percent of the total number of portfolio companies; 35 percent was invested in companies with more than 1,000 employees, representing just 2 percent of the total number of portfolio companies.

In terms of divestments, the total amount of exit proceeds in 2018 dropped by 44 percent from €5.71 billion in 2017 to €3.21 billion in 2018. Trade sales represented 34 percent of the total in 2018 against 46 percent in 2017. Secondary buyouts represented 38 percent in 2018 against 36 percent in 2017. Sales via IPOs represented 12 percent in 2018 against 4 percent in 2017.

START-UP FINANCING

One of the big discussion points in Germany is the relative lack of venture capital. This is one of the issues dealt with by the Expert Commission for Research and Innovation in its 2019 annual report.

There is little doubt that Germany has become more attractive for international venture capital investors over the last 25 years. Around 20 percent of German startups received funding from at least one US venture capital fund between 1992 and 2018. However, the total amount of venture capital investment still lags the rest of Europe when expressed as a percentage of the gross national product. According to an analysis by Invest Europe, venture capital investment was equivalent to just 0.035 percent of German GDP in 2017, against figures of 0.075 percent or more in Finland, France, the Netherlands, Sweden, Switzerland and the UK.

The Expert Commission suggested three reasons why Germany is lagging its European neighbours. »

One of the big discussion points in Germany is the relative lack of venture capital

SLIPPING BACK

Fundraising fell in Germany last year

Venture capital fundraising
↓24%
to €1.23 billion

Buyout fundraising
↓20%
to €826 million

Growth capital/mezzanine funds
↓11%
to €395 million

Source: German Private Equity and Venture Capital Association (BVK)

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NO ANCHOR INVESTORS, SMALL FUND SIZE

There are no German institutional investors that assume the role and function as anchor investors in the venture capital market and give signals to international investors. Moreover, pension funds and private pension schemes do not represent an important group of institutional investors because of the way pension commitments are funded in Germany. As a consequence, German venture capital funds are too small for larger institutional investors. For this reason, German insurance companies are more focused on the much larger venture capital markets in the US and Asia. That has damaged the track record of German managers compared with their international competitors.

This has resulted in a funding gap for German start-ups. In order to close the gap, the German federal government and the German federal states have established several programmes co-funded by the European Union to attract private investment into venture capital funds and start-ups. The most important of these are:

- High-Tech Gründerfonds focusing on early-stage investments. Its third fund started operations in 2017 with capital of €316.5 million.
- INVEST-Grant for Venture Capital, which is funded by the German Ministry for Economic Affairs. It provides tax-exempt grants to private investors, especially business angels, as well as partial relief from income tax on capital gains realised upon exit.
- The €85 million Mikromezzaninfonds-Deutschland fund co-funded by the German ERP Special Fund and the European Social Fund. The capital is for small enterprises and comes via silent partnerships.
- The ERP-EIF Facility co-funded by the German ERP Special Fund and the European Investment Fund. It has more than €3 billion for investment in venture capital funds focusing on German technology oriented SMEs.
- The €570 million European Angels Fund-Germany co-funded by the German ERP Special Fund, the Bavarian LfA and the European Investment Fund. It offers co-funding to business angels.
- The €400 million ERP-Venture Capital Fund Financing programme funded by the German ERP Special Fund and managed by KfW; its focus overlaps with the ERP-EIF Facility.

In addition, the German federal government is negotiating with the German insurance industry on funding models to encourage the insurers to offer larger commitments to German funds investing in venture capital. In its report, the Expert Commission cites the Danish model Dansk Vækstkapital as an example of how a public-private partnership can succeed in allocating large amounts of capital to start-ups and SMEs.

TAX-RELATED OBSTACLES

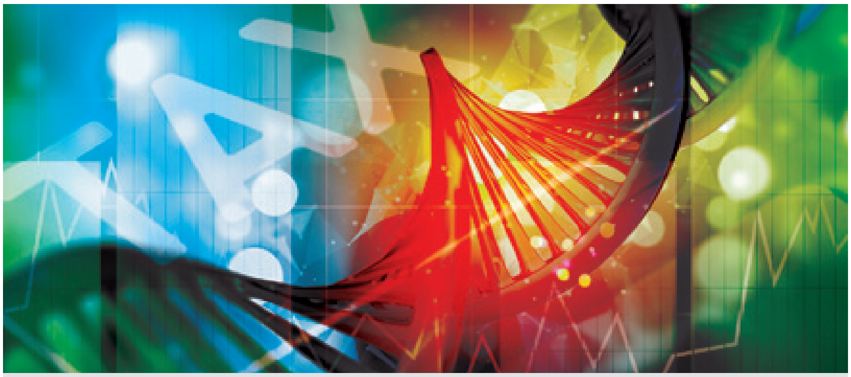
Some of these have eased in recent years. For example, in 2016 the rules were eased on the use of a tax loss carry forward in the event of admission of more than 50 percent of new shareholders during a consecutive five-year period. But the German decision to levy value-added tax (at the current rate of 19 percent) on the management of private equity and venture capital funds remains a major obstacle to establishing funds that are managed in Germany.

EXIT-RELATED ISSUES

Trade sales and IPOs are the most important exit channels for venture capital investors but the German exit environment is regarded by investors as difficult. In order to reactivate the stock exchange as a financing source for young growing enterprises and as an exit channel for investors, Deutsche Börse established the Venture Networks in 2015. This has helped: $2.4 billion has been invested in Venture Networks companies, resulting in seven IPOs, and in March 2017 Deutsche Börse set up a dedicated SME segment called Scale. Another positive sign was the first IPO of a High-Tech Gründerfonds investment: NFON in May 2018, coupled with the listing of another German high-tech company Home24 in June 2018. While this represents progress, German start-ups still struggle with specific challenges due to their small size and because their business models can restrict IPO possibilities and the structuring of subsequent financing rounds in the stock exchange.

The BVK data show a sharp fall in exit proceeds in 2018: trade sales down by 58 percent in value terms and secondary buyouts falling by 41 percent on 2017 figures. Exit-related issues have become a sensitive subject in Germany. The federal government is concerned about trends in the market because of the negative impact on the German economy as a whole. One trend currently under review relates to the large number of business models based on technology originating from Germany that are sold to purchasers from countries that offer foreign companies only limited access to their domestic market, or to foreign purchasers that take control over the technology by moving the business out of Germany or use the technology to promote their own businesses in ways that don't enhance the German economy.

The first response to the German federal government's concerns was the ninth amendment to the German anti-trust act subjecting acquisitions of German companies with sales of less than €5 million to anti-trust clearance if the total purchase price for the business exceeds €400 million.



PROPOSED TAX RELIEF FOR R&D

Germany is one of the few OECD countries that does not provide tax relief for R&D expenses. After long discussions with the industry, the German Ministry of Finance has published a draft discussion on tax-related support for R&D. In order to accommodate both taxable R&D-related losses at start-ups and taxable income for companies providing support, the relief will be structured as a tax-exempt grant, rather than as a tax credit or tax allowance. These grants are available to individuals and corporate taxpayers and to tax transparent partnerships. An appendix lists the full criteria, but, broadly speaking, the entity must be conducting basic or industrial research or experimental development in a permanent German establishment.

The tax grant for each eligible project is granted annually and is equivalent to 25 percent of the aggregate of the taxable compensation payable by the applicant to its employees involved in the project, subject to a maximum of €2 million per annum and per entity. If projects are carried out by multiple entities belonging to the same group then the €2 million threshold applies across the entire group of related entities, which means that the maximum tax grant (25 percent of €2 million) is €500,000 per annum to be divided between the related entities. To comply with the European state aid rules, the total tax grants per eligible entity and project shall not exceed a total of €15 million.

The new legislation still needs to be approved by parliament in 2019 but is set to apply to projects commenced after 31 December 2019 until 31 December 2023.

> ***There are no German institutional investors that assume the role and function as anchor investors in the venture capital market***

While the Expert Commission recognises the concerns that unequal market access and market distortion by public foreign companies may have an adverse impact on the market position of German companies, it emphasises the importance of unrestricted capital and technology transfer to spur innovation and economic growth.

The concerns addressed by the German federal government are shared by certain members of the European Union, in particular France, and discussions are currently pending on how to ensure that domestic funds supported with public money can structure exits through sales to domestic buyers.

Given the specific weaknesses of the German venture capital markets – the lack of German institutional investors acting as anchor investors, the small size of German venture capital funds and the paucity of the track records of German managers – publicly-funded programmes are concentrating their efforts on providing more support to German and European venture capital funds to increase their attractivity compared with the large non-European financial investors.

Losing control over business models and technologies originating from Germany does not only occur once the company is exited, but also in the high-volume growth financing rounds where the small German venture capital funds are significantly diluted. Moreover, the cooperation between start-ups and other companies – particularly the more mature medium-sized and large companies – regarding the technology and business models needs to be improved if the start-ups are to be attractive for the new segments established by Deutsche Börse and Euronext or for a trade sale.

R&D SUPPORT PROGRAMMES

Various public institutions provide R&D support for start-ups but the Expert Commission pinpoints difficulties in accessing this funding. To comply with the administrative requirements is a challenge for young start-ups, a challenge made more difficult by the different requirements of each programme. Moreover, each applicant has to produce financial statements to access the funding. Start-ups can't always provide the required evidence and there are significant differences in what each programme requires. ■