

**THE CHALLENGES OF
GERMAN TURNAROUND INVESTING**

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1 EXECUTIVE SUMMARY

This paper aims to give a perspective on the German turnaround investing market, by analyzing its market potential, challenges and future outlook

In our research, we encountered a severe lack of public information, thus we have conducted a series of 10 interviews. Our thanks goes to all individuals who have shared their time and expertise and have significantly contributed to making this paper possible. Please see Appendix 7.1 for a detailed list of interviewees.

The market potential for turnaround investing has seldom been better. The stagnant German economy has led to a rise in the number of bankruptcies and low corporate performance. High returns will be achieved through turnaround investing as the competitiveness of traditional LBO markets increases and leverage and multiple expansion levers are decreasing in importance.

In Germany, turnaround investments are typically structured as majority equity stakes that are accompanied by significant amounts of debt. Investors have developed specific investment criteria and approaches in order to ensure the success of their activities.

The hurdles to being active in the German market, such as labor law or the lack of management talent seem less limiting after a more detailed analysis. Management talent will be moving into *Mittelstand* companies stemming from lacking opportunities elsewhere. Germany's restrictive labor law actually allows for personnel adjustments during a

restructuring at predictable costs, and the insolvency code theoretically allows for Chapter 11-like restructurings.

2 THE GERMAN DISTRESSED MARKET

The German turnaround or distressed market has been getting a high amount of attention due to the potential offered by the decline of the German economy, the rise in the number of bankruptcies and the low economic performance of German companies. Particularly the German middle market, or *Mittelstand*, is expected to fall increasingly into distress due to a predicted increase of financing costs following the introduction of the Basel II regulations.

2.1 Private Equity Market

The European private equity and venture capital industry has shown a steady investment rate, while fundraising has declined. European fundraising during 2002 led to €19.4bn being raised (€38 in 2001), compared to €27.2bn (€24bn in 2001) being invested. While there has been a high level of late-stage buyout deals, early-stage investment has declined significantly.¹

According to figures published by BVK, the German Venture Capital Association, the German private equity and venture capital market continued its 2001 decline in the first three quarters of 2002. The total amount of funds directly invested in the first three quarters of 2002 was €1.7 billion (€2.4 billion in 2001), showing a decline of almost 30%.² Total funds under

¹ “Preliminary Annual Survey1 figures indicate difficult fundraising, but steady investment in 2002”, EVCA Press Release, Geneva, 12 March 2003, published under [http://www.evca.com/images/ attachments/ tmpl_13_art_29_att_263.pdf](http://www.evca.com/images/attachments/tmpl_13_art_29_att_263.pdf), accessed May 2, 2003

² “Germany: recent developments in the private equity market”, Toth-Feher, Geza et.al, April 9, 2003, published by AltAssets.net under www.altassets.net, accessed on May 2, 2003

management in 2001, the latest BVK numbers, were €28.5 billion (€18.6 billion in 2000), an increase of 53.2 per cent.³

In 2001, out of a total of €4.4bn invested in Germany, €75 million or 1.7 percent went into turnaround situations at 70 companies with an average deal value of €1.1m, significantly below the average investment of €2.3 million in 2000.⁴ In 2002, distressed investments in Germany dropped to €46 million

2.2 Market Players

Distressed investors are individuals and institutions that invest in troubled companies with expectations of high returns. They execute smart equity or debt transactions. Their activities include buying shares at a discount to the market price, lending money at high interest rates, or making loans in return for a chunk of equity in the troubled company. By doing so, they create a situation in which they have better claims on a company's assets and income than do existing common shareholders.⁵

2.2.1 Investors in Germany

In Germany, there are four main categories of investors in distressed companies: German banks, independent funds, consulting-backed-investors and international funds.

³ German Venture Capital Association, published under <http://www.bvk-ev.de/stats2001.php/aid/70>, accessed on May 2, 2003

⁴ German Venture Capital Association, published under <http://www.bvk-ev.de/stats2001.php/aid/70>, accessed on May 2, 2003

⁵ “The New Warren Buffett Way: From value investor to vulture investor”, by Daniel Gross, Moneybox, accessed through <http://slate.msn.com/id/2070452/>, accessed on April 12, 2003

German banks are probably the most active distressed investors without being cognizant of the fact or ever declaring themselves as such. Through their historical ties with *Mittelstand* companies, Banks have built up a significant debt portfolio and have supported it through numerous follow-on investments. The four largest banks, Deutsche Bank, Dresdner Bank, Commerzbank and Hypovereinsbank hold the bulk of this portfolio.

National funds such as Orlando Management GmbH and Nordwind Capital are highly specialized players that see the turnaround segment as their key area of expertise. Nordwind, for instance, was formed as a Carlyle split-off by the American fund's departing head of Germany, Hans Albrecht. It has managed to raise a substantial fund of €300 million specifically target at turnaround situations.

Consulting Funds have started funds as an extension of former or current turnaround consulting activities. For instance, Capital Management Partners takes its origin from Roland Berger's Turnaround Practice. Dröge Management Consulting, another specialist for distressed situations, has also offered its own capital to its clients and is now looking to raise external funds through its subsidiary Deutsches Investors Capital. A new entrant in the sector is Advisum Capital Partners that is currently in the market to raise a turnaround fund to supplement its consulting practice.

International Funds can be split according to size. True turnaround player such as Alchemy and Compass Partners invest in smaller situations, while the global funds appear to cherry-pick large carve-outs from corporate failures. Examples of the latter activity are

Permira's acquisition of pay TV firm Premiere out of insolvent media company Kirch, and the failed attempts of TPG to buy out distressed bank Bankgesellschaft Berlin.

Year	Base	Fund	Key Deals
Nordwind Capital	Munich	€ 300m	Messer Welding & Cutting, Honsel
Orlando Mgmt. GmbH	Munich	€ 160m	Forstinger
Capital Management Partner	Berlin	€ 100m	Fleming, Schock, Feinkost Böhm
Compass Partners	Frankfurt, London	€ 200m (Europe)	
Deutsches Investor Capital (Dröge Mgmt. Consulting)	Düsseldorf	€ 100m (own funds)	Madaus
Alchemy Partners	London	NA	Fitness Chain, ECM.de
Advisum Capital Partners	Munich, Berlin, Hamburg	Raising	
	Total	~€ 800m	

Table 2.1: List of Raised Distressed Funds⁶

2.2.2 Intermediaries

To support restructurings, a number of advisors are active in Germany. The three most prominent specialists are: (i) Lazard, whose restructuring team worked on the Babcock Borsig insolvency, (ii) UBS Warburg, that worked on the Kirch Media restructuring, and (iii) Houlihan Lokey Howard and Zukan (HLHZ) that is rumored to be raising a distressed fund, Sunrise Capital, with a European tranche. However, a significant share of the restructuring advisory activity is being handled by the four large German banks: Commerzbank, Deutsche Bank, Dresdner Bank and Hypovereinsbank.

⁶ Dreyer, Norbert, Nordwind Capital, Telephone Interview, April 30, 2003

2.3 Distressed Market Potential

The German market has long been seen as being ripe for private equity investment. Particularly the *Mittelstand* has been regarded as a breeding ground for buy-outs. The resulting high level of interest from international funds has waned as Germany has not lived up to the inflated expectations. Several high profile investments have failed, e.g. Fairchild Dornier, a regional aircraft manufacturer, had to declare bankruptcy, leading to large write-offs for Clayton Dubilier & Rice and Allianz Capital Partners. Consequently, Clayton Dubilier & Rice has cancelled its plans to open an office in Germany. Several other firms, including Alchemy Partners, closed down their German offices due to their downward revised expectations of the market potential.⁷

However, we believe that several drivers are increasing the potential of the turnaround investing market: (i) traditional investing markets are highly competitive, (ii) historical value drivers, such as leverage and multiple expansion, are decreasing, (iii) a rising tide of troubled companies, and (iv) rising financing costs for middle market companies.

2.3.1 Competitive Traditional Markets

The LBO market in Europe has become highly competitive. The large amounts of capital that have been raised by global investors such as Warburg Pincus (\$5.3bn), Apax (\$4.5bn) and

⁷ Beckman, Tom; Alchemy Partners, Telephone Interview on May 1, 2003

Blackstone (\$6.5bn) have lead to a glut of capital. This has increased globally available funds to roughly \$250 billion.⁸

The resulting bidding wars have led to an increase in entry multiples. For example, in July 2002, Haarmann & Reimer (H&R), the world's fifth largest flavors and fragrances producer, was acquired by EQT for roughly 10 times EBITDA. The multiple inflation will lead to lower returns for traditional players that are active in the large cap segment.

2.3.2 Shift to New Value Drivers

A private equity firm can create value through a number of levers: (i) pay-down of financial leverage, (ii) multiple expansion, (iii) revenue growth and (iv) margin expansion.

Leverage has been the predominant driver of returns in the late 80s when deals such as RJR Nabisco were financed with up to 90 percent of debt. Paying down this debt through cash-flows allowed for extraordinary returns without any changes to the underlying business. Over time, banks have become less willing to take on the risks associated with excessive leverage, and the average equity contribution increased to 41 percent in 2002.

In addition, the multiple expansion in the public markets of the late 90s allowed private equity players to simply wait for entry multiple increase by a factor of two over 10 years before exiting their investments. The EBITDA multiples of 600 publicly listed German companies

⁸ "450 firms with more than \$250bn of committed capital ...that's nice for the seller, not so good for the buyer", Financial Times, April 2, 2003, page 11

rose from around 7x in 1990 to 12x in 1999, and then dropped back to 8x in 2001.⁹ These lower and seemingly more stable multiples make it increasingly difficult to reach superior returns.

Revenue growth and margin expansion will need to be the new focus of investors. The opportunity to create improvements is greater for struggling companies as they are starting from a low base. However, these companies also face a higher risk of failure and require better management skills to improve performance.

2.3.3 Rise of Number of Troubled Companies

The potential pool for turnaround investments has never been greater in Germany. The number of under-performing companies in Germany has skyrocketed in recent years. The stagnant German economy has led to a record number of corporate bankruptcies.

The German gross domestic product has been stagnating at €2 billion, a third of the European Union, over recent years. GDP projections by the OECD have been revised downward in April from an estimated real growth rate of 1.5 percent to only 0.3 percent for 2003.¹⁰ This is accompanied by an unemployment rate of 11.1 percent equivalent to 4.6 million of the working population.¹¹

Middle market German companies have been under-performing compared to their US peers. An analysis by Nordwind Capital states that 66.3% of the companies in the SDAX,

⁹ “Restructuring for Superreturns – Next Hype or the Art of the Obvious”, Nordwind Capital, Paper presented at the Super Return Conference, Munich February 26, 2003, Bloomberg

¹⁰ “OECD schmälert deutsche Wachstumsaussichten”, Financial Times Deutschland, April 24, 2003, published under www.ftd.de, accessed on May 2, 2003

¹¹ Statistisches Bundesamt, German Statistical. Bureau, Published on <http://www.destatis.de/wochenberichte/>, accessed on May 2, 2003

Germany's middle market index, have an EBIT below 3 percent compared to only 45.7% of the US' SML index. In contrast, only 4.8% of the companies in the SDAX boast an EBIT above 10% compared to as many as 21.3% in the US SML.¹²

Globally, the year 2002 has seen 234 companies defaulting on \$178 billion of debt.¹³ European defaulters constituted 4.2% of defaults by volume and 7% in number in 2002. In Q1 2003, Europe's speculative-grade investment default rate was at 2.3 percent, far greater than that of the U.S at 1.6 percent.¹⁴

In 2002, Germany experienced 7 out of the 10 largest European bankruptcies.¹⁵ In total, 37,579 German companies defaulted on outstanding claims of €61.5bn. Only \$2bn were linked to corporate bond defaults according to Moody's.¹⁶ In particular, larger and older companies declared bankruptcies. The average claim per company has risen from €0.5m in the 90s to €0.9m in 2001. Table 2.2 details the statistics and gives some examples

¹² "Restructuring for Superreturns – Next Hype or the Art of the Obvious", Nordwind Capital, Paper presented at the Super Return Conference, Munich February 26, 2003, Bloomberg

¹³ "2002 Defaults in Profile", Standard & Poor Report, Analyst: Brooks Brady, Publication date: 31-Jan-03, accessed on <http://www.standardandpoors.com>, accessed on April 12, 2003

¹⁴ "Global Default Rates Remain Above Average While Dollar Volume of Defaults Decreases in Q1 2003", Standard & Poor Report, Analyst: Brooks Brady, Publication date: 08-Apr-03, accessed through <http://www.standardandpoor.com>, accessed on April 12, 2003

¹⁵ "Pleiten in Deutschland: Der traurige Europameister", Spiegel, February 6, 2003, published on <http://www.spiegel.de/wirtschaft/0,1518,233989,00.html>, accessed on May 3, 2003

¹⁶ "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance, 1920-2002", Moody's Special Comment, February 2003, page 7

Year	Bankruptcies	Claims	Employees	Examples
1999	26.476	NA	NA	Philip Holzman
2000	28.235	€ 24.0bn	181,000	Flowtex
2001	32.278	€ 30.9bn	203,000	Kinowelt, Kabel New Media, Brokat, Wünsche, Kaufring
2002	37.579	€ 61,5bn	NA	Philip Holzman, Babcock Borsig, Kirch Media, Herlitz, Fairchild Dornier
2003 (H1)	18.500	NA	NA	Grundig

Table 2.2: Development of German Bankruptcies¹⁷

2.3.4 Increased Cost of Financing

Mittelstand companies are likely to face increased capital costs due to the implementation of the Basel Capital Accord, known as Basel II. While it will only become effective in 2006, most banks are already starting to manage their capital allocation accordingly.¹⁸

Up to now, banks have been operating under Basel I that draws no distinction between the amounts of capital a bank needs to allocate for different risk types of corporate loans. To increase returns German banks took on riskier loans as they carry better terms.¹⁹ The resulting low cost of capital has allowed German companies to have the highest debt/equity ratio of all major European countries, around 190%, which compares to only 80% in the UK.²⁰

Basel II will define amounts of capital that a bank must apply to individual loans based on the specific credit risk and operational risk. These assessments are based on bank internal

¹⁷ Statistisches Bundesamt, German Statistical. Bureau, Published on <http://www.destatis.de/wochenberichte/>, accessed on May 2, 2003

¹⁸ “Bankers fear Basle reiles will encourage ‘over-lendig’, by Charles Pretzlik, Financial Times, page 20, April 30, 2003

¹⁹ “Basel II sums up the future for credit risk”, by Charles Pretzlik, Financial Times, page 18, May 1, 2003

²⁰ “Why invest in Germany?”, Nordwind Capital, April 2003

estimates and will be reviewed in a dialog with supervisors and need to be disclosed to the public.

It is expected that this will increase the cost of capital for 41% of small- and medium-sized companies in Germany. This will present turnaround investors with opportunities to find companies that are struggling as a consequence of their increased cost of capital.

3 TYPES OF INVESTMENTS

3.1 Investment Strategies

Investors in distressed companies can pursue either active or passive strategies. A passive strategy is based on the conviction that a market inefficiency exists, i.e., that certain distressed claims are not correctly valued. The investor purchases an undervalued distressed security and then waits until the market discovers its mistake and the discrepancy between intrinsic and market value disappears (buy-and-hold strategy). An active strategy implies that the investor influences the future of the distressed company.

The steps an active investor takes to gain control depend on his individual assessment of the situation and the level of distress that the company faces. *Distress*, as we define the term for the purpose of this paper, is a very broad concept that may be applied to (i) strongly underperforming companies outside insolvency that need to be turned around through drastic operational measures or otherwise will get into financial trouble, as well as to (ii) out-of-court restructurings that require concessions from existing claimholders, and (iii) typical insolvency

cases. For these latter companies, rescue measures often focus on a reorganization of the capital structure.

Our research has revealed that the limited amount of distressed investing that currently takes place in Germany is predominantly based on active strategies and comes more or less exclusively in the form of turnaround equity. This is primarily due to certain differences between the German and the US insolvency codes (see Section 4.3.2) and an under-developed secondary market for distressed claims.

Turnaround investors in Germany have a strong operational focus. In order to exercise control and implement changes they typically gain majority stakes, e.g. Orlando wants more than 75% and board representation.²¹ Alchemy Partners told us that they micro-manage their German turnaround investment in ECM, a Munich-based SAP implementer.²² The Alchemy professional responsible for ECM meets with the company's management team every week to discuss progress in margin improvements and sales strategies. Alchemy Partners had bought ECM from a more conventional private equity firm that wanted to get out after the company had run into serious trouble. Generally speaking, failed LBOs from traditional PE funds often represent interesting acquisition opportunities for turnaround-oriented investors.

²¹ Orlando Management GmbH, "Investment and Management Consulting for Special Situations", p. 2. PowerPoint presentation, available on website of Orlando GmbH http://www.orlandofund.com/Images/firm_presentation.pdf, accessed on April 28, 2003

²² Tom Beckmann, Alchemy Partners, telephone interview by authors, May 1, 2003

Orlando is looking for “resolvable and understandable structural deficits” in its investment candidates.²³ It follows a clearly defined investment approach that distinguishes between problems that can be solved by the fund and those that cannot:

	Resolvable by fund	Not resolvable by fund
Internal	<ul style="list-style-type: none"> • Balance sheet issues after bad investments / uncontrolled expansion • Gridlock between management, banks and shareholders • Miscalculated major order / warranty claim • Management errors • Delayed portfolio restructuring 	<ul style="list-style-type: none"> • Outdated products / technology • Product quality problems • Outdated production systems • Aging, poorly qualified workforce
External	<ul style="list-style-type: none"> • Slowdown in industry-specific boom • One-off slump in a single market / product segment 	<ul style="list-style-type: none"> • High customer concentration • Competition from cheap labor countries • Product substitution • Market slump in core markets • Unfavorable regulatory changes

Figure 3.1: Orlando Management GmbH Investment Approach²⁴

²³ Orlando Management GmbH, p. 8

²⁴ Ibid., p. 8

Like Orlando, turnaround equity investor Nordwind knows that not every troubled company represents an attractive buying opportunity. The firm has developed six basic rules for investing in restructuring candidates. Unlike Orlando, Nordwind avoids bankruptcy cases. Its guidelines for turnaround investments are²⁵:

- Limited profitability (3% to 11% EBITDA), but no bankruptcies
- Stable markets and simple logics
- Good (particularly technological) market positions
- Intensive operational due diligence – never outsourced
- Precise restructuring plan before transaction
- Internal “homemade” problems identified as reasons for trouble

Nordwind likes to invest in companies with internal problems such as a too broad product range or inefficient workflows, because improvements in these areas cannot be prevented from competitors.²⁶ According to Nordwind, homemade or internal problems can be found in many German *Mittelstand* companies, particularly in those that are inventor-founded. While still under the Carlyle umbrella, the team has invested in Honsel, an aluminum parts manufacturer, and has achieved significant improvements through a detailed action plan.

3.2 Size of Transactions

Turnaround opportunities in Germany can be divided into two tiers: 1.) the huge corporate failures such as Philip Holzmann (construction), Babcock Borsig (machinery), and Kirch Media, and 2.) a large array of middle market company failures. Almost all of the turnaround equity investors that have been mentioned so far – Orlando, Capital Management

²⁵ “Restructuring for Superreturns – Next Hype or the Art of the Obvious”, p. 17

²⁶ *Ibid.*, p. 18

Partners, Alchemy Partners, etc. – focus on German *Mittelstand* companies. Orlando, for example, targets companies with sales between Euro 50m and 250m for a transaction volume of up to Euro 100m (or more in the case of co-investments).²⁷

Nordwind is currently the only German distressed equity investor that also looks at larger turnaround candidates with sales up to €1bn.²⁸ Of the international turnaround specialists, Texas Pacific Group has come close to acquiring a large distressed company in Germany: the US investor made a bid of “hundreds of millions of euros”²⁹ for the troubled, state-owned bank Bankgesellschaft Berlin. However, the German government eventually decided to cancel the privatization for the time being.

It is interesting to point out that even though no large distressed equity investments have taken place in Germany so far, several large companies have been forced in light of their financial problems to sell-off some of their crown jewels to reduce excessive debt levels. This has created an attractive deal flow for traditional private equity investors.

3.3 Types of Securities

Whereas in the US there is an active secondary market for almost every single line item on the right-hand side of a distressed company’s balance sheet – bank loans, debentures, trade payables, real estate mortgages, equity and other claims are actively traded – distressed

²⁷ Orlando Management GmbH, p. 5

²⁸ Nordwind Capital GmbH, “About us”, Nordwind Capital GmbH website, <http://www.nordwindcapital.com/html/about.html>, accessed April 28, 2003

²⁹ “Berlin seen canceling Bankgesellschaft stake sale”, Reuters, March 24, 2003, available from Factiva, <http://global.factiva.com/en/arch/display.asp>, accessed April 30, 2003

investing in Germany primarily comes in the form of turnaround equity. The main reason for this is that Germany does not (yet) have a developed market for distressed claims.

3.3.1 Equity

Majority equity investments are the rule in Germany's young distressed investing market. Firms like Orlando and CPM either invest in strongly under-performing companies where the equity still has a certain positive value or, in more extreme cases of distress, pay a symbolic price of €1 to take over the troubled company and its debt. In the latter case, there are typically extensive negotiations with the distressed company's creditors prior to the actual investment. In these negotiations, the investor aims to get concessions on the size of the bank loans and in return agrees on a new debt pay-down schedule and offers to invest a certain amount of CAPEX to save the business. The amount of debt that the bank forgives is highly situation-specific. If the bank has already (partly or fully) written off the loan in its books debt forgiveness rates are higher. For most distressed cases, the debt forgiveness rate lies between 30% and 70% of the original claim.³⁰ If the investor fails to make debt repayments or invest in CAPEX as promised the bank's claims increase to their original size.

3.3.2 Mezzanine

Mezzanine financings, often structured as subordinated debt with equity warrants, convertible loan stock or preference shares³¹, are now widely accepted in Germany. Whereas

³⁰ Christian Hollenberg, Orlando GmbH, telephone interview, May 2, 2003

³¹ Indigo Capital, "What is mezzanine capital?", Indigo Capital website, <http://www.indigo-capital.com/mezz.shtml>, accessed May 1, 2003

mezzanine capital in Germany was historically provided by banks, specialized players such as Indigo Capital are quickly gaining market share. In the context of turnarounds, mezzanine financings can be an attractive source of capital since the troubled company may not have access to conventional bank debt.

3.3.3 Distressed Debt

Direct investments in distressed debt are very rare in Germany. First, most debt comes in the form of bank loans, and banks have historically not placed troubled loans in the market. Second, those German companies that are rated and have issued publicly traded bonds are primarily blue-chip corporations that do not represent an investment opportunity for distressed debt specialists. The only distressed debt activity that we are aware of is Apollo Advisors' investment in the publicly traded bonds of cable company Kabel Hessen GmbH. The limited amount of distressed debt investing that currently takes place in Germany seems to be almost exclusively based on passive minority strategies. Strategies aimed at gaining control of a distressed company by buying its debt in anticipation of an equity-for-debt swap have not yet been seen in Germany.

4 MARKET LIMITATIONS

Even though most of our interview partners believe that the market potential for distressed and turnaround investing in Germany is significant they are also aware of the market's limitations. After all, the high expectations for more traditional private equity during the 1990s did not materialize. Everyone had believed that *Mittelstand* succession issues and the

predicted disentanglement of the cross-holdings between German companies would offer significant opportunities for PE firms.

4.1 Management Talent

Lack of management turnaround expertise seems to be the key stumbling block for the proliferation of distressed and turnaround investments in Germany. The investors we talked to have pointed out that most German managers of middle market companies do not possess the skill set that is necessary to bring a seriously under-performing company back on track. Particularly, they seem to lack turnaround-relevant experience, decisiveness and speed. According to Alchemy, management's missing drive towards value-maximization combined with a general reluctance to implement drastic changes are the most important reasons why there have not been more turnaround investments in Germany.³² Managers of German large-caps, on the other hand, seem to have both turnaround expertise and a value-based, change-oriented Anglo-Saxon management approach.

4.2 Cultural Barriers

Certain cultural attitudes of the German business community are still a limiting factor for the growth of private equity in the country. While large German corporations have become very comfortable with selling to financial investors the acceptance of private equity among German *Mittelstand* companies is limited. Many of the owner-managers of these small- to mid-sized firms simply do not want to sell their businesses after having spent a significant part of

³² Tom Beckmann, Alchemy Partners

their lives building them. Being very proud of what they have created, they seem to value the financial benefits associated with a sale less than their Anglo Saxon counterparts.³³ Moreover, there is still a significant level of mistrust against private equity firms. The owners of German *Mittelstand* companies are generally very concerned of what will happen to their company and its workforce after the sale, and many of them still believe that financial investors are more likely to damage the company and drastically cut the number of employees just to make a quick financial gain. Furthermore, German managers seem to be less willing to accept the high levels of leverage and overall risk that come with an LBO. Since they seem less focused on financial rewards, and attach greater importance to job security and free time than American managers, the risk-reward profile of an LBO seem less appealing to them.

For distressed and turnaround investments, the situation is different because owner-managers are in a much worse position. When the business is in or on the brink of bankruptcy a capital injection from a financial investor is often the only possibility to save (at least part of) the company. With German banks becoming much more restrictive in their lending policies many troubled *Mittelstand* companies that may have been able to obtain a relatively cheap bank loan in the past are now forced into the arms of distressed and turnaround investors.

³³ Patrik Klapp, "The German Buyout Market: Promising Future or Unsuitable Market Conditions?" (Ph.D. diss., European Business School, 2002), p. 24

4.3 Legal Barriers

The German legal environment confronts companies in the need to restructure with considerable hurdles.³⁴ Distressed and turnaround investors need to deal with restrictive labor laws that complicate workforce reductions as well as with ample worker co-determination rights and an insolvency code that is primarily aimed at liquidation.

4.3.1 Labor law

Germany's labor laws are among the most restrictive in the world. Surprisingly, several of our interview partners did not see them as significant constraints to their activities. Nordwind Capital believes that in Germany the cost of layoffs is easily predictable at 0.5-1 times monthly salary per year of employment, and that unions are very reasonable if treated properly.³⁵ In comparison to the US, they see lower labor costs in Germany due to a significantly lower number of strike days, worker flexibility and high productivity.³⁶

The legal code mandates that layoffs are “socially justified” by reasons relating to the person, his or her behavior or business requirements. The works council or *Betriebsrat* needs to be informed and given time to object. Should these layoffs involve plant closures or a substantial number of employees, management is forced to negotiate a social contract – *Sozialplan* - with the works council. This framework agreement aims to mitigate the adverse

³⁴ Clemens Aichholzer, Jan Petzel and Stanislaus Wittgenstein, Labor Cost Reductions in German Restructurings”, p. 1, Paper Assignment for Turnaround Management class, Harvard Business School, Cambridge, April 28, 2003

³⁵ “Why Invest in Germany?”, Nordwind Capital, April 2003, page 14

³⁶ Ibid, page 14-16

effects of the layoffs and avoids individual employee negotiations.³⁷ It typically includes details on severance packages, pension claims, and moving expenses.

The *Kündigungsschutzgesetz*, or Layoff-Protection-Law, regulates and restricts layoffs. Its official purpose is to maintain places of work, while taking into account economic requirements. It is applicable for companies with more than five employees and to employees with more than six months of tenure. It allows three reasons for a layoff: person related, behavior related or business related reasons.³⁸

Business requirements, such as a distressed situation, are an acceptable reason for layoffs. These could be related to inter-company circumstances or general market conditions. The layoffs are only justified if they are unavoidable (“*unvermeidbar*”), i.e. it is not possible to improve the business situation through other means such as technical, organizational or business measures. The employer has to select employees according to social criteria such as tenure, age, and financial dependents. If disputed the employer has to disclose his used criteria as well as their individual weightings. Typically, this leads to layoffs of young, skilled, and recent hires.

Severance pay scales with age and tenure and ranges from up to one annual salary to 1.5 times the annual salary for employees above the age of 55 and a 20-year tenure.³⁹ Layoffs without fundamental business changes need to be of sufficient size to allow the *Betriebsrat* to

³⁷ §111 Betriebsverfassungsgesetz

³⁸ §1 Kündigungsschutzgesetz

³⁹ §10 Kündigungsschutzgesetz

demand a *Sozialplan*. For instance, for a company with 60 employees it requires more than six layoffs, and for a company with 500 employees more than 60.

All layoff decisions need to be presented to the works council or *Betriebsrat*. Council members need to be supplied with name, type of layoff and reasons before any redundancy becomes effective.

These detailed legal requirements typically lead to numerous legal disputes, which can drag on for years. Should the layoff be deemed non-socially justified the employer has to reimburse the employee for all lost wages. In general, the courts tend to interpret and decide in favor of the employee.

Tactics employed in restructuring cases include an intense communication process and finding legal loopholes. Due to the pivotal role of the works council, management is advised to create an open and constructive relationship. Once the necessity for layoffs is understood and shared, the council is typically cooperative in negotiating terms of severance. To circumvent the issue of having to fire young and skilled employees in business related layoffs, it is possible to successfully reason that the person is indispensable to the company.⁴⁰

4.3.2 Insolvency Code⁴¹

Historically, there was a fundamental difference between German and US bankruptcy laws. Whereas the US legislation is based on the philosophy that a distressed company is

⁴⁰ Based on a telephone interview with Brian Cassedy, AlixPartners on April 11, 2003

generally worth more as a going concern than in liquidation, German bankruptcy laws were focused on leading an orderly liquidation once the company became insolvent. Creditor protection was the primary objective.

In 1999, the German Bankruptcy Code was reformed with the introduction of the *Insolvenzplan* (insolvency plan). The objective was to create a restructuring tool in the German bankruptcy legislature similar to the US Chapter 11 proceedings. The new insolvency plan permits liquidation as well as re-organization as possible outcomes of the bankruptcy process. Similar to the United States, it has provisions for an *automatic stay*, *cram-downs*, and also allows for senior new financing during reorganization. The new German insolvency plan even allows for *Eigenverwaltung* (debtor administration), the German equivalent to the *debtor-in-possession* provisions in the US.

However, our interviews have revealed that the *Insolvenzplan* has not yet been widely adopted in Germany. The vast majority of bankruptcies still lead to liquidation. In fact, only one German company, Berlin-based office supplies producer Herlitz AG, has so far taken advantage of the new reorganization provisions and successfully emerged from bankruptcy. Our interview partners' explanations for the rare use of the new insolvency laws somewhat surprised us. According to them, knowledge and understanding of the new bankruptcy legislature and its opportunities are still very limited among German practitioners. However, considering the fact that turnaround and distressed investing *per se* is only a very recent

⁴¹Clemens Aichholzer, Jan Petzel and Stanislaus Wittgenstein; "Labor Cost Reductions in German Restructurings", pp. 6-9, Paper Assignment for Turnaround Management class, Harvard Business School,

phenomenon in Germany, this statement becomes less surprising. Again, cultural aspects also seem to be of relevance when searching for reasons for the limited adoption of the *Insolvenzplan*. For example, debtor administration, i.e., allowing existing management to stay in power after the insolvency filing, has hardly ever been used in Germany because creditors tend to mistrust the distressed company's managers. The latter are seen as the culprits who are to blame for the company's problems.

4.4 Tax System

The German taxation system presents several hurdles for turnaround investors such as the taxation of capital gains, the inability of a fund to become directly involved in the portfolio company and the treatment of reorganization profits. However, in our discussion it became apparent that the largest barrier was the constant change of the government's position, making it impossible for funds to structure their investments accordingly. For instance, the German Federal Fiscal Court has recently questioned whether the management fee should be subject to German value added tax if it is not clearly structured as profit participation (e.g. in the absence of clawback). The final decision is still awaited.⁴²

Cambridge, April 28, 2003

⁴² "Benchmarking European Tax & Legal Environment: Indicators of Tax & Legal Environment Favouring the Development of Private Equity and Venture Capital in European Union States", published by the European Private Equity and Venture Capital Association, March 2003

There is uncertainty as to if and when these changes will be implemented. It is thought likely that the final private equity tax environment will be less favorable than the current situation.⁴³

4.4.1 Capital Gains

Discussions are ongoing whether carried interest should be taxed at the full rate instead of the current beneficial rate and if capital gains for asset disposals of limited partnerships should be reintroduced.

In the UK, the US and France, carried interest is taxed as a capital gain at a beneficial rate. The Federal Ministry of Finance disagrees with this treatment and is trying to impose proposals to tax it in full.

Capital Gains Tax (CGT) on asset disposals by limited partnerships – the wording used by the central government to abolish CGT on asset disposals in 2002 – has been challenged by regional governments keen to raise additional tax revenue. The wording of the change could be interpreted as allowing trade tax to be charged on capital gains made by limited partnerships on asset disposals. The outcome of this essential legal wrangle is anticipated within a month.

4.4.2 Asset Manager vs. Business Partnership

For turnaround investor it is essential to be involved with their distressed portfolio companies. The German tax code stipulates different tax treatment for asset managers and

⁴³ “Germany: Country Profile”, Nicholson, Lucy, March 12, 2003, published by AltAssets.net

business partnerships. Recently, the criteria for treating funds as either an asset manager, or a business partnership, have come under review.

The activities of a fund have historically been treated as asset management rather than a 'business activity'. Reclassification would increase taxation on profit allocations of capital gains to individual persons and corporations. Capital gains and other income of the fund would also be subject to a trade tax (a local tax of between 15-20 per cent) at fund level. The outcome of this debate is not likely to be known for some time.

Distressed investors have managed to circumvent these regulations through being involved in their portfolio through very active board seats or through external contracts to managers that help them achieve their performance targets.

4.4.3 Reorganization Profits

The German tax code currently allows for a tax exemption for profits from reorganizations (*Sanierungsgewinne*). These are profits resulting from a bank forfeiting a part of its claims solely for business needs, such as funding a social plan for employees. Since 1997, investors were able to use this instrument to gain tax exemption for turnaround investments. In a recent letter from the German Ministry of Finance, it is stated that this tax exemption lies in conflict with the German Insolvency Code of 1999.⁴⁴ Should this be implemented it would

⁴⁴ "Ertragssteuerliche Behandlung von Sanierungsgewinnen; Steuerstundung von Steuerstundungen und Steuererlass aus sachlichen Billigkeitsgründen", Position Paper by the Bundesfinanzministerium (German Finance Department), March 27, 2003

decrease returns for turnaround investors and thus significantly reduce the number of closed deals.⁴⁵

4.5 Financial Markets

German financial markets place several limitations on turnaround investors. First, the public markets and especially small company listings are small compared to the rest of the developed world. This creates difficulties in achieving public exits. Second, the lack of ratings of companies makes international funds apprehensive to supply loans. Finally, the current misallocation of capital independent of company risk by domestic banks distorts market forces.

Germany's equity markets are underdeveloped compared to its peers, leading to limited exit opportunities, especially for smaller firms. Germany only has 985 listed companies, compared to roughly 7,000 in the US (NYSE and NASDAQ combined) and 3,500 in Japan.

Country	Listed Companies	Market Cap (bn Euro)	Market Cap as % of GDP
Germany	985	1,249	59%
UK	2879	2,444	151%
United States	7106	15,981	123%

Table 4.1: Stock Market Comparison, March 2002⁴⁶

The German market only has a limited number of rated companies. Moodys only follows about 60 companies⁴⁷ and Standard & Poors evaluates 51 in Germany. This creates intransparency for investors in regards to the credit risks especially in the mid-cap market. Distressed debt investors thus find it difficult to make qualified decisions.

⁴⁵ Dreyer, Norbert; Capital Management Partners, telephone interview by authors, May 1, 2003

Finally, Germany suffers from unprofessional capital allocation. Many German banks are still holding on to a large number of troubled company loans. While some banks such as HypoVereinsbank have started to professionally divest their portfolios, others, such as the local *Sparkassen* (savings banks) are still holding on to their distressed portfolios. This restricts access to these troubled companies for turnaround investors.⁴⁸ Basel II capital allocation requirements are likely to encourage banks to increase their divestment activities.

Stephen Choi, a member of the Lazard restructuring team, sees Germany as a market in which only a few financial players have the sophistication to professionally evaluate the financial risks and performances of distressed companies. However, he believes that the market is becoming more and more sophisticated following increased awareness stemming from several large restructurings in the past year.⁴⁹

5 OUTLOOK

Based on our interviews, we believe that there is significant potential for the German turnaround investing market. The large market potential, the proliferation of different investment types and diminishing Germany-specific hurdles to turnaround investing all contribute to this phenomenon.

⁴⁶ Der Finanzplatz e.V. „Der Aktienmarkt, Facts & Figures“, Stock market information page, November 19, 2002, <http://www.finanzplatz.de/>, accessed November 20, 2002

⁴⁷ Based on Interview with Kambiz Nourbhaksh, Goldman Sachs Credit Desk, on April 9, 2003

⁴⁸ Dr. Hollenberg, General Partner, Orlando Management, Telephone interview May 6, 2003

⁴⁹ Choi, Stephen, Lazard Restructuring Group, Telephone Interview on May 6, 2003

The potential for turnaround investments in Germany will continue to be fuelled by the under-performing German economy, leading to large numbers of distressed and severely under-performing companies. Turnaround investors will increasingly seek these opportunities and use operational and margin improvements to boost their returns.

While majority equity transactions have been the norm in Germany we expect increased activity in the mezzanine and distressed debt areas. Over time, the distressed debt market will gain sufficient size and liquidity to attract global distressed funds such as Appaloosa and Angelo Gordon. This prediction is substantiated by the fact that Cerberus is currently recruiting a German team to set up an office in Frankfurt.

Many Germany-specific limitations to turnaround investing are gradually diminishing or turn out to be less relevant than a superficial analysis would have led to believe. Management talent is increasingly moving into *Mittelstand* companies due to lack of other opportunities and a general change in attitudes towards small- and mid-sized companies. More and more young and talented managers regard it as more desirable to work for a small company than for a big corporation. Cultural barriers to turnaround investing are also slowly diminishing following increasing transaction numbers and sizes in Germany. Finally, Germany's restrictive labor law actually allows for personnel adjustments during a restructuring at predictable costs, and the insolvency code theoretically allows for Chapter 11-like restructurings.

While it will never be easy to invest in turnaround situations, we believe that the underlying drivers are in place to see significant growth in the turnaround investment segment in the foreseeable future.

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7 APPENDIX

7.1 List of Interviewees

Name	Position/ Organization	Background
General		
Dr. Marcus Meier	Employment Lawyer, Maier, Ollert & Kollegen, Munich	Focuses on employment law in Germany
Brian Cassedy	AlixPartners	Working on the Ish GmbH & Co.KG reorganization with James Bonsall in Germany
Private Equity Players		
Norbert Dreyer	Investment Manager, Capital Management Partner	
Norbert Danneberg	Nordwind Capital	
Alexandra Jung	Goldman Sachs Distressed Investing	
Dr. Christian Hollenberg	General Partner, Orlando	HBS Class of 1988
Dr. Carl-Albrecht Schade	Deutsches Investors Capital	
Tom Beckmann	Alchemy Partners, London	
Intermediaries		
Kambiz Nourbhaksh	Goldman Sachs Credit Desk	
Stephen Choi	Lazard, Restructuring Group	

7.2 Comparison of German and US Insolvency Codes⁵⁰

Characteristics	US Chapter 11	German Insolvenzordnung
Control Rights	Debtor in control: in majority of cases, previous managers retain control; in remainder, new managers appointed	Insolvency court appoints insolvency administrator or allows debtor to stay in possession of assets but so far courts reluctant to grant this right to debtor
Solvency Requirements	Firm does not need be insolvent	Firm has to be insolvent or face significant risk of future insolvency. Criteria: 1) Cannot meet payments to creditors 2) Over-indebted, leading to significant risk that firm will not be able to meet future debt payments
Automatic Stay	Most creditor claims are stayed (exception are e.g. lease payments)	Automatic stay for unsecured, a minimum of three months for secured
Renegotiation of Liabilities	Great discretion to renegotiate debt contracts. Debt-equity swaps permitted	Renegotiation may take place with all creditors. Secured and unsecured have to vote in their respective classes. No debt-equity swaps
Cram Down Provisions	Yes, if plan is fair and equitable to all classes	Yes, if the court can establish that plan is in best interest of this group
Constraints of Firms as Going Concern	Few	All creditors vote on the plan
New Financing in Reorganization	New financing is easily accommodated because it has priority over existing claims and there are institutions that specialize in "DIP financing"	New financing can be arranged. Must be repaid in full before secured creditors are considered ("creditors of the estate"). No specialist institutions. German banks see DIP financing rather as necessary evil
Preservation of Residual Claims of Equity Holders	In majority of cases, deviations from absolute priority in favor of equity	Deviations can be arranged but must be agreed by a creditors' vote

⁵⁰ Franks, Walter, Torous, "A comparison of US, UK, and German insolvency codes", p. 5, and: Aichholzer et al., p. 7

