Distressed German companies: Opportunities for Asian investors?

Germany's merger and acquisition market has been booming. In 2006 there were more than 600 billion euros worth of M&A deals and the 'frenzy' has continued into this year. While the media have focused on takeovers involving private equity and venture capitalists, some 70 per cent of all takeovers are undertaken by strategic investors.

According to INSEAD Affiliate Professor of Accounting and Control and Business Law, Jake Cohen, and Jörg Nürnberg, a partner with consultants Dröge & Comp., this M&A activity has opened up a window of opportunity for Asian investors to buy up distressed companies and become part of 'Germany Inc', the close-knit network of German companies and banks.

"Basically, it's the continuous break-up of 'Germany Inc' or 'Deutschland AG', where in the past a lot of companies have been closely entangled with each other. Banks owned large portions of publicly-owned companies and also heavily invested in small- and medium-sized firms, which didn't give any opportunities to outside investors," Nürnberg says. "Now this is breaking up, also due to tax laws which have been changed, giving companies opportunities to sell off their shares and this is one of the reasons why outside investors are now more welcome and able to invest in Germany."

German M&A
Jan-Dec 2006
(by value)

	Bank	US$bn	No
1	Deutsche Bank	88.3	48
2	Morgan Stanley	69.8	25
3	Goldman Sachs	64.5	25
4	Dresdner Kleinwort	48.0	20
5	JP Morgan	47.8	24
6	Credit Suisse	43.6	19
7	Merrill Lynch	35.1	13
8	Rothschild	21.0	38
9	Greenhill & Co	21.0	38
10	UBS	20.4	22

Source: Rothschild/Dealogic

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Saddled
with bad debts of more than 300 billion euros, banks have been taking a close look at their credit portfolios and have been seeking to recover non-performing corporate loans. This, though, has resulted in the number of insolvencies rising significantly to nearly 36,000 in 2005 from 28,000 in 2000. "This increasing number of insolvencies is mainly caused by Basel II (rules on capital adequacy)," Nürnberg says, whereby banks have to cut loans if customers don't meet the requirements.

Cohen says this all adds up to present Asian investors with good buying opportunities. "The German market … has not been managed maybe as well as it could in terms of the balance sheet. The balance sheet is a lot of money that's mostly bank financing rather than equity financing. As we are moving towards a higher level of liquidity around the world, that level of liquidity looking for best returns, the returns could be created by finding markets which have not been broken into or that heavily invested in and Germany fits the bill."

"Germany has been a country that was mostly financed with bank financing and if there's equity looking for higher returns, they're not necessarily going to find those higher returns in the US where there are many dollars chasing the same deals. Rather they could find those higher returns in a market which is still relatively unexplored," Cohen says.

Potential M&A targets

Companies likely to be targets would be firms which "have not been managed well or have a high cost structure," Cohen adds. This sometimes results in private equity firms coming in. For example, the family behind Rodenstock, Germany's largest manufacturer of eyeglasses, which had been unable to raise additional capital to fend off insolvency, sold a majority stake in the company to UK-based private equity firm Permira.

Struggling German companies are also targets for Asian firms which are riding economic growth and are looking beyond the region for investment opportunities. China's Harbin Measuring and Cutting Tool Group (The Harbin Group) found a logical partner in Kelch, which makes precision tools, allowing it to acquire technological know-how and gain access to trade contacts in Europe and the USA. Another Chinese company, Shenyang Machine Tool Group, took over insolvent German firm Schiess, which had been making heavy lathes and boring machines for 140 years. Again, the Chinese firm gained expertise, including access to patents. From the German company's perspective, Schiess was able to hire more workers instead of shutting down its operations and laying off all its employees.

The hurdles

Buying a German firm in theory sounds straightforward, but in reality, there are plenty of regulatory hurdles to overcome. And then there's the difficulty in marrying different cultures. "That's difficult in any merger and acquisition," Nürnberg says. "The cultural challenge is probably even greater when you marry cultures of two different countries or even two different continents. But usually you'd have those cultural challenges anyway, even when you have to marry two German companies, because each company would have its own culture."

High cost structures in Germany are likely to deter some investors though and interest from private equity firms also means that investors might have to pay higher prices for assets. "I definitely think that prices have gone up and it's true they're not cheap as before," Cohen says, "But that does not necessarily mean that the opportunity has passed you by and you can't find other companies in that market which still provide a nice risk-return profile."

"So the fact that prices have gone up is not a question and that's driven by financial and strategic buyers looking for deals around the world, but that doesn't prevent you from finding other such opportunities which I believe exist."

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