CorporateLiveWire

BANKRUPTCY & RESTRUCTURING 2019
EXPERT GUIDE

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VTR VALUE TRANSITION RECOVERY

Private Debt and "German Mittelstand" – does it fit?

By Joern Trierweiler

For a long time, debt-financing – mostly of Anglo-American origin – has been despised as a means of external capital financing, but now it has become a real attractive alternative to the traditional local banks. In the meantime, more than 50 providers have established their offices in the German-speaking area and have already completed several successful financing rounds.

Nevertheless, the German middle-market companies, which are mostly family owned, are still reluctant to use these business-driven debt-instruments. There are multiple reasons for that: in most cases, cultural barriers and a lack of capital orientated management which are preventing SMEs from using these instruments.

The financing situation for the mid-sized sector changes rapidly.

In recent years, European Banks have flooded the corporate financing market with low-interest deals, thus encouraging constant economic growth. The companies, however, have often neglected their homework such as optimisation of their business models or adaptation to modified economic conditions, e.g. the influence of digitisation on their competitive situation.

The banks, in turn, due to the increased pressure on margins and the oppressive over-regulation, have lost a big part of their business attitude. Whole departments including sector- and industry know-how have been abandoned and replaced by abstract automated scoring models.

As a result, the banks have lost many characteristics which are typical of a classic advising and supporting local bank of the mid-sized sector, with the consequence that they can no longer offer a tailor-made financing to long-standing clients in stressed situations. This is all the more remarkable when considering that tailor-made financing has been the strength of German-based commercial banks for many years.

This gap is now increasingly filled by debt funds which have instruments that are much better adapted to the individual situation. By this, they can finance, for example, M&A transactions, dedicated growth scenarios or even demanding special situations. Thanks to their abilities to structure also equity-like financings they are sometimes the only cornerstone for continuation financing – as well in combination with local banks.

Apart from strengths such as condition and collateral structuring models which are much more flexible, long-term maturities or performance driven interest rates, debt funds have, due to their business attitude of the teams, short reaction times and are able to grant loans quickly. And, in contrast to corporate bonds which are currently very popular, debt funds have one contact person for the debtor instead of a more or less anonymous investor structure.

Challenges for companies and financiers currently inhibit a wider dissemination of alternative financing.

SMEs, however, have to prepare for that newly gained freedom. Debt funds generally have higher expectations of regular reporting: apart from financial statements during the year (mostly monthly) according to International accounting standards (usually IFRS instead of HGB), in most cases, mid-term planning of business driving units, projects or branches are expected. In practice, this means that the traditional planning by departments and cost accounts will be abandoned and replaced by a segmented profit-and-loss-statement with strong focus on the realised net cash flow and thus a planning and controlling serving that aim. Finally, the whole company must get used to a capital driven return on invest (ROI) management and practice it actively in daily business.

The funds, in turn, have to adapt their processes to the bits-and-pieces business of the SMEs. Not every company has double-digit growth rates per year. But the long-term client relationships, a strong value adding chain and the solid employment situation constitute decisive factors for a stable and reliable future cash flow. If the fund additionally agrees to participate in the entrepreneurial risk, for example in the form of project or customer contract financing in the automotive supplying industry, this leads to long-term partnerships with solid return potential.

In the end, the funds as financing partner must recognise themselves as a companion of the company and support the companies – with the exception of their financing round – by providing them with advice, network and expertise.

Active behaviour and practice form the basis for common success.

We, as a service provider specialised on execution, often see well-structured basic ideas with the SMEs; ideas which, however, get jeopardised by a lack of time – either, because the consultant arranging the financing has left the project or because the management takes a break after the intense (re-)financing phase and reverts to old well-known habits.

Finally, it is the top management's task to adapt the company to the described capital orientation and to practice it in a sustainable manner in day-to-day work. This process is often connected to a transformation of organisation and processes and requires, especially in large corporate group structures, for example with foreign subsidiaries, a change management team within the company.

Traditional business banks in the German-speaking area are currently – and we expect also in the medium term – not able to provide their clients in the usual form with financing operations which carry a higher risk potential, or which need a performance-based compensation.

The financial evaluation and realisation of innovation, investment and new entrepreneurial culture require the contribution of all employees, and, therefore demands an incentive and payment scheme which must be synchronised with the objectives of the capital lenders.

The financing funds must adjust their attitudes to the German industrial and economic cycles which are of rather long-term nature. Based on our experience, cultural barriers between partners can be overcome by active entrepreneurial support, for example by sending respected locally known industry experts to advisory committees or supervisory boards, or by strengthening the fund management team with bankers experienced in consulting corporate clients.

In our projects, we have had good experiences with writing down – in parallel to the documentation of the financing agreement – the expectations of both sides in an "Operational Business Agenda" which also serves as a timetable for implementing the measures and findings defined in the restructuring concept or in a due diligence.

To conclude, traditional business banks in the German-speaking area are currently – and we expect also in the medium term – not able to provide their clients in the usual form with financing operations which carry a higher risk potential, or which need a performance-based compensation. When applying the right strategy, debt funds can fill this gap and secure a solid business field in German medium-sized companies.

The necessary changes in the companies must be planned realistically from the economic and cultural point of view and be implemented consistently. Specialised service providers such as VTR can accelerate these change processes and secure them. Hence, from the very first day, they contribute to a successful partnership between financiers and companies.

As a transformation and change manager, Joern Trierweiler has supported medium-sized companies, as well as international groups in change situations and crisis management for more than fifteen years. The graduate industrial engineer has acquired experience in various sectors with a particular focus on high technologies such as the automotive industry. In his current engagement Joern works as a member of the Managing Board of an IoT-specialist in Germany. Prior to this, he led as a CEO/CRO a multi-national building materials corporation headquartered in Austria through a complex financial and operational restructuring process. Joern started his professional career as a Group Controller of a big German automotive supplying corporation in Munich and has more than 20 years' experience in commercial and operative management of international companies.