Non-technical summary

1. This report was commissioned by the German Federal Ministry of Finance. It is focused on the following topics: (i) An analysis of the economic role of private equity. (ii) A description of the tax and legal environment for private equity in Germany within an international comparison. (iii) An analysis of the value drivers in private equity transactions. (iv) A summary on the empirical evidence of the economic effect of private equity. (v) A sketch of a proposal how Germany should change the tax and legal environment for private equity.

2. With respect to the economic analysis the most important results are: Private equity might be an important institution to overcome control and incentive problems in corporate finance. Hence, it should be regarded as a valuable alternative to public equity. As a consequence, private and public equity should be treated equally. Moreover, in private equity financing geographic proximity between the private equity investor and the corporation seems to be important. This is why the legal system should not only be neutral with respect to the choice of private vs. public equity; it should also be attractive on an international basis. Evidently, these two goals might be conflicting.

3. Benchmarking the legal and tax environment with other European countries, like France, Spain, Switzerland or Luxemburg, leads to the conclusion that there is ample room for improvement in Germany.

4. The empirical evidence presented in this report supports the view that the most important value driver in a private equity transaction is operational and strategic intervention by the private equity management team as well as the implementation of tighter control mechanisms. Value creation as a pure redistribution from other stakeholders (e.g. former owners, creditors, workers and state) certainly exists as well. However, our evidence suggests that this value source is by far not as important as value creation through efficiency gains.

5. It should nevertheless be mentioned that there is clear evidence supporting the view that leveraging in private equity transactions has significantly increased in 2006. By using an econometric model we show that the increase in debt-multiples observed over the last quarters cannot simply be explained by fundamental economic factors. It is the financial supervision authority that has to tackle with this issue.

6. We propose to change the tax and legal environment for private equity in a way that private equity funds can benefit from a tax neutral status like investment funds are already doing in Germany. Moreover, a cautious supervison should be implemented as well, especially with respect to the qualification of the management team. This could also be achieved by implementing some self regulation mechanisms. The treatment of carry taxation should not be changed, while a favourable tax treatment of venture financing should be implemented.