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GERMANY



Introduction: The financial market in Germany is undergoing fundamental change

For the last couple of years the financial markets have been undergoing a profound process of change worldwide. This change affects Germany in particular, since the local financial system has been strongly banking orientated for decades in contrast to the rather capital market orientated financial systems of the Anglo-Saxon hemisphere. Close and trustful financial relations between medium-sized companies and their main bank were on one hand a fundamental reason for Germanys economic success, but on the other hand resulted in a comparatively weak equity capital structure of German companies in comparison to international standards and an only hesitantly developing capital market. Numerous important factors as may be the development and broad appliance of information and communication technologies, the liberalisation and deregulation of the international capital markets, the harmonisation of financial market regulation as well as the growing importance of risk and efficiency consideration make it inevitable for German companies and banks to acclimatise quickly to international standards. Due to that development the general conditions of corporate financing in Germany have changed in recent times. German banks and saving banks have conducted deep structural reforms in order to reduce costs and to gain efficiency and since have put credit requests under systematic credit assessments. Now it is increasingly the rating of the companies which decides about loan commitment or credit rejection. In case of credit terms, risk differentiated interests more and more substitute an unitary interest. The banks furthermore have increased their demands for provision of loan securities. Companies have to rise to the challenge of acclimatisation to the changing requirements of this new rating culture. Thereby new financing instruments like private equity or mezzanine capital are increasingly available to optimise the capital structure.

II. Financing terms

According to the so called “wide financing term”, financing is the provision of financial means of any kind for the creation of operative goods and services on one hand and for conducting certain extraordinary financial procedures on the other hand, like for example the foundation of a company, capital increase, fusion, commutation, recapitalisation and liquidation. The so called “narrow financing term” limits it to the raising of capital as the opposite to capital assignment or capital investment. Two ways of financing have to be distinguished: Self-financing and external finance. The different methods of financing can be roughly systemised the following way:

Origin of the capital

External finance is the raising of capital from outside of the company in the form of equity capital or outside capital. Internal financing is the raising of capital from the operative business.

2. Legal status of the investor at external financing

Self-financing means financing with deposits or participations. External-financing means financing through the money and capital market, through loans in goods and service traffic as well as through special forms of financing like leasing or factoring.

3. Duration of the provision of capital (unlimited, long dated, medium or short term)

4. Cause of financing (e.g. foundation, capital increase, fusion, commutation or recapitalisation)

IIII. Initial considerations of companies:

There are three basic questions, which have to be brought forward by an entrepreneur with capital demand: 1. How much new capital should be added to the business, 2. which method of financing is available and 3. which available method of financing is the most fitting? The aims of corporate financing can be summarised as being efficiency, minimisation of costs of financing and liquidity. Furthermore the following aspects have to be taken into consideration:

1. Size of the company

The size of the company (e.g. turnover, capitalisation) is of central importance for the need and demand of additional capital as well as for the access to financial resources. The larger the company, the more current assets will normally belong to the company. The amount of short term loans should be about $\frac{1}{2}$ in relation to the current assets. The larger the company, the more comprehensive the intended projects will be and the accordant need of investments. Concerning the access to capital the situation of small and medium sized companies is regularly more difficult than the situation of large conglomerates. Other than in the USA, where publicly owned firms are the dominant sort of companies, many German companies are still family owned. Such basically small and medium sized companies often are suffering from difficult financing problems, if their equity capital is not sufficient to get fresh outside capital. As a result of e.g. Basel II, medium-sized businesses are exposed to a more restrictive policy of loan extension of the banks. In many cases the result is a threateningly low capitalisation of these companies.

2. Stages of development

Commercial companies go through many stages of development beginning with the stage of foundation and subsequent stages of growth and stagnation until - as the case may be - the stage of cancellation and liquidation. These different stages are bounded with different demands on corporate financing. The following stages of development have to be taken into consideration:

- a) **Seed-financing:** In this early stage most of the times only a business idea (business plan) exists.
- b) **Start-up-financing:** Stage of foundation, in which product development as well as the first steps of marketing have to be financed.
- c) **Early-stage-financing:** Capital for the early stage of the company, in which the product development is already finished, but the company has not reached any noteworthy business volume yet.
- d) **Expansion-financing:** Capital for the upgrading of capacities and the entering into new markets.
- e) **Second- or later-stage-financing:** Capital inflow after the first period of marketing.
- f) **Mezzanine-financing:** Method of financing for the middle stadium of development of a new commercial company – often the last round of financing before IPO (also known as “Third stage-financing”).
- g) **Bridge-financing:** Preparation of the business company to IPO

3. Branch of trade, industrial sector

Depending of the branch of trade or industrial sector the company belongs to, the costs of financing in order to successfully carry out investments and generate growth, e.g. for capital equipment and resources, costs of market access, costs of innovation and cooperation, might vary notably. The branch of trade or industrial sector is furthermore important for the rating of the company. Rating means the evaluation of the economic efficiency and ability of the company as a potent credit user to fulfil its payment obligations in the future entirely and on schedule. The better the current business and the outlook for the future of a certain branch or sector, the higher the creditworthiness of its companies is going to be. Basically the most important factors for the rating are “the economic measures of the company” with about 50 %, the “qualitative evaluation of the company” with about 30 % and the “analysis of branch, product and business environment” with about 20 %.

4. Track record

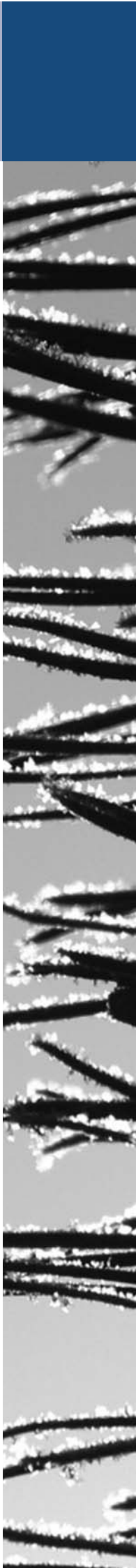
The better the track record of a company, the easier the access of the company to new capital will be. “Experience” is a key element at choosing between different financial methods and resources.

5. Financial situation

One of the basic aims of the company has to be the achievement of financial balance, which requires two fundamental conditions: In first place the liquidity of the company has to be ensured at any time and in second place the financial dispositions should lead to a maximum of profit. Hereunto a continuous control of liquidity is necessary. Creditors for example can extract information about liquidity from the annual accounts. Furthermore cash flow analyses deliver insight in the liquidity situation and the financial development of the company. Cash flow means the balance of trade surplus during a period. It is derived from profit and loss account and is an indicator of the self-financing power of the company. Other instruments of fiscal analysis are the statement for the application of funds and the account of capital drain.

6. Securities

Finally, the search of an optimal method of financing includes the question, whether securities have to be provided. In case of financing by outside capital as is the case with bank credits, providing securities is common practice.





IV. Types of financing

The following methods of financing have to be differentiated:

- 1. Financing by existing shareholders and directors**
- 2. Grants and tax breaks**
- 3. Financing by a bank**
- 4. Hire purchase and leasing**
- 5. Trade financing**
- 6. Business angels**
- 7. Venture capital**
- 8. Flotation of shares and IPO**

V. Regulatory framework

1. General considerations

Regulatory framework is enframing on one hand the capital structure within corporate enterprises (application of capital, maintenance of capital and capital replacement) and on the other affixes general conditions for stock trading. The Stock Exchange Act, Stock Exchange Regulations, the Securities Trade Act and Securities Prospect Act etc. are directed at ensuring a secure stock trading as well as at saving potential investors, shareholders and creditors of the company from unfair methods.

2. Legislation concerning incorporated companies (AG, GmbH)

a) Private Limited Company Act (GmbHG)

The private limited liability company in Germany (GmbH) is an incorporated company, which comes into existence as a legal entity with its registration at the commercial register. Solely the assets of the company are liable for any debt of the company. Foundation is carried out by a notarial certificated company agreement. Concerning the capital endowment of the company, the Private Limited Company Act (GmbHG) comprises a comprehensive body of legislation. The Arts. 5, 7, 9, 19 GmbHG deal with the rising of capital and the Arts. 30, 31, 32a, 32b GmbHG with the maintenance of this capital. Furthermore the German Federal Court of Justice or Bundesgerichtshof (BGH) has developed comprehensive jurisdiction concerning the Arts. 30, 31 GmbHG dealing with shareholder loans replacing equity capital.

However, the Private Limited Company Act (GmbHG) will be profoundly reformed within the next years on the grounds of a draft of a corresponding ministerial commission, the so called „Referentenentwurf eines Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG)“ from May, the 29 th of 2006. Among others, the following major changes are to be expected: The minimum nominal capital shall be reduced from 25.000,- € to 10.000,- €, the foundation and registration of the GmbH shall be facilitated by the renunciation of the need to immediately present evidence of the requisite official authorisations, the relocation of the administrative domicile of a German GmbH abroad shall be allowed, the chance of acquisition of shares in good faith shall be stipulated and the rather strict rules of jurisdiction about equity capital replacing loans of shareholders shall be dropped. With these changes the competitiveness of the German GmbH shall and should indeed be increased in international comparison. The GmbH still is not and will not be marketable. Accordant to Art. 15 III GmbHG a notarial certificated agreement is necessary to transfer shares of the GmbH.

b) Stock Corporation Act (AktG)

The public limited company (Aktiengesellschaft - AG) is an incorporated company. Solely the assets of the company are liable for debts of the company, Art. 1 I 2 AktG. The authorised capital is split into shares, Art. 6 AktG, and has to amount to at least 50.000,00 €, Art. 7 AktG. Shares can be registered in a certain amount (Nennbetragsaktien) or represent a participation of authorised capital (Stückaktien). Stocks are marketable at stock exchanges. The AG is founded by the signing of the articles of association, which has to be asserted by notarial certificate, Art. 21 I AktG. The raising of capital is regulated in Arts. 9, 27, 36, 54, 66 AktG. The rules of maintenance of capital can be found in e.g. Arts. 57, 61, 62 AktG.

3. FSMA and the German Securities Trade Act (Wertpapierhandelsgesetz - WpHG)

The Financial Services and Markets Act 2000 (FSMA 2000) is an act of the United Kingdom parliament which created the Financial Services Authority (FSA) as a regulator for insurance, investment business and banking. Some of the key sections of this act are:

Section 2 outlines the regulatory objectives of the FSA: (a) market confidence; (b) public awareness; (c) the protection of consumers; and (d) the reduction of financial crime.

Section 19 requires firms to be authorised to conduct regulated activities.

Section 21 makes it a criminal offence to issue a financial promotion in the United Kingdom unless it is issued or approved by an authorised firm or exempt via the Financial Promotions Order.

Section 59 states that a person can not carry out certain controlling functions in a firm without approval by the FSA.

Section 71 allows private persons to sue a firm for damages if a person performing a controlled function is not approved.

Section 118 deals with market abuse.

Section 132 establishes the Financial Services and Markets Tribunal.

Section 138 grants the FSA rule-making power.

Section 150 allows private persons to sue for damages if an authorised firm has breached certain rules.

Section 165 gives the FSA power to require certain information.

Section 397 makes it a criminal offence to mislead a market or investors.

The German counterpart to the FSMA is the Securities Trade Act or Wertpapierhandelsgesetz (WpHG), which applies for the provision of investment services, the trading with financial instruments at or outside stock exchanges, the closing of forwards contracts, financial analyses as well as for changes of proportion of voting rights of shareholders of listed companies. The WpHG arranges with its Arts. 4 and following the duties and authority of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). Art. 14 WpHG forbids insider dealing and Art. 15 WpHG engages listed AG to immediately publish insider information by a so called Ad-hoc-notification. In the case of non compliance the listed company is threatened with claims for damages on the grounds of Arts. 37 b, 37 c WpHG. Furthermore, manipulations of the market are forbidden due to Art. 20 a WpHG. Art. 38 Abs. 1 WpHG prohibits insider dealing and comprises more penal provisions, while Art. 39 WpHG includes a catalogue of facts of administrative fines.

4. Listing rules

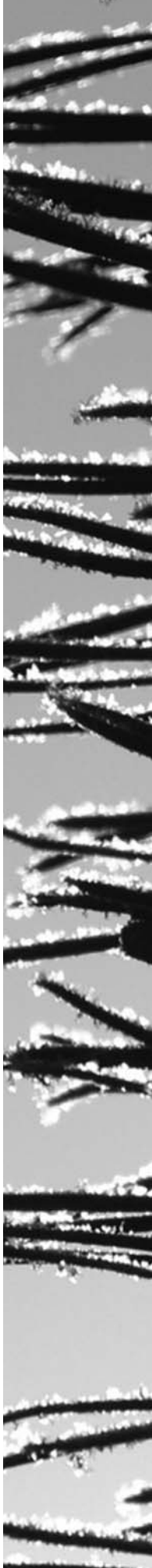
The Stock Exchange Act (Börsengesetz - BörsG), the Decree of Admission to Stock Exchange (BörsenzulassungsVO) and the Securities Prospect Act (WpProspektG) are fundamental key pieces of the corresponding German legislation.

The Stock Exchange Act includes e.g. general rules about stock exchanges and their decision makers, the evaluation of the listing price, the admission of stocks to the stock exchange at official market, at regulated market as well as at curb market and finally several penal provisions. Accordant to Art. 13 BörsG the stock exchanges are committed to give themselves further rules of the exchange, that have to be up to certain standards in content.

5. Rules of the stock exchange

Each and every stock exchange admitted in Germany has got its own rules, charges and fees. The most important stock exchanges in Germany are the „Frankfurter Wertpapierbörse“, the „Börse Düsseldorf“, the “Börse Berlin/Bremen” and the “Börse München”. The corresponding rules of the exchange are determined by the respective Stock Exchange Council and have to ensure accordant to Art. 13 BörsG, that the stock exchange fulfils its incumbent duties, thereby satisfying both the interest of the public and the interest of trading. It has to encumber rules e.g. about the branch of the stock exchange, the organisation, the sorts of trading, the publishing of prices and stock exchange quotation as well as the fees for the activities of lead brokers. The rules of the stock exchange require permission by the Stock Exchange Supervisory Office.

The stock exchange regulations of charges and fees can allot the raising of fees and the refund of expenses e.g. for the admission to the stock exchange, the dealing at the stock exchange, the admission of stocks to the regulated market as well as for the revocation of the admission to the stock exchange. The stock exchange regulations of charges and fees also require permission by the Exchange Supervisory Office.





VI. Evaluation of different types of financing

1. Capital contribution and participation

Financing by capital contribution and participation are the classical types of provision of outside capital. The associates or shareholders allocate capital in form of share lifts. This causes an increase of the nominal capital. In case of insolvency this equity capital is liable for the debts of the company. There are two different sorts of share lifts called cash deposits and investment in kind. Concerning the source of funds of sole proprietors and business partnerships it has to be distinguished between credits of account, share lifts from private assets of the sole proprietor or the associates, admission of new associates and the admission of a so called "dormant partner" accordant to Arts. 230 and following Commercial Code (HGB). In case of the GmbH financing by equity capital besides share lifts caused by foundation of the company takes place in three cases accordant to Arts. 5, 7, 19 GmbHG: 1.) regular increase of nominal capital, Arts. 55 and following GmbHG, 2.) demand of additional contribution, Art. 26 GmbHG, and 3.) (nominal) capital increase from the company's own resources, Art. 57c GmbHG.

German stock corporation law differs besides share lifts caused by foundation of the company accordant to Arts. 36 II, 54 II AktG between 1.) regular increase of nominal capital, Arts. 182 and following AktG, 2.) conditional increase of nominal capital, Arts. 192 ff. AktG, 3.) approved increase of nominal capital, Arts. 202 and following AktG and finally 4.) capital increase from the company's own resources by commutation of capital reserves and retained earnings into initial capital, Arts. 207 and following AktG.

2. Grants and tax breaks

a) Types

Capital investment grants and tax breaks are governmental acts of support (by the EU, Federal Government, Federal States, local authority) to companies without any equivalent by the addressee. Therefore capital investment grants and tax breaks are known as subsidies. Subsidies can also be granted in form of additional contributions, interest benefits, premiums etc.. Subsidies are aimed at the maintenance of income, products and / or exercising influence on the market prices. It is often criticised that subsidies mostly are granted not for economic, but predominantly for political reasons. Therefore critics highlight the often distorting effects of the subsidies.

Capital investment grants are governmental transfers of money or goods, that are destined to finance the purchase of assets in whole or in part. Capital investment grants in form of money contain not only single payments but also equated payments, that allude to investments of assets from earlier periods. Capital investment grants in form of goods cover the gratis transfer of means of conveyance, equipment and other mobile assets as well as the direct allocation of buildings and other immobile assets.

The term "tax breaks" is the generic term for tax exemptions, tax abatement and tax rebates. The premises of eligibility are defined in special fiscal exceptions, that mean deficiency of receipts for the government.

b) Suitability

Capital investment grants and tax breaks do not cause any disadvantages for the beneficiary company. Capital investment grants are normally earmarked, which means that the beneficiary strictly has to refrain an ulterior application of the given capital. As far as Capital investment grants, which possibly could infringe EU-law, are involved, the beneficiary should try to be very careful, since such capital investment grants might be reclaimed at each time without any "protection of confidence".

c) Eligibility

The conditions of eligibility concerning capital investment grants and tax breaks result from the corresponding laws, which define aim, content and dimension of the subsidy.

3. Financing by banks

Credits are the typical form of bank financing. That means raising a debt with temporally delayed payback and payment of interest. Credits or loans are outside capital and cause interests, which lower the account of the company and burdens its liquidity. Bank credits can have short, medium or long duration.

a) Suitability

Bank credits basically are suitable for giving the company new impulses through new outside capital and for bridging short termed liquidity squeezes. But finally the company sustains a loss because of the debited interests. This has to be calculated thoroughly, measured and compared against the interest in immediate liquidity. An regularly advantageous form of credits use to be the credits granted by the KfW (Kreditanstalt für Wiederaufbau), which are a mix of bank credit and subsidy and therefore are granted with a comparatively low interest rate. Moreover the KfW partially passes on securities.

Availability / creditworthiness

Major banks nowadays tend to be more and more restrictive when allocating credits compared to a few years ago. One prime reason is the implementation of the new codes of equity capital for banks called Basel II from 2007 on. Accordingly to the Basel II-codes commercial banks have to orientate credit interests at the creditworthiness of the applicant. Companies have to bear a credit rating to minimise the bank's risk of non-performing loans. In every third case banks deny the extension of loans because of a lack of creditworthiness. In 60 percent of loan denying cases negotiations fail because of deficient securities. Every third credit applicant breaks down the negotiation, because the accruing interest are to high.

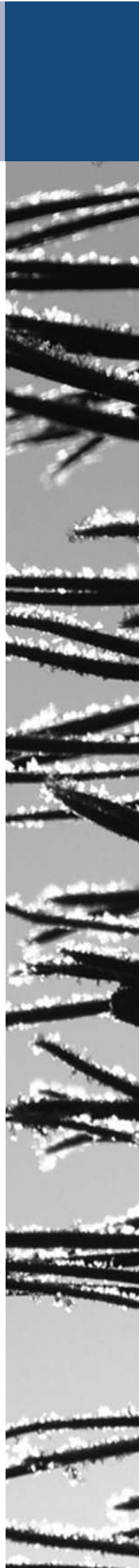
c) Securities

The following securities for the bank's claim of payback of the credit are most commonly granted:

- security collaterals, bails, guarantees or debt accedences,
- securities on property as mortgages, land charges, etc.,
- chattel mortgage and assignments of claims for security,
- liens on chattels, etc.

Bails, Arts. 765 and following BGB

A bail is a one-sided committing contract. The bailer commits to the creditor of a third person (the principal debtor) to fulfil the debt of this person. So the bail as an independent contractual obligation of the bailer assures the primary debt. In the environment of corporate clients bails, but also guarantees and comfort letters between bounded companies play an important role.



Property related securities, Arts. 1113 and following BGB

Land charges (Grundschuld) accordant to Art. 1192 BGB (German Civil Code) are very frequently used for securing loans. Mortgages (Hypothek) accordant to Art. 1113 BGB however do not play an important role in banking practice. Because of the accessoriness of mortgages, other than land charges they cannot be used for the securing of additional loans. However land charges can be limited to a particular loan by a complementary security agreement. For both cited forms of property based securities the owner of the securing mean is only liable with the piece of real estate, which has been encumbered. This piece of real estate can be exploited by compulsory auction in case of liability. The rest of the owner's estate will be untouched.

4. Hire purchase transactions and leasing

a) Hire purchase transactions

In the framework of a hire purchase transaction, the purchase price is paid in several instalments because of a separate credit contract. The buyer immediately gets the possession of the object of purchase but he will get the ownership only after paying the last rate (retention of title). Until December 2001 hire purchases were regulated separately in the "Verbraucherkreditgesetz", the "Consumer Credit Act". Since January 2002 however these rules have been integrated into Arts. 488 and following BGB (German Civil Code). They solely protect the consumer, who for example has got a right of cancellation outlined in Arts. 355, 495 and 499 BGB regarding the credit contract for two weeks after signing the contract, which according to Art. 358 BGB also affects the purchase contract. Entrepreneurs and enterprises in terms of Art. 14 BGB however are not protected under the Arts. 488 and following BGB.

Suitability

Hire purchases are suitable to provide needed assets to the company without paying the whole price at the same time.

Notation in balance sheet (equity- or outside capital)

Once the object of purchase is in possession of the buyer, it has to be assigned economically to the buyer and therefore needs to be activated in his balance sheet. The outstanding amount accordingly will be booked under liabilities and shareholders' equity.

Fitness for purpose

The basic advantage of hire purchase transactions is the immediate availability of the purchased object for the buyer. The disadvantage is on one hand the dilatory conditioned acquisition of ownership as a result of the requisite security for the seller and on the other hand the corresponding fee for the deferred payment, which increases the purchase price.

b) Leasing

Leasing comes down to an agreement between the lessor and the lessee for a certain period, similar to a hire contract. In the frame of "direct leasing" the producer of the leasing object himself acts as lessor. In case of "indirect leasing" there is a separate lessor acting in between the producer and the lessee. It has to be differentiated between "operate leasing" (cancellable at any time, basic hire time not fixed) and "finance leasing". Furthermore there is a difference between "full amortisation leasing", where the lessee compensates the whole costs of the lessor by paying the leasing fee during the basis hire time, and "part amortisation leasing", where the costs of the lessor are not compensated only by paying the leasing fee, but additionally either by the lessee paying a final clearing amount at the end of the basic hire time or by the lessee executing the options of buying or extending the hire time.

aa) Suitability

Leasing offers an alternative to the immediate purchase of assets. The lessor incurs the financing of the leasing object. During the hire time there are normally only leasing costs, which influences positively the liquidity of the company.

bb) Fitness for purpose

Overall leasing costs are relatively high, since in addition to the regular leasing fee during the basic hire time an acquisition fee as well as other costs for the use or purchase of the leasing object arise once the basic hire period is over. Another disadvantage of leasing is the fact, that the lessee will not achieve property of the leasing object after the basic hire time is over, although he already tends to have laid out about 125-155 % of the aboriginal cost. Furthermore leasing can cause high extras, for example for cargo, crossover, assurance of risks, attendance and repair. So to lease an object for a couple of years and finally take the purchase option is in the whole much more expensive than an immediate purchase. Therefore leasing is generally only purposeful, if the lessee is able to set off his leasing costs against tax liability.

5. Trade financing

Accreditation

A document-accreditation is an abstract, conditioned payment promise of the bank of the importer, in which the bank commits itself towards the exporter of the goods to pay the purchase price, as soon as the exporter presents “accreditation conform” documents. “Abstract” means, that the payment promise of the bank is legally detached from the underlying transaction and binds the bank autonomously beside the act of sale. “Conditioned” means, that completion of the payment promise is dependant on the presentation of certain documents. Accreditation is an instrument of financing, that is suitable to balance the interests of sellers and buyers mainly in foreign commerce (rarely in domestic commerce). The sale and purchase has to be agreed under the conditional “accreditation” and has to state the requisite type of qualified documents, that have to be presented by the exporter to get the payment by the bank. Accreditation conformed documents are – among others – considered to be the following: The commercial invoice, the freight invoice, the packing list, the certificate of origin, the bill of lading, the express courier receipt or the airway bill, furthermore the forwarders certificate receipt as well as certificates of assurances.

Guarantee

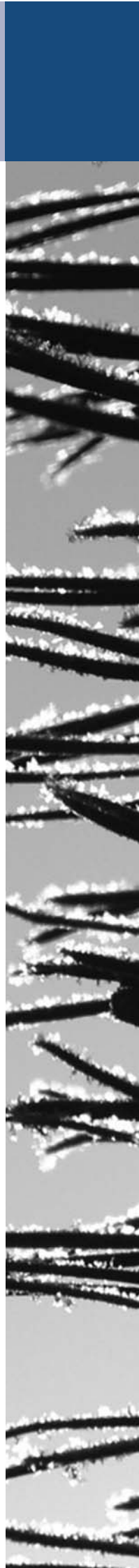
As is the case with a bail, a guarantee is a one-sided committing contract. The guarantor commits to the guarantee to be liable either for the admittance of a special profit or for the absence of failure. The guarantee is not accessory. In contrast to the declaration of a bailer, the guarantee does not need any written form. Guarantees are of importance in foreign commerce and at public advertisement.

Bill of credit

A bill of credit obliges one or several banks to pay sums of money to the assignee up to a certain maximum amount. Bills of credit are more and more being replaced by cheques.

Discounting

Discounting is the calculation of the seize of an amount at a certain time x from the seize of this amount at a later point in time y , if interests are to be paid for the amount during the interim peri-



od. In doing so only the accumulation is cancelled, that means the interest, which have accrued until the time y are subtracted to get the amount at the beginning time x . By discounting an amount is reached, which would have had to be invested in order to achieve a certain ending capital in y . So discounting of bills in fact is the purchase of claims, which will be due at a future date (e.g. acceptance), on the grounds of previous subtraction of the corresponding interests. Discounting of bills is widespread especially in banking business. Thereby the seller of a not yet due acceptance gets paid out the note total, diminished by the interests until due date and a bank commission. The rate of interest to be deducted adjusts with the discount rate of the Bundesbank (German Central Bank). The legal platform is provided by the Acceptance Law (Wechselgesetz), the Law about the German Central Bank (Bundesbankgesetz) as well as the particular business conditions of the banks. Legally, Discounting business is to be regarded a purchase and is classified as a banking business in the sense of the German Banking Act. It is a predominantly safe banking business because of the acerbity of acceptances and the liability of endorsers. Banks mostly discount only up to the amount of the discount credit, which is allowed to the customer.

Factoring (sales factoring / purchase of demands)

Factoring is a type of corporate financing with its origin in the U.S.A.. The aim of factoring is a sales congruent financing in combination with a shortening of the balance sheet and possibly an assurance against the loss of claims instead of an assurance of commercial loan. In the frame of the so called "Full-Service-Factoring" also service duties and responsibilities of encashment are provided. Factoring as a purchase of claims by financial institutions stands for the takeover of the risk of default as well as the takeover of accounts receivable, dunning process and encashment. At the purchase of the claims the amount invoiced less interests, fees and a bonus for the risk of default (delcredere commission) is paid.

6. Business Angels

Description

Business Angels invest in promising businesses and bring in their experiences and contacts. They are financier and at the same time mentor of young and innovative corporations with strong growth. The legal embodiment of the participation is flexible. Possible are for example dormant partnerships or profit sharing rights.

Suitability

In the U.S.A. Business Angels have got an enormous economic impact. Privatiers do invest there in a by far greater volume than institutional Venture Capitalists. In Germany an increase of private investors could boost the development and the foundation of corporations as well. The corresponding participation can be constructed in a flexible way for example by the instalment of profit sharing rights. In doing so, both the founders interest in operational and corporate autonomy as well as the economic participation of the Business angel can be duly observed. Although Business Angels are consultants, they regularly do not get any specific rights from the point of view of corporate law. They rather participate from the economic success of the corporation by profit payout rights and accretion of their attendance like an associate or shareholder.

Fitness for purpose

The participation of Business Angels has got plenty of advantages. It may take place under cover and compared to an open participation it usually originates less effort. Neither a notarial certification nor any registration is needed. The participation is divisible and tradable, which eases the entrance of other investors as well as the purchase of the participation.

7. Venture Capital

Venture Capital can be brought into the business either in form of fully liable equity capital or equity capital similar financing instruments like for example mezzanine capital. It generally is invested in not listed, newly founded and technology oriented Corporations. But venture capital can also be a possible way of financing for already existing companies, especially as part of a preparation for IPO.

Types and legal construction

Venture Capital is a special form of financing by participation. The investors thereby risk great losses for promising innovations to achieve big profits in case of economic success. The general plan of venture capital is divided into three major steps:

1. the phase of capital accumulation, in which the venture capitalist directly participates in the business (equity capital) or allocates his capital to a financing corporation by contract,
2. the phase of investment, in which either the venture capitalist or the venture capital financing corporation invests in the innovative business and advises the business in matters of management, marketing and organisation (like Business Angels) and finally
3. the phase of disinvestment, in which the venture capitalist or the financing corporation sells the business' shares, once the business has warmed-up (exit by going public). The following ways of disinvestment have to be distinguished:

Initial Public Offering (IPO): Through an IPO the shares may be sold at the market;

Trade Sale: The young company may be taken over by another company;

Secondary Sale: The venture capitalist may sell his lot of shares to a third person;

Company Buy-Back: The business or its founders buy back the shares of the venture capitalist;

Liquidation: The company may be liquidised in the worst case.

Mezzanine capital

Mezzanine capital is a very flexible instrument of financing, which pretends to include and combine possible trade and tax law advantages of both equity and outside capital. By adequate contractual arrangement it can possibly increase the equity capital rate of the company and fiscally function as outside capital at the same time. Mezzanine capital does not bound securities, it can be provided for a long term and does not change the structure of associates or shareholders and thereby does not influence the company in any way. The hereby contractually created equity capital economically includes typical elements of outside capital like for example fixed interests, a fixed amount repayable or a limitation of duration. Likewise outside capital can be provided with economic attributes of equity capital by individual contractual arrangement, in particular with the typical control and decision authority of shareholders as well as with profit sharing. For that reason mezzanine capital represents an economic mixture between equity and outside capital. The term "mezzanine" as a matter of fact stems from the Italian language („mezzanino“) and recalls the construction of a mezzanine floor. Assigned to the balance sheet mezzanine capital constitutes a special item in between the notation as equity capital and the notation as outside capital. The so called „equity mezzanine“ tends towards equity capital and the so called „debt mezzanine“ tends towards outside capital. Economically both forms are traded as equity capital because of the subordinated liability at insolvency. In respect to a fiscal approach mezzanine capital in case of accordant contractual arrangement is considered as outside capital. The features of a typical mezzanine financing instrument are characterised as "magic pentagon":

1. restricted liability of the capital due to subordination;
2. increase of the equity capital rate on the balance sheet;
3. flexible interests depending on the results of the company;
4. fiscal deductibility of profit distribution as operating expenditure as well as
5. none or limited corporate influence of the investors (flexible).

Variations (buy-outs, buy-ins)

The term “management buy-out” stands for the takeover of the company by its own management. In contrast to that, the term „management buy-in“ stands for the takeover of the company by an external management.

Rights of the owners of risk capital

Rights of executive calling

The shareholders of the company are entitled to decide about the nomination of its executives. The venture capitalist mostly steps into a company by depositing money and getting shares therefore. In that case he has got automatically all the rights of a new associate or shareholder, as might be voting rights, profit participation, information and controlling rights. If the investor however does not get into the position of an associate or shareholder, but is rather connected to the company in personam (like in cases of mezzanine financing as a dormant partner or as a creditor of a subordinated loan), he cannot decide about the calling of executives by voting.

Rights of investors, privileges, veto rights, information and controlling rights

Investors often let themselves be granted comprehensive privileges independently from their position under company law. Besides information and controlling rights for the current business, the need of their approbation for essential business dealings is also often agreed. Therewith the investor makes sure he has got a say before essential actions like for example abandonment and purchase of lines of business, rearrangement of business policy and strategy, essential changes in production and marketing as well as great investments are carried out. Veto rights also are entitled to the associates or the shareholders in the sense of a blocking minority. As venture capitalists normally get participations under 50 % and do not act as executives, a dominant influence of the original associates or shareholders mostly persists. However venture capitalists often insist on a blocking minority of 25 % + 1 vote, so that at the end of the day they are able to block all fundamental actions of the company, which need a previous change of the contract of association.

Mezzanine financing in the form of dormant partnerships basically does not grant any vote or power of representation for the investor. Art. 233 German Commercial Code (HGB) however grants some limited legal controlling and information rights to the dormant partner has such as a right of access to the annual accounts and the right to challenge their accurateness with the help of the companies books. These rights of the dormant partner can be flexibly amplified by a variant contractual agreement.

cc) Management and consulting fees

Besides the financing component, venture capital regularly includes an offer of support and counselling, which can be charged with a contractual fee. Young companies often profit from this external counselling, which might provide support for the day to day business and for strategic orientation, counselling at organisations as well as at the intermediation of partner-

ships and distribution markets. Therefore the counselling of a private investor might have the function of a “door opener”, the company might get access to new networks and might be able to build important contacts to potential customers or other investors. However it has to be taken into consideration, that the success of consulting cannot be forecasted beforehand and especially young companies in their start up phase do not have the capital base to commit themselves to pay additional consulting fees. Given the natural personal interest of the investor in the economic success of the company, the counselling tends to be for free or against allowance of the investors special expenditures.

8. Initial Public Offer (IPO)


IPO stands for the first time offer of public limited company shares at an organised capital market. Either old shares or new shares are tradable with occasion of the IPO. In case of old shares, the net revenues accrue to the selling shareholder, in case of new shares they flow to the public limited company as emitter. Transaction mostly is handled by a bank.

Suitability

IPO arranges a broad capital basis for the company, which also includes other advantages. The company is able to grow faster and fitter to survive in international competition, which has become a very hard to achieve aim in times of globalisation. Stock exchange noted companies furthermore are much more present in public and media than other companies. A positive media presence moreover increases competitiveness and supports the acquisition of new customers. IPO beyond that as well improves the creditworthiness at banks and contractors, since in credit assessments creditors can take hold of a higher equity capital and of public information. Finally strategies of internationalisation can be better realised and the public attention may increase the attractiveness of the company as an employer of high qualified employees.

Procedure of IPO admission

For a start the current shareholders and the management have **preliminary talks** with specific banks. On the grounds of conversations, firm walkabouts and the draft of a business plan taking into account the future plans of the company, the banks get a first impression of the target. After that banking analysts take an indicative assessment or **rating** of the company. Thereby they estimate the anticipated market capitalisation of the company and suggest the most suitable segment of stock exchange for IPO. Meanwhile, the emission bureaus of the banks submit an offer regarding the conditions for their monitoring of the IPO in the frame of a **beauty contest** run in parallel. These offers normally account for four to six percent of the volume of emission. After closing the negotiations about the corresponding conditions, the current shareholders normally assign one bank as lead manager and often give participation at the planned IPO to other banks. Following this comes the **due diligence** of the company by the assigned bank, which is divided in a legal due diligence (legal opinion) and a financial due diligence (comfort letter), the results of which will not be published. The business plan of the company and the results of the due diligence make for the so called **equity story**. This is the concept of the companies argumentation to achieve a successful marketing of the IPO. The equity story is the fundament of the so called **stock exchange prospectus**, which advertises the IPO and has to be submitted for the requisite announcement at the stock exchange together with further documents. Thereupon the company files an **application for admission** at the chosen stock exchange for the required segment of the stock trading market together with the bank, which has to be admitted at a stock exchange authorized to take part in stock trading. The admission office of the particular stock exchange decides about the admission of stocks



to the official market or regulated market. The official market is reserved for companies, which have existed at least for three years and furthermore have disclosed their annual accounts of the last three years before filing their application for admission. The regulated market has been created for small or medium-sized public limited companies to ease their way towards IPO. Companies, which are not able to fulfil the conditions of admission of an official or regulated market, can sidestep it by going for the curb market with its pricing under private law. Besides these three statutory segments of the stock exchange market, the German Stock Exchange Corporation (Deutsche Börse AG) as responsible body of the Stock Exchange Frankfurt (“Frankfurter Wertpapierbörse“) has created more independent markets and segments of market like for example the DAX, MDAX, New Market and SDAX.

The announcement is followed by **research reports** about the company. These reports are prepared by consortium banks to describe the market position and potentials of the company. While introducing equity story and research reports the banks try at first in the so called **pre-marketing-phase** to generate the interest of institutional investors for the purchase of stocks from the emission volume. In the **bookbuilding phase** the bids for potential investors are intensified for instance by road-shows and the interest shown by those potential investors is evaluated. As a result of the bookbuilding phase the banks declare the price margin. This price margin constitutes the range and limits of the presumable emission price. Alternatively a fixed price might be appointed. Hereupon the stocks are offered for signing by the public in the **signing phase**. Investors interested in the shares have to commit themselves on how many stocks they want to purchase. In case the interest is greater than the quantity of offered stocks, a situation of “oversubscription” is the result. Eventually the consortium banks make allocations of supplementary shares out of the greenshoe. After the allocation the stocks are traded at stock exchange to a specific market price for the first time (**opening price**). Then an instructed bank, often the primal lead manager, assumes the business of the designated sponsors. Hereby the bank commits to always carry the stocks tradable.

AIM

The Alternative Investment Market (AIM) is a segment of the London Stock Exchange founded in 1995 as a segment of the stock trading market for small and medium-sized companies without a long history. The AIM only requires minor preconditions for an IPO. As a result, the listing price is comparatively expensive. Public limited companies, which want to be included in the AIM, have to assign a nominated advisor (NOMAD), who arranges the listing and the due diligence and after the admission functions as “market maker”. However, AIM has got many critics. Particularly in the sector of exploration and raw material values, quite a few cases accumulated in the past, which gave proof of an only cursory checking and admission procedure to AIM, that was only used and exploited for quick capital procurement without being in place any equivalent value.

OFEX

OFEX is the independent public market of the UK, which is dedicated to smaller companies and based on a quote-driven trading platform. Owned and operated by PLUS Markets Group plc, it is authorised and regulated by the Financial Services Authority. The Market Abuse regime covers all securities traded on the OFEX market. OFEX with his over 500 companies is a flexible market with broad appeal to companies, their professional investors, and those investors wishing to invest in smaller companies. Its regulatory framework strikes a careful balance between flexibility for smaller company management teams and the protection required by equity capital investors.

Financing of IPO

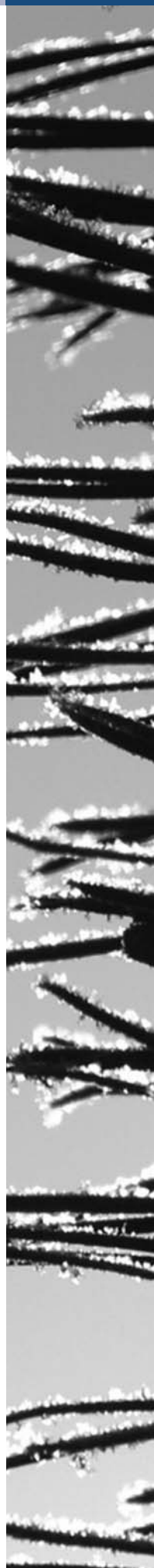
The so called “bridge-financing” serves as preparation for the IPO. The company gets the necessary financial instruments to reach the IPO and bridge financing allegorically builds a bridge to a higher equity capital rate of the company be provided by the IPO. Bridge financing is a typical instrument of financing by venture capital, which is why at this place a referral to capital VI.7. is indicated.

Not listed stock corporations

The public limited company or stock corporation (Aktiengesellschaft or AG) has got a fixed nominal capital, which amounts to minimum 50.000,00 €. As „signed capital“ it makes up the equity capital of the company together with the capital and revenue reserves. Even without IPO the public limited company has got the best possibilities of raising capital. As a result of the participation of an unlimited quantity of stockholders, the company can potentially raise huge amounts of capital. Furthermore the stock capital is not cancellable by the shareholders. To quit his membership in a stock corporation (AG) the stockholder needs to sell his shares. Stock trading outside of the stock exchange normally takes place by agency of banks. As a result of the usually larger equity capital rate compared to the German GmbH, stock corporations finally enjoy an regularly an easier access to bank credits and thereby to more fresh capital.

JUNGE • SCHÜNGELER & PARTNER

Marcel Leiser
Rechtsanwalt







GERMANY

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