

3 Financing Investment Projects in Germany

Equity

Debt Financing

Mezzanine

Off-Balance Financing

There are different models for financing investment projects, all of which include different instruments and sources of funding. But all of these models hinge upon two basic questions: First, do current business activities cover the investment or are outside sources necessary? And second, what form will best fit the project's needs- equity or debt? Are there alternative options?

Equity

When financing investment projects, possible financial partners usually require a share of equity of at least 20 to 30 percent. In most cases, start-ups have to rely solely on financing through equity.

Equity can result from a company's own business activities or is acquired by finding new shareholders. Most commonly capital is then raised through:

- Business Angels
- Venture Capital
- Private Equity
- Initial Public Offering (IPO) which is the first public sale of shares on the stock exchange by a private company

With the provision of money, shareholders usually acquire certain company rights which can range from controlling and participating rights to a share of profits.

Apart from these equity forms, money resulting from public funding to promote investment projects in Germany (usually in the form of cash incentives) is also considered equity by financial partners.

Business Angels

Business angels are wealthy individuals, often self-made and with considerable business background and industry expertise, who allocate some of their resources to invest knowledge and seed money in new ventures.

During a company's seed phase, business angels are often the only source of external financing for a project. For first-time entrepreneurs and young companies, it is almost always easier to raise money through angels than it is through traditional venture capital firms.

This start-up support provides the entrepreneur with enough capital to fund initial product development and sales so that the company can later raise additional capital through other sources.

Business angels also often act as mentors by tapping into an extensive, worldwide network to help finding customers and other business partners for an investment project.

German BAND Business Angels Netzwerk Deutschland e.V. (in German only)
www.business-angels.de

Venture Capital

Venture capital (VC) is often required for the financing of high-tech, high-risk projects. VC is provided by VC companies who manage funds from private, institutional, and public investors.

Generally, VC fund investors accept a higher risk of failure than is normally the case for other more conservative investments. This is because young companies rarely have significant assets or revenue history. In return for taking on this risk, VC companies expect to recoup their investment as a result of increased market potential resulting from a perceived unique selling proposition.

VC participation is limited to a specified period of time, at the end of which the VCs “cash out” by selling their shares and realizing profit at a margin of between twenty to thirty percent. These shares are usually sold as part of an “initial public offering” (IPO) - the first sale of stock by a company to the public. Where an IPO is unrealistic or holds little promise, VC companies can realize their shares through a so-called “trade sale”: the selling of shares to another company.

Companies can approach VCs directly to apply for VC money. In Germany, the appropriate financial partner can be found through the German Private Equity and Venture Capital Association (*Bundesverband Deutscher Kapitalbeteiligungsgesellschaften e.V., BVK*). Special conferences and events like the German Equity Forum (*Deutsches Eigenkapitalforum*) provide an opportunity for young enterprises to come into direct contact with VC companies.

German Private Equity and Venture Capital Association e.V. (BVK)

www.bvkap.de

German Equity Forum

www.eigenkapitalforum.com

Private Equity

Private equity is privately traded capital provided by private equity companies financed by institutional funds (e.g. pension funds) and private investors. As a broader term it also comprises venture capital.

Private equity, in the literal sense, is an appropriate instrument for established and growing companies. Private equity firms usually concentrate on companies with a sales threshold in excess of EUR 20 million. For deals above EUR 50 million, the market proves highly competitive.

Like venture capital companies, private equity companies provide funding to a company for a fixed period (usually three to seven years). The participation of a private equity firm is often concluded by a trade sale (i.e. the selling of shares to another company).

The German Private Equity and Venture Capital Association (*Bundesverband Deutscher Kapitalbeteiligungsgesellschaften e.V., BVK*) and the German Equity Forum



(*Deutsches Eigenkapitalforum*) are good starting points for identifying the appropriate private equity partner.

German Private Equity and Venture Capital Association e.V. (BVK)
www.bvkap.de
German Equity Forum
www.eigenkapitalforum.com

Initial Public Offering (IPO)

The IPO is the first time a company approaches the public capital market to finance its business by selling shares at the stock exchange. IPO provides the right option for companies wishing to avoid dependency on a select few private investors.

There are two ways to gain access to capital markets in Germany:

- The Regulated Unofficial Market or Open Market (*Freiverkehr*), offers an appropriate first entry point for small or recently founded companies.
- The Regulated Market (*Amtlicher Markt*), governed by EU regulations, requires higher entry, reporting, and transparency standards.



Germany's most established stock exchange is the Frankfurt Stock Exchange (*Frankfurter Wertpapierbörse - FWB*), which is the third largest in the world. In addition, there are seven exchanges which concentrate on local or sector-specific markets:

- Berlin Stock Exchange (*Börse Berlin*)
- Stuttgart Stock Exchange (*Börse Stuttgart*)
- Hamburg & Hanover Stock Exchange (*Hamburger Börse*)
- Munich Stock Exchange (*Börse München*)
- Düsseldorf Stock Exchange (*Börse Düsseldorf*)
- Commodity Exchange Hanover (*Warenterminbörse Hannover*)
- European Energy Exchange Leipzig

Cash Incentives

Investors can call upon a wide range of public funding in Germany. There is a large selection of programs available which are designed to support business activities at all stages of the investment process.

One of the main instruments are cash incentives usually provided in the form of grants. Promotion rates can account for up to 50 percent of investment costs. They are usually regarded as equity by financial partners.

Other public funding instruments, such as interest reduced loans, are usually debt oriented.

Debt Financing

Debt financing is a central financing resource and the classic supplement to equity financing in Germany. It is available for day-to-day business (working capital loans), can help bridge temporary financial gaps (bridge loans) or finance long-term investments (investment loans).

The main differences in comparison to equity financing are:

- Time limit
- Payment of interests and amortization unlinked to the earnings trend
- No transfer of shares to the creditor
- No liability of the creditor
- Preferred repayment in case of insolvency

Debt is mainly provided by banks. In Germany, universal banks offer the whole range of financial services. In addition, there are also special banks focusing on specific products or clientele.

Investment Loans

The main debt financing instrument for a project is the investment loan. The preferred loan duration is seven years with a one year repayment holiday (1+6); the usual maximum period is ten years with a two year repayment holiday (2+8). Interests are charged on an annual or semi-annual basis.

Creditors, mainly banks, always require securities against a risk of default of payment. Fixed assets will usually serve as the first source of security. Inventory and receivables can be used as collateral - primarily for working capital facilities. As well as the above-mentioned sources of collateral, shareholder guarantees (recourse) are often required as a means of reducing the bank's credit risk.

Bridge Loans

Bridge loan financing becomes necessary when a company has to bridge a deferred financial inflow, which usually results in a financial gap. Generally, such gaps follow from having to pre-finance orders, or from time-shifted payments of incentives.

Interest rates for bridge loans are favorable because the company assigns the claim to the bank.

Working Capital Loans

Working capital loans, including overdraft facilities, provide liquidity for day-to-day business activities. They finance the stock of goods and reserve stock, payment deadlines, and the exploitation of supplier discounts.

Working capital loans are adapted per annum. The interest rates depend on the level of loan utilization and the period of usage. The level of the overdraft amounts to a certain percentage of the net working capital.

Credit Rating

The availability of debt depends on the default risk of a company or an investment project. This is usually determined through a credit rating of the debtor. Banks conduct these ratings themselves or require external ratings from private rating agencies.

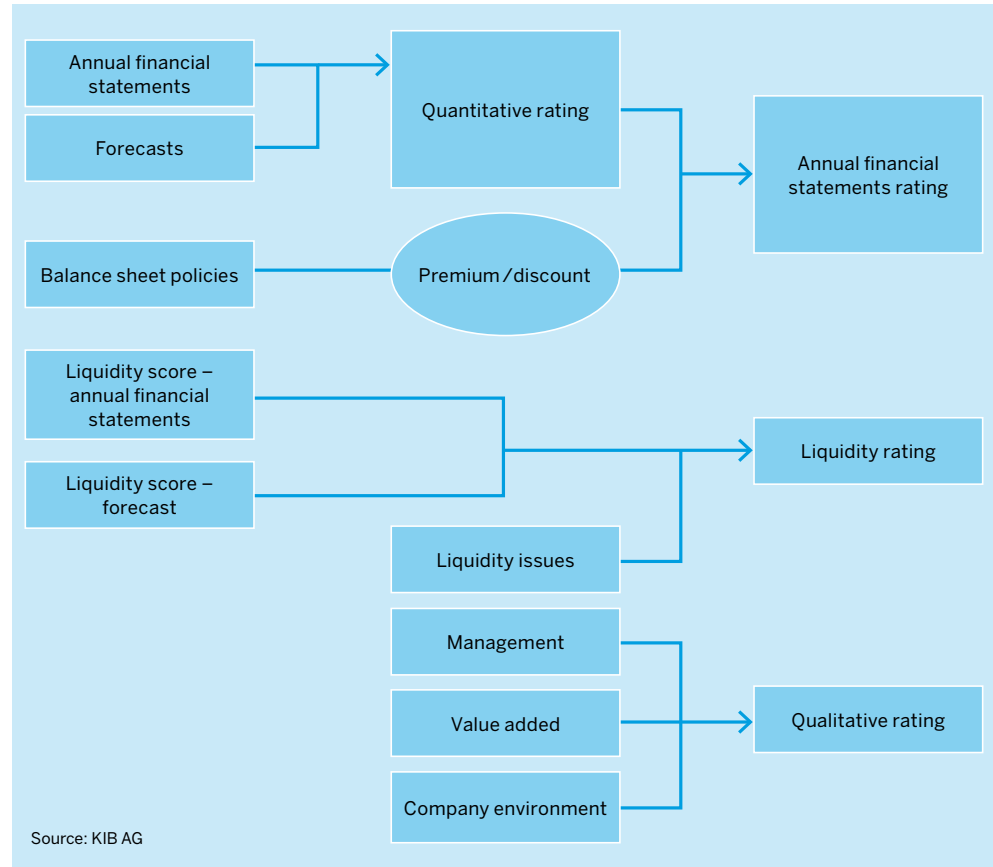
The creditor “grades” the debtor according to a set of certain criteria. The procedure results in an investment grade describing the risk associated with the company or project and determining the margin associated with that risk. Accordingly, pricing is determined risk adequate. For companies receiving a so called non-investment grade credit rating, debt financing is usually not available.

Although rating criteria are more or less the same, each bank has its own rating process, where all financial data (e.g. annual financial statements, liquidity, financial structure) and qualitative factors (e.g. balance sheet policy, market potential, management, economic framework) are analyzed.

A company applying for debt has to be aware that this financial instrument deteriorates its equity ratio which may worsen the credit rating for subsequent financing.



Credit Rating Modell



The German “Hausbank” Concept

The Hausbank (literally “house bank”) concept is unique in Germany and refers to a company’s primary banking institution. This term is derived from the longstanding tradition of companies in Germany having a strong financial relationship with one particular bank.

In addition to lending and corporate financing, the Hausbank supports the day-to-day business activities of a company through electronic and international banking services, receivable management, and treasury activities. Special services include rating, advisory, and application support for public funding.

Today the importance of having one specific Hausbank has begun to diminish in Germany; particularly for larger companies who often prefer a relationship with several banks or to secure financial support through a consortium.

Nevertheless, the Hausbank still plays an important role with regard to the procurement of public funding. During the application procedure, authorities require a signed bank statement stipulating total project financing. From this point onward, the bank is responsible for administering incentive payments and reporting requirements. Should the company require a public guarantee, the bank acts as the applicant.

The Hausbank does not need to be a German bank. For financing purposes, and for practical reasons, a subsidiary of a foreign bank in Germany is sufficient. For all incentive-related tasks and services the bank must be German or have at least a German subsidiary and has to be accredited by the German government (as is generally the case for most banks).

Financing by a Consortium

Financing by a consortium refers to the participation of several banks in structuring a financing package. Usually one of the banks acts as the lead arranger and serves as the primary negotiation partner of the company. The other banks, known as underwriters, are invited by the lead arranger to participate in financing.

Financing by a consortium, also known as syndication, entails combining loans with different terms and conditions from multiple banks (known as a syndicated loan). The result is structured financing with fixed terms and conditions. The portfolio can consist of:

- typical amortizable loans
- loans being repaid at the end of maturity
- mezzanine capital
- working capital facility

Financing by consortium has the advantage of stability and flexibility over single bank financing, but can also result in potentially higher margins, complexity, and a longer approval waiting time.

Corporate Financing vs. Project Financing

When a company applies for a loan at a bank, the bank first of all has to determine who is liable for paying interest, amortization and providing securities. Based on this, the bank generally makes a distinction between corporate financing and project financing.

Corporate financing requires the payment of interest and amortization by the company itself. The credit rating focuses only on the company, its repayment history, and its ability to earn profit.

Project financing is based upon a more complex financial structure. Generally, a special purpose entity is created for each project, which shields other assets owned by a project sponsor in case of failure - particularly if the project company is considered to have no assets other than the project.

Hence, project financing is preferred if project sponsors wish to significantly reduce their liability or if a young company is not able to produce a sufficient repayment and profit earning history. Risk identification and allocation is an essential element of project financing. The possibilities for minimizing risks and thus increasing the chances of securing financing are greater when:

- dealing with established technologies;
- a large or growing or sufficient market for the products or services can be identified;
- contracts with customers and suppliers exist;
- robust projected cash flows from the investment can be expected, determined through massive stress testing;
- an experienced management team with the relevant technological and commercial skills is in place.

Mezzanine

Mezzanine capital is a broad financial term that refers to unsecured, high-yield, subordinate debt or preferred stock. Mezzanine capital represents an intermediary between equity and debt in a company's balance sheet.

Due to increased credit risk, mezzanine capital is a relatively expensive source of company financing. For this reason, it is most appropriate for financing growing companies with high profitability.

One reason a company might prefer mezzanine capital is to maintain its equity-ratio, as even loan-oriented mezzanine instruments are often valued as commercial equity.

Mezzanine capital is mainly offered by banks, especially when it comes to debt-related products. In return, private equity firms focus on equity-related instruments.

Mezzanine Capital as Equity or Debt

Different forms of mezzanine capital are classified as equity or debt according to three factors:

1. Duration of the Capital Commitment

The duration of the capital commitment should be unrestricted or at least long-term for consideration as equity. Generally the spread of the maturity for the mezzanine capital is between five to ten years.

2. Liability and Loss-Sharing


The loss-sharing is one of the major factors for the assessment of equity. In case of insolvency equity-oriented mezzanine investors usually participate on losses, whereas debt mezzanine is only subordinated.

3. Conditions of Compensation

Compensation for mezzanine investment comprises a fix current interest payment and participation on the generated profit and growth. A mezzanine instrument is rather equity than debt if the compensation is flexible, dependant on profit and takes part on the performance of the company.

The following chart illustrates several forms of mezzanine capital and their respective categorization as either debt or equity. Variations may occur due to the different accounting rules such as International Financial Reporting Standards (IFRS) and German Accounting Rules (*Handelsgesetzbuch - HGB*).

MEZZANINE CAPITAL AS
INTERMEDIATE BETWEEN EQUITY
AND DEBT



Mezzanine forms	Taxable Debt	Equity on the Balance Sheet	Control Rights	Duration in Years	Liability in Case of Insolvency
Subordinated Loans	Yes	No	Restricted to creditor's rights	3–10	None
Silent Partnerships (typical)	No	Yes	Depending on contracts	5–10	Depending on contracts
Convertible Bonds	Before conversion	After conversion	Restricted to creditor's rights	at least 1	Yes
Preferred Stocks	No	Yes	Mostly not, but possible in exceptional cases.	3–10	Yes
Silent Partnerships (atypical)	No	Yes	Approval and control rights	5–15	Yes

Example: Silent Partnership

In Germany, one of the classical forms of mezzanine financing is the silent partnership. The silent partner contributes a share of the capital and obtains a share of the profit in return. The participation in losses is typically limited to the capital contribution.

There are two main types of silent partnership. The typical silent partnership and the atypical silent partnership:

- The typical silent partner does not influence the management of the company and expects a minimum rate of return on a regular basis (usually yearly).
- By comparison, participation in management and risk is an inherent part of the atypical silent partnership, and for this reason, the atypical silent partner demands an extraordinary return.

The typical silent partnership is widely used in public funding. In Germany, public venture capital companies (*Innovations- und Technologiebeteiligungsgesellschaften*) or public-private equity enterprises (*Mittelständische Beteiligungsgesellschaften*) take minority shares in technological ventures or growing small or medium-sized enterprises (SMEs).

Example: Subordinate Loan

The subordinate loan, also known as a junior tranche, is a debt instrument that takes a lower repayment priority than the normal debt provided by lenders. In the event of payment default, the repayment is subordinated and all other lenders are repaid in the first instance.



Subordination also refers to the payment of amortization and the provision of securities. With regards to securities, subordination means that banks do not require collateral for these loans. However, the advantages over normal debt for the creditor are combined with a higher risk for the bank. These risk factors must be covered with a higher margin, which means higher interest rates for the borrower.

Off-Balance Financing

Off-balance financing (also referred to as alternative financing) comprises financial instruments that affect only the profit and loss account of a company and not the balance sheet.

A company chooses off-balance financing in order to reduce strains on liquidity and capital lockup. This enables the company to maintain the equity ratio, avoiding a degradation of its credit rating. In return, it has to accept higher total costs in comparison to financing on-balance.

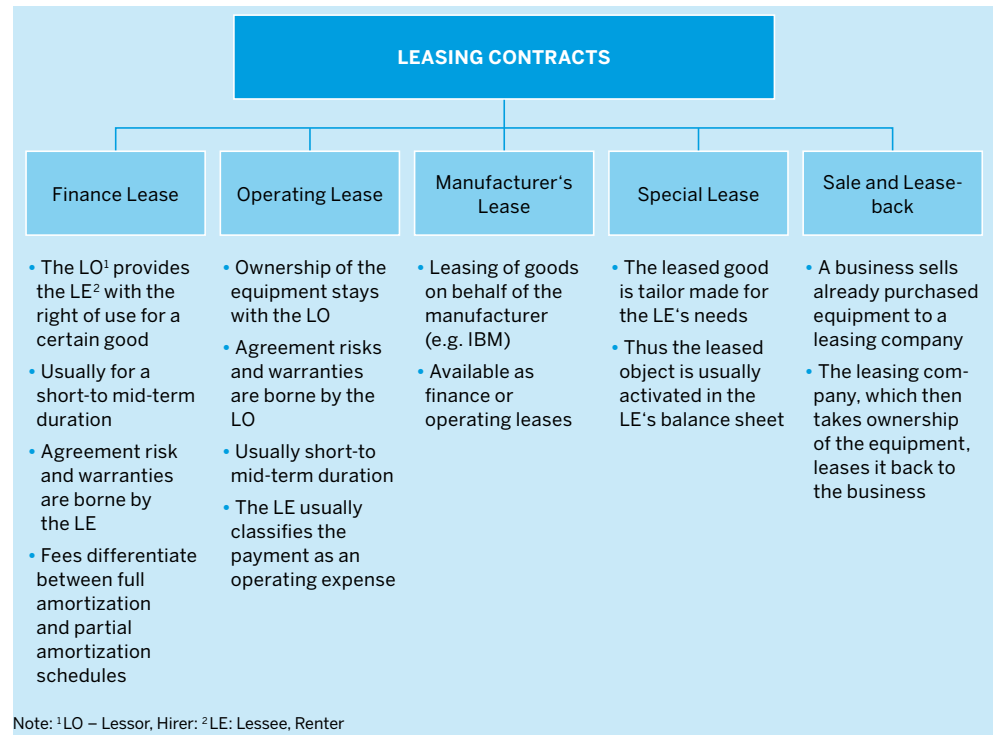
Leasing

Leasing, especially operating lease, is the most widespread form of off-balance financing in Germany. Leasing is provided by general leasing companies or companies who specialize in financing particular goods.

Various interpretations of the term “leasing” exist in different sets of accounting rules, for example, in the International Financial Reporting Standards (IFRS) and in the German Accounting Rules (*Handelsgesetzbuch, HGB*).

To qualify as off-balance financing, the financing measure must be an operating lease. An operating lease is usually a short-term financing instrument in which the ownership and risk stay with the lessor. The lessee pays an expense fee comprised of interest and remuneration for depreciation. Other forms of leasing and their activation in the balance sheet are shown in the following illustration.

Leasing as an Alternative Financial Tool



More information on leasing in Germany is provided online by the German Association of Leasing Companies (*Bundesverband Deutscher Leasing-Unternehmen*).

Factoring

Factoring is a process in which a company sells its receivables in order to immediately obtain cash for liquidity. Special financial institutions called factors provide this advanced financing at a discount. The factor secures the payment and offers protection against default by the creditor.

Over the past decade, factoring has gained importance as an internal source of financing in Germany. Banks in particular insist that companies sell receivables from goods or services as soon as possible. Since factoring is an optimization of cash management, it cannot be used to finance larger projects.

German Factoring Association
www.factoring.de