

3 Financing a Business

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

Equity to finance an investment project can be provided by a company's shareholders or external sources such as:

- Business angels
- Venture capital
- Private equity
- Shares sold on the stock exchange

In the early phase, equity is the sole source of financing for an investment project. Even if additional financing options are available, a portion of at least 20 to 30 percent of equity is still required.

Business Angels

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

Often, business angels can also act as mentors by tapping into an extensive, world-wide network to help find 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 needed for the financing of high-tech, high-risk projects. Venture capitalists are willing to get involved in an investment project at a very early phase in order to later sell their stake in an investment for above-average returns.

Investors in VC funds understand that the investments made by venture capitalists run a higher risk of failing than other more conservative investments because young companies rarely have significant assets or revenue history. To take the risk VC companies expect an apparent market potential due to a unique selling proposition covered by intellectual property.

Each VC participation has a limited duration, at the end of which the venture capitalists cash out by selling their shares and thus earning profit with a margin of twenty to thirty percent. If an Initial Public Offering (IPO) is not realistic or promising, the VC company can at least use a trade sale to realize its shares.

Private Equity

Private equity is an appropriate instrument to obtain capital for established and growing companies.

Private equity firms usually concentrate on companies exceeding a sales threshold of EUR 20 million. For deals exceeding EUR 50 million, the market is especially competitive.

Like venture capital companies, private equity companies provide funding to a company for a temporary period (usually three to seven years). The participation of a private equity firm is often ended by a trade sale.

German Private Equity and Venture Capital Association e.V. (BVK)
www.bvk-ev.de

Initial Public Offering (IPO)

There are two ways to gain access to capital markets in Germany, and each is accompanied by different levels of transparency. The Regulated Unofficial Market, also called the Open Market (Freiverkehr), offers an appropriate first entry for small or recently founded companies. The Official 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 five regional exchanges which concentrate on local or sector-specific markets:

- Börse Berlin-Bremen
- Börse Stuttgart
- Hamburg & Hanover Stock Exchange (Hamburger Börse)
- Börse München
- Börse Düsseldorf

There is also a commodity exchange in Hannover and a power market in Leipzig.



Debt Financing

Debt financing is a central financing resource and the classic supplement to equity financing in Germany. Debt is available for day-to-day business as well as for long-term investments.

The main differences in comparison to equity financing are:

- Time limitation
- Payment of interests and amortization
- No transfer of shares to the creditor
- No liability of the creditor
- Preferred re-payment in case of insolvency

The availability of debt depends on the credit rating of the debtor. The creditor distinguishes between the investment-grade and the non-investment grade.

Debt financing is usually not available for companies with a non-investment grade credit rating.

Investment Loan

The main 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 is ten years with a two year repayment holiday (2+8). Interests are charged on an annual or semi-annual basis.

Creditors always require securities against a 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. In addition to 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 financing becomes necessary when a company has to substitute (or bridge) a deferred financial inflow, which results in a financial gap.

Usually such gaps follow from having to pre-finance orders, or from time-shifted payments of incentives. The Investment Allowance, for example, has to be bridged as this financial support is paid by the government in the year following the investment.

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

Cash Incentives for Investments

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Working Capital Financing

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

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.

The German Concept of a Hausbank

The concept of a Hausbank (literally “house bank”) is unique in Germany and refers to a company’s primary banking institution. This term is derived from the long-standing 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.

The Hausbank plays an important role with regard to the procurement of public funding. During the application procedure, authorities require the signing of a bank statement that stipulates the total project financing. From that point forward, the bank is responsible for administering the incentive payments and reporting requirements. Should the company need a public guarantee, the bank acts as the applicant.

For all incentive-related tasks the bank must be German or have a German partner.

Today the importance of having one particular Hausbank has begun to diminish in Germany, especially for larger companies, which often prefer a relationship with several banks or to secure financial support through a consortium.

Incentives

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During the incentive application procedure authorities require the signing of a bank statement regarding the total financing. In the following process the bank administers the incentive payment and reporting. Should the company need a public guarantee, the bank acts as the applicant. For such administrative tasks the bank has to be German or has to have a German partner.

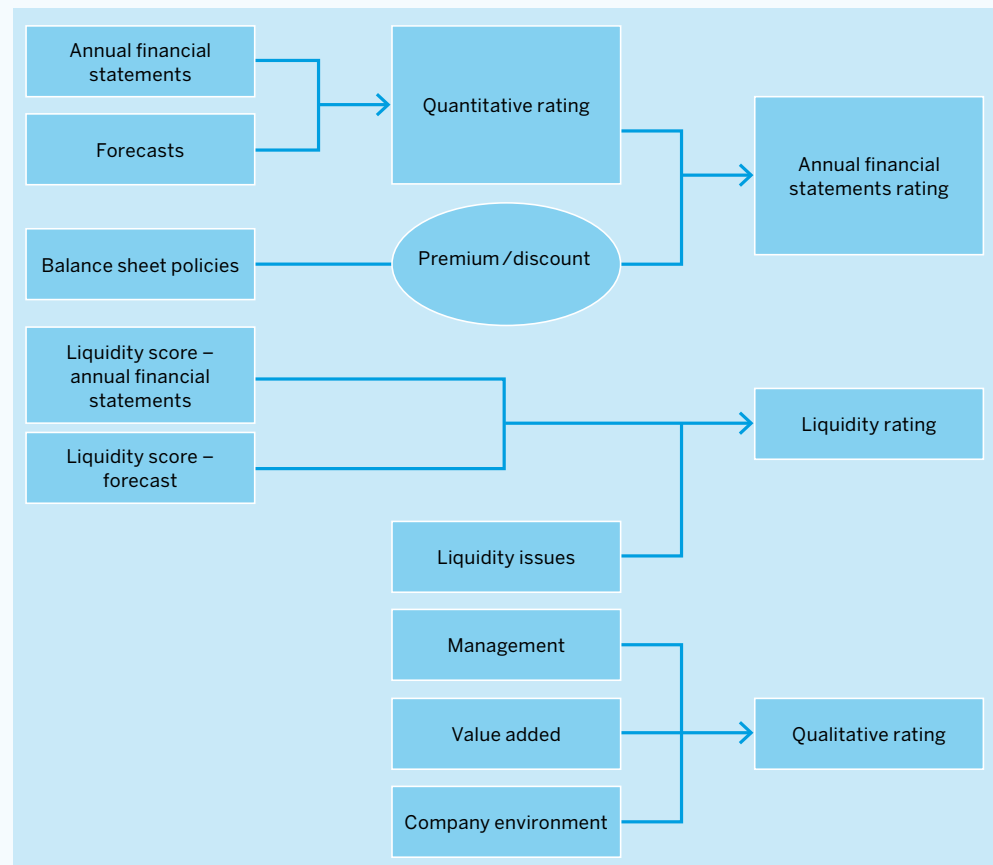
Rating

Rating is a process through which the default risk of an investment project is assessed. The procedure results in an investment “grade” that describes the risk associated with the project and determines the margin associated with that risk.

Banks financing investment projects conduct these ratings themselves or require external ratings from private rating agencies.

Although the criteria are more or less the same, each bank has its own rating process. They analyze financial data (e.g. annual financial statements, liquidity, financing structure) and qualitative factors (e.g. balance sheet policy, market potential, management, economic framework). The following chart depicts an exemplary rating process of a German bank.

Credit Rating Modell



Source: KIB AG



Corporate Financing vs. Project Financing

The difference between corporate financing and project financing is determined by the sponsor and terms of liability.

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

Project financing is based upon a more complex financial structure whereby project debt and equity are used to finance the project. Generally, a special purpose entity is created for each project, which shields other assets owned by a project sponsor in the event of failure essentially the project company is considered to have no assets other than the project. In this way, project sponsors are able to greatly limit their liability.

Risk identification and allocation is an essential element of project financing. The possibilities for minimizing risk and thus increasing the chances of securing financing are greater when dealing with:

- Established technologies
- A large and/or growing and/or sufficient market for the products or services
- Existing contracts with customers and suppliers
- Robust projected cash flows from the investment, determined through massive stress testing
- An experienced management team with the relevant technological and commercial skills

Financing by a Consortium

Financing by a consortium 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 with bullet re-payment
- mezzanine capital
- a working capital facility

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, participate pro-rata in the financing.

The syndication has the advantage of stability and flexibility over single-bank financing, but can also result in potentially higher margins, complexity, and a longer wait time before approval.

Mezzanine

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

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 (typical) | No | Yes | Approval and control rights | 5–15 | Yes |

Due to increased credit risk, mezzanine capital is a relatively expensive financing source for a company. For this reason, it is mainly appropriate for financing growing companies with high profitability. One reason a company might prefer mezzanine capital is to maintain its equity ratio. Even loan-oriented mezzanine instruments are often valued as commercial equity.

Whether mezzanine capital is classified as equity or debt depends on three factors:

1. Duration of the capital commitment
2. Loss sharing
3. Conditions of compensation

Variations also occur because of different accounting rules, such as IFRS and the German Accounting Rules (HGB).

Silent Partnership

In Germany the silent partnership is the classic form of mezzanine financing. There are two main types: the typical silent partnership and the atypical 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, but can be higher in atypical partnerships.

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 widely used in public funding. Public venture capital companies (Innovations- und Technologiebeteiligungsgesellschaften) or public-private equity enterprises (Mittelständische Beteiligungsgesellschaften) take minority shares in technological ventures or growing SME.

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 default, the repayment is subordinated and all other lenders are re-paid first.

Subordination also refers to the payment of amortization and the provision of securities.

With regards to securities, subordination means that banks do not require collaterals 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 only affect the profit and loss account of a company, not the balance sheet. This enables a company to maintain the equity ratio and thus avoid the degradation of its credit rating.

Leasing, especially operational leasing, is the most widespread form of off-balance financing in Germany.

Leasing

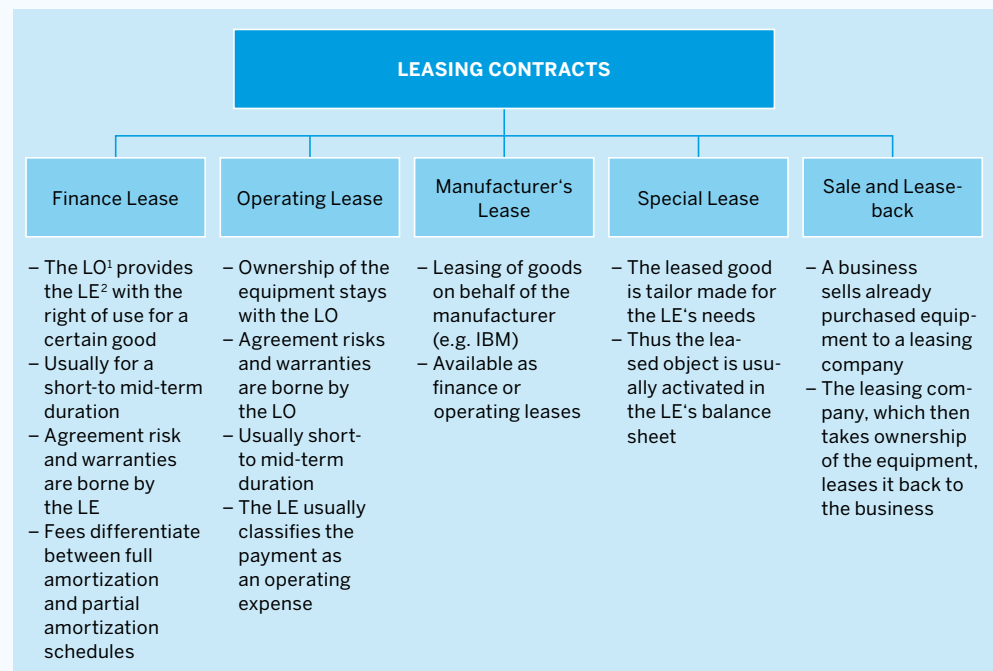
The most common off-balance financing instrument in Germany is leasing.

Various interpretations of the term “leasing” exist in different accounting rules, such as IFRS and the German Accounting Rules (HGB). To qualify as being off-balance, 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.

The following chart explains different forms of leasing:

Leasing as an Alternative Financial Tool



Note: ¹LO – Lessor, Hirer; ²LE: Lessee, Renter

Factoring

Over the past decade, factoring has gained importance as an internal source of financing in Germany.

Special financial institutions called factors provide advanced financing at a discount. The factor secures the payment for a certain period and offers protection against default by the creditor.

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.