Standort Deutschland

Turnaround Financing, "Classic" M&A and other Investment Opportunities –

Why Germany remains one of the most active business locations in Europe

Introduction:

Recent years have been characterized by significant global economic fluctuations, which have had repercussions for the German economy. While we saw a veritable explosion in the number of start-up companies during the period from 1998 to 2001, particularly in the IT and telecommunications industry, the period since then has experienced exactly the opposite. The terrorist attacks of September 11, 2001 were followed by drastic drops in the stock market, numerous corporate insolvencies and a dramatic rise in unemployment. However, beginning with the second quarter of 2003, the German economy showed first signs of a recovery, together with increased and stable stock exchange market prices.

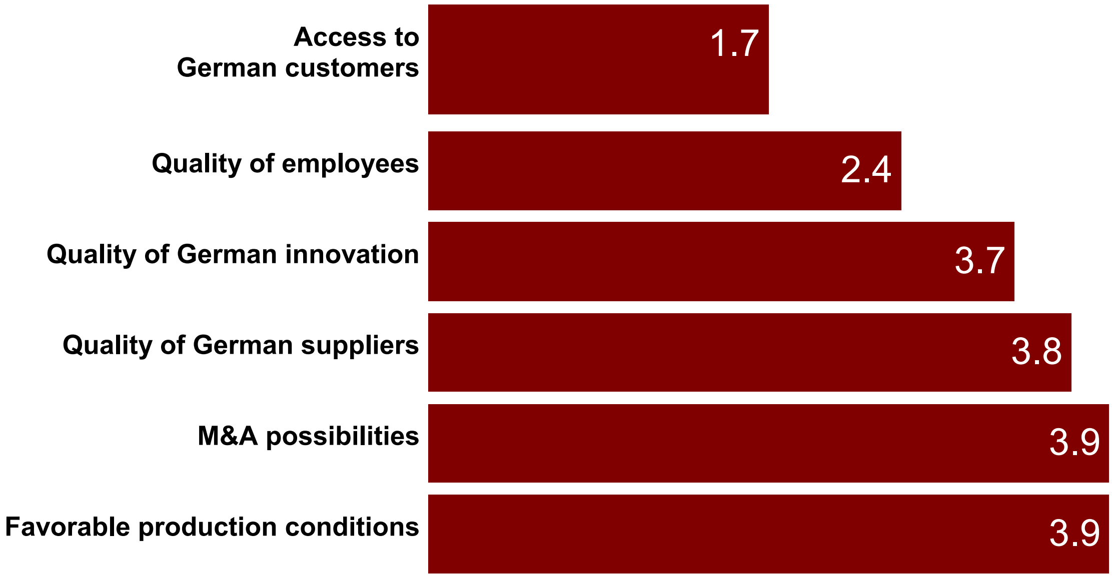
The 2003 AmCham Business Questionnaire revealed: Standort Deutschland remains one of the most attractive business locations in Europe. Representing € 110 billion worth of investments resulting in 800,000 direct jobs, Germany also continues to have the largest concentration of American investment in Europe. The most important reasons mentioned by the 100 largest US companies in

Germany for choosing Germany as their business location in Europe are **market access** together with the **quality of the work force** in Germany.

Improvements were claimed particularly with regard to labor law and the tax system: specifically an increase in the **flexibility of the labor market** followed by a significant **simplification of the tax system** are at the top of the wish list in order to improve the attractiveness of Standort Deutschland in the future.

Reasons for choosing Standort Deutschland[1)]

(1 = very important, 6 = unimportant)



1) other reasons mentioned: Centrally located, stable legal system, investments in innovation

Source: commerce germany, Vol 2, May 2004

Clearly, production conditions are not the predominant reasons for investments in Germany. Competition from low wage countries is simply very high. With opening international markets, international investors think twice before they decide for

Germany. Specifically with access to low wage labor in Germany's close vicinity (Czech Republic, Hungary and Poland etc.), the importance of this issue has increased.

However, production conditions as such have never been the sole decisive criteria for investments in Germany: political and economical stability of a country has always been of at least equal importance for investors. Thus, the country's high cost structure and regulated labor market can be countered by a variety of positive aspects - such as the high level of trained personnel in Germany, social freedom and a consequent reliability on the work force – Germany has strong unions and, despite that fact, the country historically enjoys lowest labor dispute rates among industrial countries.

While reforms are continuously demanded and certainly necessary, we will see that quite a few have already been adopted. One of the most important was the 2000 tax reform, followed by the so-called “Basket II”- legislation at years end 2003. These reforms brought a number of tax changes and are believed to significantly enhance the attractiveness of Standort Deutschland. Apart from the tax reform, also labor law changes have been introduced – reinforcing to a certain extent changes to the Termination Protection Act adopted by the Kohl-Administration but abolished under Chancellor Schröder when he took office in 1998.

In my presentation, I would like to give an overview on the legal framework governing foreign investment in Germany and focussing here in particular on the most important changes adopted over the past years. I will further try to give a brief overview on the German transaction environment, describing some of the investment tools that can be successfully used by a foreign investor, taking into account consequences for small and midsize companies resulting from the New Basel Capital Accord (known as “Basel II”).

The 2000 tax reform and the Basket II-Legislation (2003)

With an attempt to reduce the overall tax burden on taxpayers, the German government introduced the Tax Reduction Act (*Steuersenkungsgesetz – StSenkG*) in October 2000. The most significant tax changes contained in the Act were phased reductions in the minimum rate of income tax (from 22.9% in 2000 to 15.0% in 2005) and in the maximum rate of income tax (from 51.0% in 2000 to 42.0% in 2005).

For 2004, the top tax bracket is reduced to 45% and the bottom bracket to 16%, to fall to 42% and 15% respectively in 2005. Furthermore, a definitive flat tax rate for corporations of 25% was introduced, regardless of whether the profits are retained or distributed. Specifically the flat rate taxation for corporations is assumed to significantly enhance the attractiveness of Germany as a place of business for foreign companies.

Another aspect of interest for foreign investors is a new rule allowing profits to be distributed by one corporation to another without incurring taxation, which means that those profits passed along a chain of companies are only subject to corporation tax once, i.e. at the entity where these profits arose. No further taxation arises until the profits are effectively passed outside the sphere of corporations and are distributed to individuals. At the level of the shareholder, only 50% of the dividend income is then included in the basis for calculation of income tax (so-called "half-income"-principle).

The Basket II legislation

The so-called Basket II legislation is based on a political consensus reached in spring of 2003 and was enacted in December 2003, bringing the following changes:

Thin capitalization rules

As of 2004 (fiscal year 2004/05 for non-calendar-year taxpayers), new thin capitalization rules apply to loans to corporations and downstream partnerships from material shareholders and related parties. The new rules cover loans from German as well as foreign shareholders and related parties, whereas the old rule essentially applied to loans from foreign shareholders and related parties only – a rule that was held to violate EU law by the European Court of Justice in December 2002.

According to the new rules, interest allocable to fixed interest debt in excess of a safe haven of 1.5:1 (debt : equity) and all payments on hybrid loans are deemed to be non-deductible constructive dividends (*verdeckte Gewinnausschüttung*).

However, an arm's length exception continues to exist for conventional loans that exceed the safe haven, meaning that no deemed dividends occur if the debtor corporation shows that it would have received the same loan on the same conditions from an unrelated third party lender.

Furthermore, under the new thin capitalization rules, it no longer makes a difference whether loan interest or other payments are subject to tax in Germany. However, the new rules do only apply above a *de minimis threshold* of 250,000.00 € per annum – a limit which is supposed to soften the impact of the new rules on small and medium sized corporations, many of which are German owned.

60% limit on use of NOL

While in the past the possibility to offset loss carry forwards was essentially unlimited, a new rule came into effect in 2004 (fiscal year 2003/04 for non-calendar-year taxpayers), limiting the offset of losses carried forward (not operating losses or NOL) to 60% of the current period income, a limit which applies for trade tax purposes as well. An exemption applies to the first 1 million € of current period income, which is exempt from the limit and may therefore be offset in full.

Investment Modernization Act

Another very important piece of legislation that came into force in 2004 was the Investment Modernization Act. The Act completely revises the organizational and regulatory framework of the investment industry, for the first time allowing hedge funds and umbrella funds in Germany, ending disadvantageous tax treatment of mutual funds, and also postponing the taxation of certain retained or accrued mutual fund earnings until distribution or until sale of the fund shares.

The two main components of the Act are a new Investment Act and a new Investment Taxation Act. While the Investment Act defines the legal conditions for the operation of investment companies, the Investment Taxation Act combines the previously applicable tax provisions – which were widespread over several tax laws – into one single tax act. Thus, the new legislation supersedes entirely the Investment Companies Act (*Gesetz über Kapitalanlagegesellschaften – KAGG*) and the Foreign Investment Act (*Auslandsinvestment-Gesetz – AuslInvestG*) further amending numerous provisions in the various applicable tax statutes, such as the Income Tax Act, the VAT Act or the Credit System Act.

Labor law changes – the Labor Market Reform Act

German **labor relations** are currently governed by law, collective bargaining agreements and individual employment contracts. Unlike other countries, like France, for example, collective bargaining agreements will only be applicable to individual employment contracts, if both parties (i.e. employee and employer) are members of the contracting party organizations or if one of two exemptions apply: First, a collective agreement may be extended to govern all employees and employers of the respective industry through a governmental **declaration of general applicability** (Sec. 5 *Tarifvertragsgesetz*; best translated as *Collective Agreements Act*). Second, they can always be referred to in the **individual employment contract**, in which case they are applicable between the contracting parties, too.

The German **statutory model** expects an employment contract to be concluded for an **unlimited** period of time. Consequently, termination of employment contracts were only permitted for operational reasons and under consideration of social priorities. Likewise, **limitations** were for a long time only permitted for **justified reasons**, i.e. seasonal work, pregnancy replacement or student employment.

This stiff and rigid model was first softened in the mid-eighties by introducing **exemptions** that provided a certain level of flexibility and allowed the **limitation** of the **initial term** of employment up to **two years**. The ratio behind the new regulation was the attempt to secure employment by eliminating labor protection provisions.

During the Kohl administration further significant changes were adopted by reducing applicability of the **Termination Protection Act** to companies with more than 10 employees (from < 5), reducing social selection to three specific criteria (Age, years of service and support obligations) and by the same token allowing the employer to exclude certain employees, in which he has a specific interest, from the social selection.

The administration under Chancellor Schröder in the famous 1998 legislation abolished the changes to the Termination Protection Act, reinforcing applicability of the Act to companies with more than 5 employees and also returning to the stronger pre-Kohl social selection rule.

However, and certainly forced by the slow worldwide economy, the **Labor Law**

Reform Act (*Arbeitsmarktreformgesetz*), which was enacted on December 31, 2003 and came into force January 1, 2004 as part of the so-called “Agenda 2010”, again brought more flexibility for the labor market:

The Termination Protection Act has essentially been brought back to where the Kohl-Administration left it: while still applicable for companies with more than 5 permanent employees, for employees joining a company subsequent to December 31, 2003 the Act will only apply if more than 10 permanent employees are engaged.

For start-ups and newly established companies the new Statute on Part Time and Limitation (*Teilzeit- und Befristungsgesetz*) further enhances flexibility, allowing the initial limitation of an employment contract for up to four years.

To sum up one can say that labor – I mean individual labor law – may still be far from well structured. However, it is simplified in a certain way and it provides practicable tools for entrepreneurs and foreign investors to limit their risk in the start-up phase of a new business in Germany as well as to cover needs for short term manpower in business peeks.

Co-determination and works council

A question that I am frequently asked in take over situations is that of the existence and role of a works council. Therefore, I also want to briefly address co-determination and works constitution in Germany. Many investors or their representatives have a picture of unionized / non-unionized operations in their mind.

The first, frankly speaking, is generally considered a nightmare.

Well, co-determination in Germany works different. The most important fact that makes the difference is that the works council is not linked to the trade unions (thus, not driven by their particular interests!) but is a representation body for the employees in a specific operation. As such it is bound by the operational interest of the company and its employees – an interest that may in some cases be quite detrimental to the interest of the trade union.

We have seen this phenomena in situations were flexibility was required on a company level (working hours/overtime/wages). The works council was open to constructive negotiations whereas any statements from the trade union was politically induced, fighting for certain principles instead.

Co-determination at an operational level is governed by the German Works Constitution Act 1972. In all enterprises – irrespective of the legal form – with more than five permanent employees entitled to vote, elected works councils must be established at the employees' request which means that the employees have to take the initiative. There are, accordingly, many companies with quite significant numbers of employees that do not have a works council.

Once a works council is established, it has various **codetermination rights** in **social** and **personnel matters** and also **information rights** on **economic issues**. Furthermore, works council members enjoy special **termination protection**. During their office as works council and for a period of one year thereafter, they can only be terminated for cause.

In operations with more than 100 employees an **economic committee** has to be established with the aim to **inform** the works council on **economic issues**. In corporations with more than **500 employees one third** of the members serving on the **Supervisory Board** have to be employees. In enterprises with more than **2000 employees** the Supervisory Board consists of **equal** numbers of representatives from the employer and from the employees.

To sum up, co-determination in Germany is an essential part in labor relations every investor is faced with. Effectively used, however, it can be used as a catalyst between the management and the workforce, increasing their motivation and to achieve best operational goals.

Turnaround financing , Classic M&A

Having briefly described the regulatory framework a foreign investor will face in Germany, I will now turn to the opportunities that are available to a potential investor.

As markets tumbled, German corporations have become attractive targets for acquisitions because market capitalization of many robust companies has fallen sharply. Even some of the world's largest companies were available at attractive prices. With Germany as Europe's largest consumer market, any company with the ambition to be a global player must have a presence on the German market.

A recent analysis in the Fortune magazine showed that more German enterprises than ever before ranked amongst the 500 largest and most dynamic international companies. With a legal framework that has been significantly reformed, specifically including the above described important changes in German tax law, the prospects for the German M&A market look promising.

But not only the 20 or 50 largest German corporations are subject to acquisition considerations: also small and medium-sized enterprises (SME), the so-called *Mittelstand*, are attractive targets on the German market. The Mittelstand constitutes the fundamental basis of the German economy, and, therefore, is most important, as the following data shows:

3.3 million SME's – of which 90% have an annual turnover > 5m € – constitute more than 95% of all German enterprises, employing approx. 70% of the German work force and 80% of all trainees, contributing about 50% to the German total annual turnover and the national product.

By the same token, German SME's often are significantly undercapitalized, bear a high insolvency risk in a difficult economic environment and are facing unclear future prospects as successor questions are not resolved – we have to bear in mind that many of the German SME's are family owned.

The Basel II Accord (Basel II)

Most of the German SME's are financed with mid- and long-term credit facilities from their house bank. However, Basel II will bring significant changes for SME financing. Let me briefly explain the aim of Basel II:

Under the old Basel I Accord, in order to stabilize the banking system, banks were required to “retain” a certain amount of equity capital to back the granted loans, since default on loans can of course jeopardize deposits and even the very existence of a bank (minimum capital requirement/regulatory capital). Under Basel I the necessary minimum capital is determined in a general way by assigning borrowers to mainly three categories : public borrowers, credit institutions, other customers. As a general rule, loans to corporate customers must be backed with 8% equity capital.

Since Basel I – which came into effect in 1988 – capital markets have changed considerably. Investors have become more risk sensitive, and are demanding higher yields for risky operations. At the same time, risk management and measuring techniques (keyword **rating**) have been further elaborated. This makes it possible and necessary for banks on their part to examine credits more thoroughly. These requirements, however, can no longer be fulfilled by Basel I and lead to the new Basel II Accord.

Under Basel II a borrower’s (internal or external) credit rating will be the key criterion for determining the minimum capital requirements of the lender (with direct impact on the interest rate, of course). Other important factors are corresponding collaterals, the business segment (retail customers, corporations, small business, equity investments etc.) and the level of a bank’s credit risk management.

While Basel II consists of **three pillars**, I will focus on the most important one for SME’s, the **standards for minimum capital requirements** (CMR’s).

For further information on the other two pillars (**the supervision review process** concerning the individual options of the regulator to assess individual banks, and **the promotion of market transparency** addressing extended reporting duties for credit institutions) I would like to refer you to the Consultative Document issued by the Bank for International Settlements on July 31, 2003 – an excellent overview on the Basel II Accord for those who want to increase their familiarity with the options available to banks in Basel II.

In the standardized approach the borrowers are assigned external ratings. Until now the risk weight has always been 100% of the capital coefficient (8%) for loans to corporate borrowers. In the future the risk weight will depend on the rating. The following table will illustrate the risk weights (in percent of 8%) and the regulatory capital for the standardized approach:

Risk Weights and Regulatory Capital for Corporate Loans

Credit Standing of the enterprise	AAA to AA-	A+ to A-	BBB to BB-	lower than BB-	Without rating
risk weight	20,0%	50.0%	100.0%	150.0%	100.0%
Regulatory Capital	1.6%	4.0%	8.0%	12.0%	8.0%

Upon disclosure of Basel II the German SME's saw themselves exposed to a tremendous financing problem: as I indicated above German SME's are to a significant part undercapitalized and they naturally feared that they would receive below average ratings with a consequently high interest rate – if they would get financing at all – meaning that financing costs would be significantly higher than before.

The various discussion rounds initiated subsequent to the release of Basel II brought major improvements for SME's: credits of up to 1 m €, for instance, will be considered in the Retail or private customer portfolio, meaning that the banks need approx. 25% less in equity than before to secure these loans, a benefit in which approx. 90% of the total SME's will participate.

While this and other achievements are certainly remarkable, German SME's will be much stronger scrutinized by their house banks when trying to get financing. Moreover, none of the negotiated reliefs will apply to a company with limited or no rating. Thus German SME's will be subject to more M&A transactions than ever before.

One of the key words, therefore, is turnaround financing as an alternative to the "regular" credit financing. Unlike a standard M&A transaction, turnaround financing essentially leaves operational control with the existing management except that, however, additional control mechanisms (such as advisory boards or the like) are instituted in order to control the companies activities.

In a turnaround situation, where fresh money is required for the existing owner, the potential investor has various options, the most common of which is to increase the share capital of the company, diluting the existing participations and buying into the company at very favorable share prices.

As the typical turnaround financing is a share deal, the potential investor will have to assume the continued liabilities originating from the operation prior to his investment. It is thus critical that the target company undergoes detailed Due Diligence that should normally cover all areas of the target company, such as contractual, legal and financial issues as well as technology, IP and marketing issues. While in other M&A transactions due diligence may be limited to a minimum (compensated by stringent guarantees and warranty provisions), this may not really help as the best contractual penalty is only enforceable if the debtor is able to dispose of the equivalent funds. In other words, the costs of a more comprehensive due diligence is a good investment as it may reveal hidden risks previously not disclosed and, therefore, prevent the investor from falling short with his investment due to such a risk.

Ladies and Gentlemen, I am at the end of my presentation. I would like to thank you for your valuable time and I am happy to answer – or better try to answer – any questions you may now have.

Peter König

Please bear in mind that this is a written transcript of an oral presentation given in Summer 2004. The spoken word shall thus prevail over any of the foregoing statements. While prepared with diligence, this paper and the information contained therein might be incomplete or outdated. It shall, therefore, not be relied on but solely provide certain information to the interested reader.