

Austria

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MARKET

1. Please describe briefly the venture capital market in your jurisdiction, in particular:

- How it is distinguished from private equity.
- The sources from which early-stage companies obtain funding.
- The types of companies that attract venture capital investment.
- Market trends (for example, levels of investment, the type of companies invested in and where those companies are located).

Venture capital and private equity

Both private equity and venture capital are finance instruments that provide equity to companies not listed on the stock market. Venture capital is a subset of private equity. Typically, venture capital is early-stage financing beginning at the second, or third stage (if a business angel contributes to the investee company) of a traditional start-up financing sequence. Venture capital financing covers:

- Seed-financing (pre-formation financing).
- Start-up financing (financing at the investee company's formation stage).
- First-stage financing (financing at market entry).

Broadly, private equity is financing beginning in the expansion stage and covering subsequent later stages, particularly, management buyouts (MBOs) and privatisations.

Sources of funding

The private equity market (covering both private equity and venture capital) is funded by the following sources (there are no separate figures available for venture capital):

- Insurance companies: 20%.
- Government agencies: 17.4%.
- Funds of funds: 11.9%.
- Corporate investors: 11.9%.
- Banks: 8.9%.
- Private individuals: 1.1%.
- Unknown/other: 28.8%.

Types of company

Venture capital investors invest in young, private companies with potential for innovation and growth. In recent years, the majority of venture capital investments involved companies active in the life sciences, computer and consumer electronics, and business and industrial products sectors. While investments in the IT and life science sectors decreased in the last year, more traditional industries such as manufacturing, business and industrial products and services, and energy and environment continued to be able to attract venture capital investors.

Market trends

Fundraising declined significantly in 2008, due in part to the general economic downturn with private equity and venture capital providers raising EUR230 million (about US\$340 million). However, the decline is modest in comparison with more developed markets. The Austrian venture capital market in general is still underdeveloped in comparison to other European countries. With a percentage of investments as a share of GDP of 0.005%, Austria remains at the lower end of the scale (the European average is 0.05%). The same applies to the typical fund size, which is significantly below EUR100 million (about US\$147 million).

Although overall investment activities remained stable in 2008, the investment activities of venture capital investors declined by 25% compared to 2007. Only EUR36 million (about US\$53 million) of a total of EUR231 million (about US\$340 million) were venture capital financings (EUR48 million (about US\$71 million) of a total of EUR256 million (about US\$377 million) in 2007).

Most investments in 2008 were made in the life sciences sector, followed by business and industrial products and consumer services. Consumer goods and retail as well as IT sectors were able to attract investors.

Divestments experienced a significant decrease in 2008 by about 43% to EUR120 million (about US\$177 million) compared to EUR210 million (about US\$309 million) in 2007 and fell to 2005 levels. Initial public offerings (IPOs) remained scarce and 58.6% of local exits were through secondaries and 15.2% through trade sales. Divestments included only 4% write-offs.

2. What tax incentive schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

There are no specific tax regimes available to encourage investment in venture capital companies.

3. From what sources do venture capital funds typically receive funding?

For venture capital funds' sources, see *Question 1, Sources of funding*.

Austrian venture capital funds are mainly funded by insurance companies, government offices and banks. Most of the funds raised are domestic.

4. Can the structure of the venture capital fund impact on how investments are made?

A fund benefits from tax exemptions if it is structured in the form of a medium-sized business financing company (*Mittelstandsfinanzierungsgesellschaft*) (MFG) (see *Question 6*) and complies with the following investment rules:

- Each investment can only account for a maximum of 20% of the MFG's equity capital.
- The finance tranches for each target, including the initial acquisition and subsequent participation increases, must not exceed EUR1.5 million (about US\$1.9 million) over each period of 12 months.
- At least 70% of funds provided to a target company must be equity capital (in particular, partnership shares, silent participations, stocks, shares or *juissance* rights).
- An investment in a target company must not exceed a participation of 49% in the target's nominal capital and must not result in a controlling interest over the target.
- Investments must not be made in enterprises in difficulty (within the meaning of the European Commission's Guidelines on state aid for rescuing and restructuring firms in difficulty).
- Investments must not be in the shipbuilding, coal or steel industries.
- Investments must be made in unlisted small- or mid-cap companies (within the meaning of annex I of Regulation (EC) No. 70/2001 on the application of Articles 87 and 88 of the EC Treaty to state aid to small and medium-sized enterprises) in the EU or the European Economic Area.

5. Do venture capital funds typically invest with other funds?

Whether venture capital funds invest with other funds depends on the size of the required investment within a specific financing round. It is common for new investors to join subsequent financing rounds.

FUND FORMATION AND REGULATION

6. What legal structure(s) are most commonly used as vehicles for venture capital funds in your jurisdiction?

Until introduction of private equity and venture capital fund vehicles (*Mittelstandsfinanzierungsgesellschaft*) (MFG) from 1

January 2008 by the *Mittelstandsfinanzierungsgesellschaften-Gesetz* 2007 (MiFiG 2007), the most popular fund vehicle and main fund structure was a stock corporation for the purpose of investing in small- and medium-sized enterprises (*Mittelstandsfinanzierungsaktiengesellschaft*) (MFAG). The profits of an MFAG were entirely exempt from corporate income tax until the end of the fifth calendar year following the year of registration with the commercial register, and after this five year period, profits from investments were exempt under section 6b of the Corporate Income Tax Act (*Körperschaftsteuergesetz*) (KStG).

Since 1 January 2008, it is no longer possible to incorporate new MFAGs. Current MFAGs will lose their beneficial status on expiration of the five year period from registration.

Under the new regime, an MFG's earnings derived from investments in companies (*Finanzierungsbereich*) are tax exempt, but its earnings derived from bank deposits and bonds (*Veranlagungsbereich*) are not (see *Question 4*). The MFG must comply with section 6b of the KStG for at least seven years, otherwise the tax exemptions are retroactively revoked. MFGs are also tax exempt from capital duty and stamp duties.

To qualify as a MFG, the following conditions must be met:

- The MFG must be established in the form of a limited liability company (*Gesellschaft mit beschränkter Haftung*) (GmbH) or a stock corporation (*Aktiengesellschaft*) (AG) with a minimum share capital of EUR7.3 million (about US\$10.7 million).
- The purpose of the MFG is limited to investing money, and it cannot carry out its own business.
- Only 50% of the MFG's shares can be held by public bodies and organisations.
- The MFG must invest at least 70% of the funds in companies. The remaining 30% of the funds can be held as cash, bank deposits or in the form of bonds.

In light of these changes, limited partnerships (*Kommanditgesellschaft*) are likely to become increasingly popular for venture capital funds. Fund vehicles are normally structured as a limited partnership, with a GmbH as its general partner and the investors as limited partner. The general partner is excluded from management, which is provided by a separate management company with limited partner status.

The Austrian private equity industry views the current legal framework as putting pressure on finance corporations investing in medium-sized businesses and start-ups, and fund companies, which are migrating into foreign structures where the framework conditions are more attractive and conform to international standards.

There are still ongoing discussions between the private equity industry and the Ministry of Finance on establishing an alternative structure that would meet the expectations of international investors. Those discussions led to publication of the draft of the Capital Market Strengthening and Innovation Act (*Kapitalmarktstärkungs- und Innovationsgesetzes 2008*) in early 2008, introducing the Investment Companies Act (*Investmentgesellschaftengesetz*) for the implementation of an alternative investment vehicle (*Investmentgesellschaft*) (IG) which would give large tax exemptions compatible with EC state aid rules.

Such IGs may be established as Austrian limited partnerships or as Austrian stock corporations with a minimum share capital of EUR2 million (US\$2.9 million). The purpose of an IG is limited to the investment of risk capital, and such investments may be made through direct equity investments or through so-called *Annexfinanzierungen* (additional debt financings). In any event, investments are subject to certain restrictions relating to the:

- Target of an investment.
- Amount invested in one single target.
- Duration of an investment.

In addition, the Investment Companies Act provides for specific regulations about the management of IGs, deposit of assets and publicity requirements.

From a tax perspective, IGs established in the form of a stock corporation and corporations invested in an IG are exempt from corporate income tax in relation to capital gains from disposals of domestic, and under certain conditions also from foreign, investments held by the IG. Tax exemptions also apply in relation to income received from additional debt financings, subject to certain limitations.

Legislative initiative is welcomed, and regarded as an important step towards the creation of a competitive legal framework. However, various issues still requires review and development so that the private equity and venture capital industry can improve and benefit from these initiatives. However, it remains unclear if, and when, the draft in its current or in amended form will be implemented.

7. Do a venture capital fund's promoter, manager and principals require licences?

Under certain circumstances, promotion of a venture capital fund to potential investors on a commercial basis can qualify as banking business within the meaning of the Austrian Banking Act (*Bankwesengesetz*), in which case a banking licence is required.

8. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions? Include, in the answer, any restrictions on how a venture capital fund can be marketed or advertised (for example, under private placement or prospectus rules).

Venture capital funds do not usually qualify as domestic investment funds under the Austrian Investment Fund Act (*Investmentfondsgesetz*), as this requires the fund's portfolio to consist mainly of securities. Therefore, venture capital funds are not generally subject to the Investment Fund Act regulations.

Any venture capital fund marketing activities that are deemed to be a public offer of securities are subject to the publicity and prospectus regulations of the Austrian Capital Markets Act (*Kapitalmarktgesetz*). If so, a prospectus must be filed with the Financial Market Authority (*Finanzmarktaufsichtsbehörde*) and published before any marketing activities are made. An offer of securities is considered a public offer if it is made to more than 100 non-institutional investors.

9. How is the relationship between investor and fund governed? What protections do investors typically seek?

The relationship between the investor and the fund is set out and determined in the partnership agreement, the articles of association (articles) or in a shareholders agreement.

Investors typically seek to negotiate protection provisions such as:

- Restrictions on the types of investment the fund can make (for example in relation to a specific geographical or sector focus).
- Restrictions on the fund size and investors' capital commitments.
- Restrictions on borrowing by the fund.
- Restrictions on the fund managers other activities, including provisions for conflicts of interest.
- Key executive clauses.
- Powers for a specified percentage of investors to remove managers in certain circumstances.
- Regular reporting to investors, including quarterly and annual financial statements.

10. What are the most common investment objectives of venture capital funds (for example, what is the average life of a fund, what return will a fund be looking for on its investments and what is the time frame within which a fund would seek to exit its investment)?

Venture capital funds seek to:

- Safeguard the invested funds.
- Increase the value of the investee company.
- Create healthy returns on their investments in the medium term.

In general, investors aim to achieve an overall internal rate of return of between 15% and 25%. They also seek management expertise and resources, new technological developments, and business ideas.

Funds typically have investment periods of five years during which commitments can be drawn down for investments. The average life of funds ranges from eight to 13 years.

11. Are there any recent or proposed regulatory changes affecting the venture capital industry?

Apart from the most recent legislative developments (*see Question 6*), there are no other proposed regulatory changes that would affect the venture capital industry.

INVESTMENTS**12. What form of investment do venture capital funds take? (For example, equity, debt or a combination.)**

Venture capital funds generally take equity interests, but often also agree on additional contributions due on reaching defined milestones.

13. How do venture capital funds value an investee company?

Venture capital funds use different valuation methodologies in valuing investee companies, depending on the stage at which an investment is being made. Generally, venture capital funds value investee companies in accordance with European Private Equity and Venture Capital Association (EVCA) valuation guidelines.

In later-stage investments (expansion stage, MBO or IPO) it is often appropriate to value investee companies using:

- **Discounted cash flows.** The company's value is derived from the present value of expected future cash flows (or the present value of expected future earnings).
- **Earning multiples.** An earnings multiple is applied to the company's earnings.

For early-stage companies (seed, start-up or first-stage) these methodologies may not be appropriate, as there are usually no current and short-term future earnings or positive cash flow. Therefore, venture capital funds commonly base the investee company's value on the price of the recent investment, as recommended by EVCA valuation guidelines.

14. What investigations will venture capital funds carry out on potential investee companies?

Venture capital funds conduct due diligence to achieve an informed evaluation of the value and risks presented by the investee company to:

- Expedite the transaction.
- Reveal hidden risks.

This can result in a change in valuation or a decision not to proceed with the investment.

The investment decision is taken only after the investee company's due diligence and thorough evaluation of identified risks, potential for return and possible exit scenarios. The venture capital fund's management, together with external advisers, usually prepares the basis for the investment decision. The analysis primarily addresses the company's past development and strategy.

Venture capital funds usually look at the following issues for the investee company:

- Management and organisation.

- Market and competition.
- Product and technology.
- Financing and tax.
- Legal issues, often focusing on intellectual property (IP), agreements with management and key employees, confidentiality and invention assignment agreements.
- Business model and corporate planning.

15. What are the principal legal documents used in a venture capital transaction?

The principal legal documents used in a venture capital transaction include:

- Confidentiality agreement.
- Term sheet.
- Investment agreement.
- Shareholders' agreement.
- Articles for the investee company (if amended in the course of the investment).
- Procedural rules for the investee company's managing board.
- Procedural rules for the investee company's supervisory or advisory board (if established).

16. What form of contractual protection does an investor receive on its investment in a company?

Venture capital investors usually expect to receive full representation and warranties from the investee company and existing shareholders, although they are often different to those given in other kinds of corporate transactions, such as M&A transactions or public offerings.

Apart from representation and warranties, protection provisions cover:

- Consent rights for certain resolutions by the shareholders.
- Restrictions on share transfers, such as requirements for approval by a shareholders' meeting or by the investor.
- Pre-emption rights and rights of first refusal.
- Tag-along and drag-along rights.
- Anti-dilution adjustments.
- Liquidation preferences.

These provisions are contained in either the articles or the shareholders' agreement. If the investee company is established as a GmbH, the articles and any shareholders' agreement providing these rights must be signed in a notarial deed.

17. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

In principle, only AGs can issue different classes of shares with different liquidation preferences or profit participations. However, a GmbH's shareholders can grant an investor preferential rights that are similar to the rights vested in preferred shares.

In practice, venture capital funds take equity interests in the investee company in the form of ordinary shares but, if the investee company is a GmbH, they negotiate to have preferred rights attached to their shares contractually, until conversion of the GmbH into an AG, when the fund's shares are converted into preferred shares. If the investee company is an AG at the time of investment, venture capital funds often subscribe for preferred shares.

18. What rights does a fund have in its capacity as a holder of preferred shares (for example, what rights to capital and/or to interest)?

Venture capital funds usually have the following rights as holder of preferred shares, or ordinary shares with preferred rights contractually (see *Question 17*), provided these rights are given in the investment documentation and the articles:

- **Preferred dividend.** Preferred shares entitle their owner to receive preferential dividend payments (*Vorzugsdividende*). If a preferred dividend is not paid in full in a fiscal year, the outstanding portion must be paid in the following fiscal year. If the preferred dividend is not paid at that time, the relevant shareholders are granted full voting rights until the preferred dividend is fully paid. Since preferred shares are not statutorily excluded from voting, and venture capital funds usually demand voting rights, the payment structure can be individually negotiated.

The regulations on GmbHs allow shareholders to allocate a shareholder (that is, the venture capital fund) preferred dividend rights, if explicit provisions for this are contained in the articles.

- **Liquidation preference.** Liquidation preferences can include:
 - any investment amount paid by the venture capital investor;
 - financing rounds;
 - a specific internal rate of return.

They can be extended to previously omitted dividends provided that explicit provisions are contained in the articles.

- **Voting rights.** As a basic rule, each share in an AG grants the right to vote, unless preferred stocks without voting rights are issued. Shares with multiple voting rights cannot be issued in AGs.

In GmbHs, shareholders have voting rights proportionate to their subscribed share quota. For each EUR10 (about US\$15) of capital contribution, a shareholder is granted one vote. Contrary to AGs, these voting weights are not binding. Therefore, a venture capital investor shareholder may be granted multiple voting rights in the articles to the extent that each shareholder of the investee company has at least one vote.

19. What rights are commonly used to give a fund a level of management control over the activities of an investee company (for example, board representation, certain acts of the company subject to investor consent)?

A variety of rights can be granted to the venture capital fund to gain a level of management control over the activities of the investee company, including:

- The right to nominate members of the management board.
- The right to nominate members of the advisory or supervisory board.
- Consent rights in relation to certain measures of the management board.
- Transfer of material management decisions to shareholder level.

These protections are usually contained in the articles and/or the shareholders agreement.

20. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

The transfer of shares in the investee company is usually restricted by requiring consent from all or a certain percentage of shareholders or the investor. In addition, the investment documentation usually contains pre-emption rights or rights of first refusal (see *Question 16*).

21. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company (for example, drag-along and tag-along rights)?

Venture capital funds usually seek to negotiate drag-along and tag-along rights under which they can require:

- A stock exchange listing.
- A sale of the entire issued share capital or all, or substantially all, of the assets of the investee company.
- Participation in a transfer of shares under the same terms and conditions as the transferring shareholders.

22. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Shareholders have statutory subscription rights which entitle them to subscribe for shares corresponding to their shareholdings. Shareholders can only be excluded by shareholder resolution, unless they waive their subscription rights.

However, the investment documentation often requires the investor's approval for any exclusion of subscription rights or, where all of the shares are not subscribed for by shareholders on a pro rata basis, for unsubscribed shares to be offered to the investor.

23. What consents are required to approve the investment documentation?

In most cases, depending on the fund's structure, approval by the fund's investment committee is required. The investment committee generally consists of representatives of the investors in the venture capital fund.

Depending on the structure of the venture capital fund, other and/or further corporate bodies may need to give their approval. If the venture capital fund is structured as an AG, approval of the supervisory board (*Aufsichtsrat*) may also be required if the supervisory board is not the investment committee. The same applies to venture capital funds in the form of a GmbH that have a supervisory board.

Where parallel fund structures are in place (in which case the fund invests through parallel fund vehicles in the form of an AG and limited partnership, for example), consent of the AG's supervisory board and the (joint) investment committee of the parallel fund vehicles may be required.

24. Who covers the costs of the venture capital funds?

Investment costs are usually borne by the funds. Due to strict financial assistance rules, in most cases these costs cannot be passed on to the investee companies.

FOUNDER AND EMPLOYEE INCENTIVISATION

25. In what ways are founders and employees incentivised (for example, through the grant of shares, options or otherwise)? What are the resulting tax considerations?

The most common form of incentive for founders is direct participation in the investee company's equity capital in the form of corporate shares and/or (additional) share options. Employees are usually granted share options that can be exercised subject to agreed vesting provisions.

Alternatively or additionally, incentives can be granted in form of profit participation programmes, profit participation loans and bonds, and phantom shares.

26. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture (for example, good leaver/bad leaver provisions and restrictive covenants)?

Venture capital investors usually require the following protection provisions in the investment documentation:

- Lock-up periods for founder shares, during which a transfer of founder shares is not permitted or requires the investor's consent. Lock-up provisions can be combined with specific vesting provisions.

- Compulsory transfers of founder shares after defined events (for example, loss of management function) where the purchase price is calculated under good or bad leaver provisions.

EXITS

27. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Investments in unsuccessful companies usually result in write-offs involving full depreciation of the participation in the investee company following the full loss of market value. Funds may try to:

- Sell shares to special restructuring funds.
- Sell single assets (for example, IP) to strategic partners.
- Liquidate the investee company.

28. What forms of exit are typically used to realise a venture capital fund's investment in a successful company (for example, trade sale, initial public offering and secondary buyout)? What are the relative advantages and disadvantages of each?

The following exits are mainly used for investments in successful companies:

- **Trade sales.** Exiting by trade sale to strategic investors is the predominant exit strategy for venture capital investments.
- **Secondary buyout.** This is an exit by selling the investee company to another financial investor and is often an MBO.
- **IPOs.** Due to the situation on the financial markets, IPOs have lost significance as exit strategy in the last year.

29. How can this exit strategy be built into the investment?

The most common exit strategies may be anticipated in the investment documentation. In most cases, the investment documentation contains provisions that the venture capital investor is entitled to initiate an exit procedure, either by exercising drag-along rights in case of a share sale, or on the basis of the explicit entitlement to realise a stock exchange listing.

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