

High growth companies and how to fund them – a real driver of economic growth?

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National Report of Denmark

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The working session in Prague is entitled “*High growth companies and how to fund them – a real driver of economic growth?*” In the working session we plan to address funding alternatives for high growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high growth companies. This questionnaire mainly concentrates on these two topics in relation to high growth companies, but will also cover commercial and regulatory opportunities and constraints.

1. CORPORATE FINANCE – FUNDING ALTERNATIVES

1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

For good measure, the Danish definition on new high growth companies should be explained to begin with.

The Danish definition of new high growth companies partly follows the OECD and Eurostat definition, see Eurostat, OECD Manual on Business Demography Statistics, 2007 edition, which defines new high-growth companies as all new businesses that are up to five years old, having 10 or more employees at the beginning of the growing season and having an average growth of more than 72.8 percent (20 percent annually) over a three year period.

The Danish definition differs, however, in so far as the cut-off limit of 10 or more employees at the beginning of the growth period is changed to 5 or more employees, as it is estimated that a higher size limit does not apply to the Danish economic reality. The limit of at least five employees is designed to ensure that small businesses with high percentage growth, but with little absolute growth, are categorized as growth entrepreneurs.

In short, a high growth company is defined as a company which within three years has had an average annual growth of 20 per cent. Furthermore, it must have had five or more employees from the beginning of the growing season.

Types of financial instruments typically used for investments in high growth companies are often traditional preference shares or a variation of such. Contrary to more traditional share subscription in well established older companies.

The main source of preferred investment in a high growth company comes from venture capital. As venture capitalists invest with a profit return in mind, the typical instrument will be the ordinary share.

However, all the above-mentioned instruments can be used to invest in a high growth company. Though, hybrid instruments are not something which is greatly desired.

The main factor regarding which instruments are more typically used is whether or not the company you wish to invest in is willing to accept the instrument you

wish to contribute with. You will almost certainly always receive shares or a similar product in return for your investment.

1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above)
(Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

The most widely used instrument is shares. They provide a proof of ownership, the right to a return when the company delivers a yearly profit and they are very liquid. Venture capitalists and Investment angels prefer these instruments to others, especially for their high liquidity. This often combined with a strong shareholders' agreement gives the investor a strong hold on the investment.

Shares can be bought currently without any public registration, as the mandatory shareholders registry is not public. However, the companies are obliged to publish in the annual accounts the shareholders owning more than 20 % of the nominal share capital. An investor owning shares less than 20 % - and shares with preferred rights to dividends may have a stronger and less public known investment than would be the case with a larger ownership.

Shares in unlisted companies can be purchased with very low limit of formalities and thus making it very attractive. Unless limitations for transfers are made in the articles of association (e.g. board approval) (or in shareholders' agreements) the only formality to be observed is to inform the company of the transfer and ask to have the shareholders' registry updated.

If instruments such as bonds, warranties or convertible loans are used as instruments they must be approved by the general assembly and adopted by the articles of association and registered with the Danish Companies House. Such registration can usually be done electronically and without delay.

1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

All of the instruments mentioned in 1.1 are governed by the Danish Company Act and the Danish Securities Trading Act. As such, no constraints are imposed on the instruments.

1.4 Is crowd funding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.

Crowd funding, the new type of investment model for the common venture capitalist is booming overseas with a number of digital platforms that make themselves available as virtual marketplaces, but in Denmark it is presently more than difficult to establish such a platform.

The Danish legislation on companies' and securities' trading places has strict requirements and is too ambiguous to establish crowd funding activities and thus create a portal for the purpose. As one of the largest grievance points is the fact that equity crowd funding portals are subject to the Danish Securities Trading Act, which generally requires a provider of digital marketplaces to be accepted as a securities dealer.

To become a securities dealer the company must have a share capital between 0.3 and one million Euros. However, as Denmark enters 2014, it is likely that crowd funding may gain a better footing in the Danish market. But crowd funding will have to find its "Danish" version over time – most probably in a smaller and simpler scale that seen abroad.

2. INVESTORS VIEWPOINTS – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL
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2.1 Who are typical investors into a high growth company in your jurisdiction? Sources of funding (i.e. founders-family-friends, angel investments, venture capital investments, private equity).

The absolute most common and typical investors into high growth companies are Angel- and venture capital investors. In addition, these types of investors often group together and for private equity funds.

2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?

No, but the two most common investor types to a high growth company tend to follow these guidelines.

Venture capitalists will typically invest in companies with:

- An investment need of not less than 20-25 million DKK.
- An ambitious but realistic business.

- A product or service that has an unique selling position or enjoys other competitive advantages.
- Great earning potential and opportunities for high return on investment within a certain time frame, for example five years.
- A sound management expertise. (Although VCs usually don't wish to get involved in the company's daily operations, they will often help with the overall company strategy).
- A successful history which shows that the company is healthy and can manage.

Business angels will typically invest in companies with:

- An investment need between 100,000 and 2.5 million DKK. Most investments are less than 1 million DKK.
- With the potential for high returns - BA "are not afraid to run great risks.
- With good prospects for development or growth - preferably at an early stage in the company's life.
- In a particular industry.

2.3 Describe the process of documenting the investment (Which documents are typical? Which terms need to be included in the articles to be enforceable etc.)

Initially, in accordance with The Danish companies act, any decision to raise equity must be made at the general assembly. Subsequently, the board of directors can agree to issue shares in accordance with a donation/investment from a third party.

Regardless of the type of investment and size, certain procedures must be followed. For example, the decision to issue shares must be entered into the company's articles of association.

The general assembly can mandate a direct investment into the company or mandate the board to accept such investment within boundaries decided at the general assembly.

A decision to issue new shares or intension to do so must be recorded and adopted in the articles of association of the target company.

Any changes to the articles of association must be recorded with the Danish Business Authority (in Danish *Erhvervsstyrelsen*). As such the decisions to allow investments are subject to mandatory rules of registration, but as changes to articles must be recorded such decision are de facto subject to public record.

Since these investments into high growth companies are usually singular and not public, the actual and detailed documentation of the investment will be in the form of a shareholders' and/or investment agreement between the two parties owner/company and investor. Such an agreement is not public and has no formal procedure.

2.4 Are there incentive schemes for investing into high growth companies (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)?)

There are no incentive schemes for investing into high growth companies in Denmark. However, as an entrepreneur you may apply for funding at the Danish Entrepreneurship Foundation. In addition, you can apply for funding via EU.

It seems relevant to mention that Denmark recently amended its tax regulations on portfolio shares. In the Danish Capital Gains Tax Act, there is a provision which defines tax-free portfolio shares. The provision includes shares that are not publicly traded and owned by a company that owns less than 10 % of the shares in the portfolio company. It is a condition that the portfolio company is a limited company, or an equivalent foreign company.

The provision does not include shares held by a life insurance company, subsidiary's shares, group shares, convertible bonds or subscription rights to convertible bonds. Gains on shares covered by the definition of tax-free portfolio shares are tax-exempt irrespective of ownership period. The tax exemption does not apply to dividends from portfolio companies. Therefore, the current Danish rules for tax on dividends will continue to apply.

Be aware that it is not possible for companies to gather publicly traded equity securities in an unlisted portfolio company in order to make profit by using the above-mentioned rule. There is a protective rule which prevents this.

2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?

The investment made as a combination of preference shares and a strong shareholders' agreement is clearly preferred by investors. As the requirement for agreeing terms are quite informal most issues can be agreed in the documents freely. Thus giving the investor a good strong foothold.

Due to the low level of red tape in the Danish process most of the traditional and most common instruments are available to international investors too. As long as investments are not done in person by foreign nationals into Danish real estate no restrictions are made. However, this is hardly the case with high growth companies.

3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

3.1 Which company form is most popular? (Special company forms for high growth companies? Tiers of management typical for a high growth company? Liability point of view?)

Denmark has a very easy and available regulation regarding establishment of a company and setting up a business. The type of business you wish to establish will determine what form of company you should choose.

Depending on what type of company form you wish to establish, there are two Acts to consider, either the Danish Company Act or, the Danish Act on Certain Commercial Undertakings.

In Denmark, quite many smaller businesses are set up as partnerships or sole proprietorships, but as soon as the company grows larger, the only reasonable thing to do is to convert into a limited company or a private limited company. Since partnerships and the like are not regulated in detail under Danish law, the two forms of limited companies are by far the easiest and safest to invest in and, therefore, also the most popular.

Should you wish to establish a private limited company to begin with, you must provide a starting capital of 50,000 DKK. A limited company requires 500,000 DKK. A minimum of 25 percent of the required amount must be paid at the registration of the company. The registration must be made to the Danish Business Authority, and must be made within a time limit from the point of deciding to create the company.

3.2 What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?

The two most popular sectors of high growth companies are Trade and transport and Business services.

3.3 Are there incentive schemes for entrepreneurs incentivising high growth companies (e.g accelerators/incubators? Other?)

No, not in general. But the governmental venture fund, the Business Development Finance (in Danish *Vækstfonden*) provides under certain limited terms funds (both equity and loans) to growth companies. For a high growth company such funding does not normally fall within the scope of the Business Development Finance.

3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?

Not as such. However, fundamental and traditional concerns like retaining control and future profits speak in favour of simple loan capital as to actual third party ownership. For the entrepreneur himself the preference is to retain as much share capital as possible.

4. CORPORATE GOVERNANCE – CONTROL ISSUES

4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor take and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:

- a. Anti-dilution measures

Subject to the Danish Companies Act any shareholder has a right to subscribe to new shares in order not to be diluted. However, the general assembly may agree on an aimed issuance of new shares. Such may dilute the shareholder. Thus a need to have an antidilution clause in a shareholders' agreement is crucial.

However, for all issues relating to shares and equity it should be noted that in order to fully safeguard the provisions on anti dilution and other shares-related issues such should be adopted in the articles of association of the company in

order to secure that they are binding by the company and not just between the shareholders.

b. Rights of first refusal, pre-emption rights, drag and tag along

Such provisions are common standard as in international agreements. However, they are not subject to any type of legislation as such.

c. Protective provisions

Such provisions are often included, but are often part of other provisions such as the above-mentioned anti-dilution and exit-provisions.

d. Information rights

These are often included in the agreements. However, information is mostly secured by a seat on the board for a minority shareholder/investor.

e. Dead-lock resolution

Such resolutions are commonly used – and as per international standards used on a regular basis.

f. Board seats/observer rights

In most investments you will find that a seat on the board is a requirement. This is widely accepted.

g. Any other terms specific/important in your jurisdiction?

No.

5. EXIT STRATEGIES AND TIME HORIZON

5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?

There is no exit most commonly used. However, we do see a trend of the smaller (and larger) equity funds swooping up minor companies. This is probably rooted in both the last few years' low number of transactions and of course the further growth potential in the companies.

Following this the companies are either floated on the stock exchange or sold to bigger players in the same line of business for consolidation.

5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?

There is no single answer to these questions. However, the closest is the level of strength of the new investor. If the investor has a strong position, a new shareholders' agreement covering all shareholders are usually agreed on. However, in minor investments the existing agreement is often agreed to by the investor too – especially in situations where the investor is not a professional investor.

6. REGULATORY ISSUES

6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?

No – the tax levels and brackets are the same for all companies.

6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.

No

7. OTHER

7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high growth companies which have not been discussed in responses to earlier questions (if any).

Nothing to add.