



EUROPEAN COMMISSION

Brussels, 06.IX.2005

SG(2005)D/3313 final

Subject: NN 71/2005 – Capital increase HSH Nordbank AG, Germany

Sir,

The Commission wishes to inform the Federal Republic of Germany that, having examined the information supplied by your authorities on the measure referred to above, it has decided that the increase of HSH's share capital by an amount of €556 million does not constitute aid or contain aid elements in the meaning of Article 87 (1) of the Treaty.

I. Procedure

1. The Commission on 20 October 2004 decided that the asset and capital transfers taking place in the beginning of the 1990s favoured HSH's predecessor institutes, Landesbank Schleswig-Holstein ("LSH") and Hamburgische Landesbank, ("HLB") and that illegal state aid of €432 million (LSH case) and €91 million (HLB case) had to be recovered.¹ Including interest HSH had to repay to the Länder Freie und Hansestadt Hamburg ("FHH") and Schleswig-Holstein ("SH") a total aid amount of €756 million which it did in two tranches on 31.12.2004 and 3.1.2005.
2. In the course of these procedures, the German authorities and HSH informed the Commission that the bank's shareholders planned to increase the bank's share capital, the amount of which was not yet fixed. More detailed information including the form of the capital increase and a Fairness Opinion of PriceWatehouseCoopers on a market return rate for equity of HSH was submitted on 29 September 2004, 4 November 2004 und 19 November 2004.

¹ Commission decisions C (2004) 3928 final and C (2004) 3930 final of 20 October 2004 on Hamburgische Landesbank – Girozentrale (procedure C71/2002) and Landesbank Schleswig-Holstein – Girozentrale (procedure C72/2002); not yet published.

3. Following the submission of information and comments by HSH to BdB², the latter replied to these submissions by letters of 1 and 28 October 2004, 23 December 2004, 23 February 2005 and 3 March 2005.
4. By letter of 30 November 2004 the Commission informed Germany that investments taking place after recovery raised questions with respect to the effectiveness (“*effet utile*”) of the Commission’s recovery policy and, therefore, established criteria relevant for the Commission’s assessment of such investments by the Landesbanken in question, for instance, the requirements to provide capital only after the expiry of the state guarantees on 18 July 2005 and to submit a robust investment calculation proving that the remuneration for the capital provided would be in line with the market investor principle.
5. Following a further information request of 22 November 2004 Germany submitted more details on 16 and 23 December 2004 including the timing and exact amount of the planned investment as well as a comprehensive evaluation of the bank before and after the planned investment. In reply to a questionnaire sent by the Commission on 6 January 2005, the bank submitted on 27 of January and 10 February 2005 further information including a more detailed business plan and explanations as to accounting and tax issues.
6. On 11 February the German authorities, the bank and its consultants presented HSH’s investment case in a meeting held with the Commission.
7. In the context of these discussions further issues emerged that needed clarification before the Commission could conclude its assessment of the investment. One issue concerned the timing of the investment with respect to book-keeping. In order to ensure the “*effet utile*” of the recovery decisions of October 2004 the Commission demanded the investment to only take place after the expiry of the state guarantees on 18 July 2005 which in the view of the Commission did not only apply to the investment or payment as such but to any economic or accounting effect stemming from it. Upon request of the Commission, HSH, therefore, by letter of 3 March 2005 confirmed that it would not show any claim against its shareholders in relation to the capital measure envisaged for the 20 July 2005 in its balance sheet of 2004.
8. Another issue concerned the tax treatment of the recovery in the Landesbanken decisions of October 2004 which needed to be clarified in order to close the recovery procedures before going ahead with the new investment. Due to the fact that six of these decisions, including the decisions on HLB and LSH, calculated the recovery amount as an after tax figure and that only these after tax amounts were recovered, the tax deductibility of the repayment of the aid in the view of the Commission was not given. The Commission, therefore, demanded a

² See, for instance, letters by HSH of 4 November 2004, 3 December 2004, 31 January 2005 and 30 May 2005.

confirmation of the tax neutral treatment by the competent tax authorities of SH and FHH which it received on 30 August 2005.

9. Upon information request of 15 July 2005, the Commission received concluding information on the remaining issues in the context of the investment calculation on 22 July 2005.

II. Description of the measure in question

HSH Nordbank AG ("HSH")

10. HSH was founded in June 2003 when the former HLB and LSH merged. In the course of the merger HSH was transformed into a joint stock company (Aktiengesellschaft or "AG") and thereby formally privatised, i.e. the bank is not anymore governed by public law.
11. As a consequence of this transformation and in preparation for the abolishment of the state guarantees *Anstaltslast und Gewährträgerhaftung* on 18 July 2005, the former public mission activities (Investitionsbank of Schleswig-Holstein and Wohnungsbaukreditanstalt of Hamburg), were taken out of the bank and returned to the two Länder Schleswig-Holstein ("SH") and Hamburg ("FHH").
12. The former LSH since 1994 has been owned by the WestLB Group (39.9%), the Land SH (25.05%), the Sparkassen- und Giroverband für Schleswig-Holstein (25.05%) and Landesbank Baden-Württemberg (10%). This ownership structure resulted from a transfer of capital holdings from the *Land* of Schleswig-Holstein and the Sparkassen- und Giroverbands of Schleswig-Holstein to WestLB and Landesbank Baden-Württemberg on 1 January 1994. Prior to this transfer, the *Land* and the Sparkassen- und Giroverband each held 50% of the shares.
13. The former HLB had FHH as the sole shareholder until 1997 when LSH, alongside FHH, became a shareholder in HLB. Each had a 49.5% shareholding in HLB. In addition, HLB-Beteiligungsgesellschaft mbH which was controlled by FHH and the holding company Hamburger Gesellschaft für Beteiligungsverwaltung mbH, owned a de facto share of 1% via an atypical silent partnership.
14. The merger of the two former institutes LSH and HLB and the foundation of HSH brought about the following shareholder structure of the new bank:

Freie und Hansestadt Hamburg (FHH):	35.38%
WestLB	: 26.86%

Land Schleswig-Holstein (LandSH) : 19.55%
Sparkassen- und Giroverband SH (SPGV)³: 18.21%.

15. With the merger the entire commercial business activities of the former HLB and LSH was concentrated in HSH. The main business fields of HSH are regional retail banking, special financing including the global business of ship financing and, finally, the capital market services. The bank had a balance sheet total of €172 billion in 2003 and of €164 in 2004; it employed 4500 people in 2003 and 4300 in 2004.
16. Despite the repayment of the aid of €756 million (with interest) which was included in the accounts of 2004, HSH (group) had a tier 1 capital ratio of 7% on 31 December 2005. The state guarantees (Anstaltslast und Gewährträgerhaftung) expired on 18 July 2005. According to Standard Poor's⁴ HSH achieves an unguaranteed rating of a single A.

The increase of HSH's share capital

17. On 20 July 2005 HSH's shareholders increased its capital by €556 million. A potential capital increase had been considered already earlier in the context of the merger between the former institutes HLB and LSH and the respective negotiations of its shareholders in order to strengthen the future capital basis of HSH. This was thought to be potentially necessary in order to achieve a solid rating for the time after the abolition of the state guarantees. In that context also the possibility of a Commission decision to recover a significant amount of state aid played a role.
18. When agreeing on the merger between LSH and HLB and the transformation of the new bank into an AG, the four shareholders anticipated the possibility of a negative Commission decision to recover state aid stemming from asset and capital transfers in the beginning of the 1990s favouring the two old institutes in Hamburg and Kiel. The shareholders, however, could not know whether a recovery decision would be adopted in each of the two cases and if so, what potential repayment amount would apply to each of the merging institutes and, therefore, possibly weaken its value. Moreover, it was not foreseeable whether one of the two old institutes' value would decrease significantly as compared to the other and consequently might end in a different shareholding proportion for the new HSH.
19. The shareholders therefore decided not to take into account any of these effects – which were speculative in spring and early summer 2003 when the CFI had just annulled the first Commission decision on WestLB - at the time of the merger but later. They, however, still anticipated the potential need for a capital injection to strengthen the future capital basis.

³ Savings banks association of Schleswig-Holstein.

⁴ 'Shadow' (=unguaranteed) rating of July 2004 (S&P publication) and June 2005 (see HSH's investor presentation of July 2005 published on its website).

20. HSH's shareholders consequently created a model of a potential capital injection, which allows for a capital increase from own funds in combination with so-called partial payments by the shareholders into these funds. According to this model, HSH's shareholders contribute by means of partial payments to the own funds out of which the capital will then be increased. In return the shareholders will get ordinary shares and preferred shares (shares without a voting right but with a top up dividend instead). This mechanism allows for outbalancing any distortions of the shareholder structure without changing (at least not significantly) the voting rights.
21. When in October it finally turned out that the old LSH had a significantly higher recovery to pay, this meant de facto that the value of old HLB should have to be estimated proportionately higher at the time of the merger and consequently give former HLB shareholder Hamburg a roughly 3% higher share in new HSH. The mechanism described above now allows for compensation by means of preferred to shares without changing HSH's structure of voting rights. Consequently, the investment in question is a mix of an investment in ordinary share capital and preferred shares.
22. The Commission in October decided that the asset and capital transfers taking place in the beginning of the nineties favoured the former institutes LSH and HLB and that illegal state aid of €432 million (LSH) and €91 million (HLB case) had to be recovered. Including interest HSH had to repay to the Länder Hamburg and Schleswig-Holstein a total aid amount of € 756 million which it did in two tranches on 31.12.2004 and 3.1.2005, both booked in the 2004 accounts.
23. On 20 July 2005 HSH's shareholders increased the capital by an amount of €556 million, € 488 million of which in ordinary share capital and € 68 million preference shares. Due to the above described mechanism of a capital increase from own funds in combination with so-called partial payments the shareholding structure only changed slightly:

Freie und Hansestadt Hamburg (FHH):	35.38%
WestLB AG :	26.58%
Land Schleswig-Holstein (Land SH) :	20.02%
Sparkassen- und Giroverband SH (SPGV):	18.02%.

III. ASSESSMENT

Aid within the meaning of Article 87(1) of the Treaty

24. Article 87(1) of the EC Treaty states that, save as otherwise provided in the Treaty, any aid granted by a Member State or through state resources which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods is incompatible with the common market, insofar as it affects trade between Member States.

State resources

25. Two of HSH's shareholders, SH and FHH, are German Länder. Consequently, there is no doubt that the funds provided by SH and FHH are provided by the state. The other two shareholders of HSH are SPGV and WestLB AG. The latter is owned by two savings banks associations (Rheinischer Sparkassen- und Giroverband as well as Westfälisch-Lippischer Sparkassen- und Giroverband) and NRW.BANK which itself is owned by the Land Nordrhein-Westfalen⁵ (NRW) and two regional associations⁶ (Landschaftsverbände Rheinland und Westfalen-Lippe). The question whether the funds provided by these shareholders are state resources and whether their investments are imputable to the state, can be left open, if the measure in question does not favour HSH in the meaning of Article 87 (1) of the EC Treaty.

Favouring a particular undertaking

26. A broader capital base provides for a greater lending capacity and the associated possibility of expanding business. If additional capital is made available to the undertaking on conditions better than normal market conditions, this ranks as favouring within the meaning of Article 87(1) of the EC Treaty. In examining this matter, the Commission applies the "market-economy investor" principle. The Court of Justice and the Court of First Instance have accepted and developed this principle in a number of cases, in particular in the ruling by the Court of First Instance of 6 March 2003 in the *WestLB*⁷ case.

The market-economy investor principle

27. According to this principle, no state aid is involved where funds are made available on "terms which a private investor would find acceptable in providing funds to a comparable private undertaking when the private investor is operating under normal market-economy conditions".⁸ In contrast, a financial measure such as a capital injection is deemed unacceptable for a market-economy investor if the expected return on the investment is below the return a market-economy investor ('market investor') would expect for comparable investments.
28. The market-economy investor principle is likewise applicable to all public undertakings, irrespective of whether they are profit- or loss-making. This

⁵ Also 0.79 % direct stake in WestLB AG

⁶ Also 0.42 % direct stake in WestLB AG

⁷ Joined Cases T-228/99 and T-233/99.

⁸ Commission communication to the Member States: Application of Articles 92 and 93 of the EEC Treaty and of Article 5 of Commission Directive 80/723/EEC to public undertakings in the manufacturing sector (OJ C 307, 13.11.1993, p. 3; see paragraph 11. Although this communication deals expressly with manufacturing, the principle doubtless applies likewise to all other sectors of the economy. As regards financial services, this approach was confirmed by a number of Commission decisions, e.g. in *Crédit Lyonnais* (OJ L 221, 8.8.1998, p. 28) and *GAN* (OJ L 78, 16.3.1998, p. 1).

position of the Commission has been confirmed by the Court of First Instance in *WestLB*.⁹

29. The key question in examining this case therefore is whether the expected total return on the investment is in line with the return a market-economy investor would expect for comparable investments in share capital and preference shares.
30. In contrast to the opinion expressed by the BdB, the internal agreement between the shareholders on the application of the chosen model of partial payments to compensate for value decreases that could not be recognised in the context of the merger in 2003, is not relevant in the context of this assessment. Neither is the examination of the compatibility of the booking of these partial payments with German accounting rules relevant for the assessment under the market-economy investor principle. Apart from the fact that documents submitted in the course of the investigation suggest compliance with the accounting rules and given that HSH's auditors apparently go along with the approach, the Commission has to focus its analysis on the question of whether or not the shareholders of HSH can expect a market return on their investments in order to conclude whether state aid is involved.

Investment in share capital

31. As far as the ex-ante assessment of the investment in normal shares is concerned, the Commission decided to use the so-called discounted cash flow (DCF) dividend discount model (ddm) analysis. In autumn 2004, HSH and some other Landesbanken which at that time were planning a capital increase, submitted documents and calculations to underpin their case of the market conformity of the investments. Due to the fact that the individual methods and indicators varied, the Commission saw the need for a common approach.
32. The DDM valuation methodology is a variant of the Discounted Cash Flow methodology for the valuation of financial institutions taking into account their specificities. Because of supervisory requirements and rating aspects a bank's business can only grow to an extent that it is still underpinned by an appropriate level of own capital. The DDM thus determines a bank's value through discounting the future distributable dividends, i.e. the annual surplus less the own capital needed. The thus established value is future oriented and accordingly should theoretically be the correct manner to assess the future earnings potential.
33. It decided for the DCF/DDM analysis because it is a standard method to calculate the expected total return of an investment in share capital by means of the company's expected value increase following the investment in question and is based on the business plan of the company concerned. An increase in the market value can be estimated by carrying out a valuation of the bank's business with the investment and a valuation of the bank's business without the investment. If the

⁹ Joined Cases T-228/99 and T-233/99 [2003] ECR II-435 et seq.

difference between the two (net present) values is positive and higher than the invested amount, a private investor would find acceptable to provide the capital and the investment can be considered to be market conform.

34. The Commission took the view that this method is appropriate to carry out the assessment of an envisaged investment in share capital of a specific company because it reflects an ex-ante approach commonly used by institutional market players planning to invest significant amounts of cash money. This approach is not to be confused with an ex-post assessment of an investment that had been implemented without any such ex-ante analysis of the expected returns taking into account the business plan and where, therefore, only fixed remuneration could ensure a market return for the investor.

HSH's strategy and business plan

35. According to the documents submitted HSH's main objective is to improve the capital basis in order to achieve a single A rating after the abolition of the state guarantees. Strategically this also involves HSH's capability to address capital market and to start de facto privatisation (IPO) of the bank in the beginning of 2008. In view of these priorities HSH's business plan foresees a moderate growth without a major change in the bank's core business.

36. HSH's business plan was presented by the board of directors and agreed at the meeting of the bank's supervisory board in December 2004. Accordingly, HSH envisages to concentrate on those business fields which formed already its core business in the past

- (.....)*

37. The business plan covers the usual 3-years-period, i.e. 2005-2007. For the purpose of the market investor test, HSH extrapolated the assumption and figures to also cover the period 2008-2010. From 2010 onwards the status 'sustainability' is assumed. HSH's underlying assumption for the business plan is a single A rating for the time after the abolition of the state guarantees. This unguaranteed rating was given by Standard & Poor's in 2004 and maintained recently, in June 2005. HSH's cost, income and result projection derive mainly from this rating assumption. Apart from that, HSH plans to increase its net income by 50% by closing the liquidity gap and cutting back on (...)*.

38. Lehman Brothers (LB) was engaged by HSH to evaluate, on the basis of HSH's business plan, the envisaged capital injection from a private investor perspective. Their detailed analysis and valuation of the bank to substantiate the market conformity of an equity investment into HSH was submitted in December 2004. Since then further explanations were delivered and a presentation given in the context of a technical meeting in February 2005.

* Confidential information

Valuation of HSH with and without capital injection

Context and assumptions

39. LB established the cash flow valuation for the situation without a capital increase ('pre-money')¹⁰ as well as for the situation following the capital increase of €556 million (post-money). The analysis thereby also covers the increase of the capital of preferred shares, which as a matter of principle also participate in profit and losses. An additional benchmarking analysis for the top up dividend for the preferred shares is being dealt with further below.
40. This valuation was based on HSH's business plan, which comprises detailed projections regarding the main income, cost and result elements for the period 2005-2007 and 2008-2010.
41. Upon request by the Commission a sensitivity analysis was also carried out. This included the 'likely' scenario underlying HSH's business planning and an 'optimistic' (best case) as well as a 'pessimistic' (worst case) scenario. LB took over the assumption of the single A rating and the bank's income, cost, result and profit projections for the likely scenario. From this starting point, the rating assumptions for the optimistic and pessimistic scenarios were derived as well as all subsequent estimates for key indicators such as refinancing cost, growth rates and the growths of risk weighted assets.
42. The main assumptions underlying the valuations include:
- Rating per scenario:
 - a) pre-money

<u>Pessimistic</u>	<u>Likely</u>	<u>Optimistic</u>
(..)* (2005)	(..)* (2005)	(..)* (2005-2007)
(..)* (2006 to 'sustainable')	(..)* (2006 to 'sustainable')	(..)* (2008 to 'sustainable')
 - b) post-money

<u>Pessimistic</u>	<u>Likely</u>	<u>Optimistic</u>
(..)* (2005-2007)	(..)* (2005)	(..)* (2005 – 2007)
(..)* (2008 to 'sustainable')	(..)* (2006 to 'sustainable')	(..)* (2008 to 'sustainable')
 - Sustainable growth rates: (..)*% for the pre-money scenarios and (..)*% for the post-money scenarios.
 - Growth of risk weighted assets (RWA): from (..)* % p.a. (2005) to (..)* % p.a. (2008 – 'sustainable') in the pre-money scenarios and (..)* % in the post-money scenarios.

¹⁰ This takes into account the situation after the re-payment of state aid amount of €756 million.

* Confidential information

- Income margins on interest and commissions: (...) % and (...) % respectively in the pre-money case; (...) % and (...) %- (...) % in the post-money case.
43. The shareholders of HSH also foresee an Initial Public Offering (IPO) in the medium term provided that HSH's projected economic development and the market conditions support such a step. In the scenario analysis of the valuation an IPO is – issuing of €(...) million – assumed for (...).
44. The Commission assesses these assumptions as reasonable including the key factors for the sensitivity analysis, which are the capital ratio and the rating. HSH has managed – already over the past two years - to increase its tier 1 capital ratio steadily from 6.0% in 2002¹¹ to 6.6% in 2003. On 31 December 2004 the tier 1 ratio was 7.0%. However, the ratio per 31 March 2005 (status April 2005) dropped to 6.8%. Such a fluctuation can be explained by a fluctuation of the business volume and by external factors. Moreover, this ratio is within HSH's as well as the rating agencies' target range for a single A rating. However, HSH's principle target tier 1 ratio remains 7%.
45. Without the capital increase, the current unguaranteed rating of a single A could be at risk of being lowered by one notch. In particular with regard to the high proportion of hybrid capital. The theoretical possibility of an over-capitalisation following the capital increase is consequently not realistic.
46. HSH would have probably sought capital in any case. In the instance that the current shareholders would not re-invest any funds, HSH would be able to raise capital on the market. Due to HSH's record there is no reason to question the banks' capability in this respect.¹²

The Discounted Cash Flows (“DCF”) valuation method

47. The DCF method calculates the total of the projected and discounted free cash flows for the pessimistic, likely and optimistic pre- and post-money scenarios over the relevant period. Therefore, the analysis comprises 6 scenarios in total. The individual steps of the valuation are the following:
- (...) % cost of equity was calculated as the discount rate based on the CAPM¹³ with a risk free rate of (...) %, a market risk premium of (...) % and a Beta¹⁴ of (...) to calculate the total of the discounted cash flows for the here relevant planning period (2005-2010).

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¹¹ Pro forma data (based on ratios of the former institutes).

¹² Placements with banks and insurances including international placements (for the retail and the institutional market).

¹³ $R = r_f + MRP \times \beta$ (r_f = risk free rate; MRP = general long-term market risk premium and β = statistically measured deviation of the individual risk premium from the general long-term market risk premium).

¹⁴ See above.

- The Beta was determined on the basis of comparable but listed companies. The market risk premium was derived from a 1987-2004YTD¹⁵ statistics of all shares in the FTSE¹⁶ World Index.
- Furthermore, the present value of the so-called terminal value (“TV”) was calculated which is the discounted free cash flow p.a. for the sustainable period, i.e. beyond 2010, divided by the cost of equity ((...)*%) minus the growth rate assumed for the scenario ((...)*% or (...)*%)¹⁷.
- To arrive at the full DCF valuation of HSH for one scenario, the present value of the TV was added to the total of the discounted cash flows.
- If, furthermore, hidden reserves are added to this DCF valuation the result is the so-called equity value of HSH.
- Finally, a ‘fair’ equity value was calculated by the deduction of a) a discount for increased transaction costs in case of a liquidation of the investment in a non-listed bank and b) a discount in line with comparable capital increases taking account of the amount of the planned capital increase in relation to the equity base of HSH and the market environment at the particular time of the decision for the envisaged IPO.

48. The Commission has no reason to doubt the method and estimates used for the valuation including the parameter to calculate the cost of equity on the basis of the CAPM. The BdB submitted comments criticising the beta factor of (...)* calculated in the fairness opinion initially submitted by PriceWaterhouseCoopers. BdB criticised the used method for determining the beta factor, in particular the calculation of the arithmetic average, on the basis of comparable companies which it reasoned by the fact that this beta factor was significantly lower than the one used in the recovery decisions concerning HLB and LSH (0.74 and 0.67 respectively).

49. The Commission does not agree with this criticism. First, the beta factors used in the recovery decisions referred to, relate to the asset and capital transfers to the former institutes HLB and LSH that predominantly occurred in the beginning of the 1990s. Consequently, the beta factor agreed upon by BdB, HSH and FHH as well as SH and not objected by the Commission was supposed to reflect the situation of these institutes at that time and not the situation of the current HSH which was only formed two years ago and, moreover, is not backed by state guarantees anymore.

¹⁵ Year-to-date.

¹⁶ Financial Times Stock Exchange.

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¹⁷ $TV = CF_{N+1} / (r-g)$.

50. Secondly, the beta factor initially calculated by PriceWaterhouseCoopers was based on the combined HLB and LSH business plan 2002-2004. Upon request by the Commission, however, the cost of equity had to be calculated on the basis of the business plan for the period 2005 – 2010 reflecting HSH’s actual strategy and planning as well as a different capital market environment influencing volatility of the market. This new analysis was carried out by LB and resulted in a beta factor of (...)*. The Commission does not see any reasons for doubting the applied method for determining the beta factor.
51. The calculations result in equity valuations after discounts in the range of €(...)* billion in the pessimistic case, €(...)* billion in the likely case and €(...)* billion in the optimistic case for the three pre-money scenarios. The equity valuations result in the range of €(...)* billion in the pessimistic case, €(...)* billion in the likely case and €(...)* billion in the optimistic case for the three post-money scenarios. The difference, and therefore the value increase due to the capital injection, ranges from €(...)* billion in the optimistic case to €(...)* billion¹⁸ in the three scenarios. Consequently, the value increase is in all scenarios higher than the additional equity of €556 million. Even in the pessimistic scenario the investment does not only earn the cost of capital but creates additional value for the investors.
52. The Commission, therefore, concludes that the investment in share capital is in line with the market investor principle. This is also backed by a plausibility check carried out by LB.

Plausibility check by means of a market multiples analysis

53. The market or trading multiples valuation methodology values the company based on multiples at which similar companies (“peers”) trade on the stock market. The equity value is expressed as a multiple of the net income, operational income or book value. The Price/Earnings (“P/E”) multiple was taken as the most relevant multiple and applied to the company’s net income.
54. A group of publicly listed financial institutions was defined, which are comparable to HSH with respect to their business profile and environment in which they operate. The analysis was based on the following comparable banks: HVB, Commerzbank, Deutsche Bank, SEB, BNP Paribas and Société Générale.
55. LB calculated a median P/E multiple based on these comparable banks of (...)* for 2005 and (...)* for 2006. If this factor is multiplied with HSH’s net income (after tax; scenario range) the equity value for HSH is between €(...)* and €(...)* billion for 2005 and between €(...)* billion and (...)* billion for 2006. This result based on the P/E multiple is comparable with - even if slightly lower than - the

* Confidential information
18 Rounding may cause differences.

‘fair’ equity value derived from the DCF method where the range is between € (...) billion and €(...) billion.

Return on equity

56. The DCF analysis estimates a Return on Equity (“RoE”; after tax) that ranges from (...) % to (...) % in the scenarios excluding the capital increase and (...) - (...) % in the scenarios including the capital injection. The higher figures ((...) % - (...) %) are mainly estimates for the earlier years 2005 and 2006 whereas for the later years and afterwards (‘sustainable’) the figures get more stable.
57. For the planned capital increase the bank and LB assumed that the additional equity capital will be mainly used for improving the bank’s capital structure and not for growing its business volume. As a result, the bank’s ACE ratio¹⁹ and therefore its risk/return profile improve significantly and move closer towards the average ACE Ratio of European financial institutions. The more stable capital structure is envisaged to result in a more secure investment from the perspective of the current and future shareholders. As a consequence the RoE will slightly decrease over time.
58. In that context it should, however, be noted that the RoE is not the decisive criterion for an investment. A rationally acting investor would base the decision to invest primarily on the total return earned on his investment rather than on the RoE. The price at which the investor makes his investment and the subsequent exit would be additional critical factors that would determine the return on investment.
59. The Commission included the RoE in its assessment only as an additional indicator, not as the decisive criterion, which is the valuation analysis based on the method outlined before.

Preference Shares -Benchmarking

60. As already mentioned, preference shares formed part (€68 million) of the capital increase. Preference shares are attractive to investors due to their participation in liquidation proceeds and therefore their participation in the company’s equity value increase: Furthermore, the dividend payments are higher than the dividend payments of ordinary shares. This is a kind of compensation for the fact that preferred shares have no voting rights.
61. The Commission analyzed this top up as the main distinctive feature in comparison with ordinary shares by means of a benchmarking analysis.
62. Preference shares are not widely used among German and European banks. Only Italian banks use this instrument more often but with differed conditions (e.g. they

* Confidential information
19 Ratio of adjusted common equity to assets.

can have limited voting rights). Due to these different national regulations the benchmarking is to a certain degree distorted. Therefore, an additional comparison with German industry was carried out to allow for a benchmarking within one jurisdiction, which, however, is also not perfect in view of the difference between industry and banks regarding the capitalisation. Both comparisons should provide for the best possible benchmarking with respect to HSH's preferred shares.

63. The HSH preferred shares have a 5% top-up dividend as compared to HSH ordinary shares. This payout premium is above German Corporates and other European banks average as the documents submitted indicated. As a result, the Commission has no grounds to doubt that the top up dividend in combination with the terms and conditions of HSH's preference shares is in line with the market investor principle.

Result on the market-economy investor principle

64. The Commission concludes that the planned capital increase of €556 million by the shareholders of HSH is in line with the market investor principle and does not favour HSH.

IV. Effectiveness of the Commission's recovery policy

65. As indicated in paragraph 5 above, during its assessment, the Commission took into account the need to ensure that the increases of capital concerned did not undermine the effectiveness of its recovery policy. The Commission is satisfied that the illegal aid granted to LSH and HLB has been entirely recovered on 31.12.2004 and 3.1.2005. Furthermore, the State guarantees have been abolished on 18 July 2005.
66. Both from the standpoint of payment and accounting, the capital increase takes effect only after that date. The capital increase has been subjected to a robust analysis and found to be entirely in accordance with the market economy investor principle, and thus does not contain any element of State aid. Accordingly the Commission is satisfied that this is the case.

V. Decision

67. The Commission has accordingly decided that the capital increase of € 556 million does not constitute State aid in the meaning of Article 87(1) of the EC Treaty.
68. If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet

site: http://europa.eu.int/comm/sg/sgb/state_aids/. Your request should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
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Yours faithfully,
For the Commission

Neelie KROES
Member of the Commission