

7 REPORT ON OPPORTUNITIES AND RISKS

7.1 MANAGEMENT OF OPPORTUNITIES AND RISKS

7.1.1 POLICY ON OPPORTUNITIES AND RISKS

The goal of our policy on opportunities and risks is to assure the continued operation of the Phoenix Solar Group as a going concern and to systematically and sustainably increase the company's value. In accordance with these basic principles, business decisions are always made only on the basis of a detailed analysis and assessment of the associated risks. Because all business activity necessarily entails opportunities and risks, the Group's risk strategy covers both elements. In the areas of our core competence, therefore, we consciously take on manageable, assessable risks when the income to be generated by assuming such risks is appropriate. We avoid risks in all other areas, as a matter of principle.

7.1.2 RISK AND OPPORTUNITY MANAGEMENT SYSTEM

The Group's risk and opportunity management system is designed to identify individual risks, present them in a transparent manner and determine ways of managing them appropriately. Aside from risks that would endanger the company's continued operation as a going concern, we also monitor those activities, events and developments that could have a significant influence on the Group's future business success. The corresponding goals and procedures and the division of responsibilities within the risk management system are documented in the Risk Management Handbook of Phoenix Solar AG.

In connection with the strategy process, we analyse the company's strengths and weaknesses within the market environment, also by means of benchmark analysis, and identify ways of exploiting optimisation potential and sales opportunities. For more information on this subject, please refer to our comments in Section 1.2 "Management, Goals, Strategy" and in Section 8.7 "Opportunities in the Business Segments". In that regard, we are guided by the goal of simplifying our processes, so as to achieve better results more quickly and efficiently. We employ an instrument known as the "balanced scorecard" for the purpose of managing and evaluating the measures taken to exploit opportunities. We employ the same instrument for the purpose of recognising undesired developments in the implementation of the Group's business strategy, as a means of detecting risks at an early stage.

Using a standardised risk inventory, a defined group of employees with bearing responsibility for risks in interface functions reports all existing risks, newly detected risks and potential risks to the Risk Manager on a regular basis. Each such risk is classified according to the criteria “probability of occurrence”, “potential loss amount” and “ability to influence”. The Risk Manager analyses, assesses and documents all such risks at regular intervals of time and keeps both the Risk Officers and the Executive Board informed. The Risk Officers review the risk assessment and adopt appropriate counter-measures. The Risk Manager then communicates these measures to all relevant organisational units and to the persons bearing responsibility for risks.

Insurance policies are maintained, to the extent they are available and economically tenable, to minimise the financial repercussions of a potential loss. The extent and amount of such insurance policies are reviewed on a regular basis.

7.1.3 INTERNAL CONTROL AND MANAGEMENT SYSTEM RELATIVE TO THE CONSOLIDATED FINANCIAL REPORTING PROCESS

Our internal control and risk management system relative to the (consolidated) financial reporting process is designed to ensure that the Group’s accounting system is uniform and conformant with applicable laws and regulations, German generally accepted accounting principles und International Financial Reporting Standards (IFRS). The objective of this control system is to provide reasonable assurance that the consolidated financial statements are prepared correctly, in conformity with all applicable laws, regulations and guidelines. That goal is achieved by means of various control and review mechanisms, including plausibility checks and the strict application of the dual control principle on all levels of the company.

The task of the internal control system is to identify key risks and monitor the measures implemented to counteract them. To that end, key elements such as process descriptions, job descriptions and alternate representation arrangements are reviewed by different entities, including the internal audit function, to verify that they are complete and up-to-date, using a risk control matrix for that purpose.

In addition to automated system controls, we also conduct manual controls and analytical audit activities, with due consideration given to the respective control environment and the relevance of the given accounting matters to the information provided in the financial statements.

The process of preparing the consolidated financial statements is based on uniform, Groupwide accounting policies. The Group companies first prepare their separate financial statements in accordance with the national laws and regulations applicable to them; they then convert their local financial statements to what are called the “Commercial Financial Statements II”, drawn up in accordance with IFRS, and submit the corresponding data to Corporate Accounting in a uniform, predefined format (“reporting package”). Corporate Accounting uses this data to perform the consolidation measures. Group companies are required to observe Groupwide accounting policies and are responsible for the adequate and timely conduct of their accounting-related processes and systems. Corporate Accounting supports the Group companies throughout the entire accounting process.

7.2 REPORT ON RISKS RELATED TO FINANCIAL INSTRUMENTS

A detailed description of the risks related to financial instruments is provided in Section F, Note (39) of the notes to the consolidated financial statements.

7.3 SIGNIFICANT RISK AREAS

7.3.1 INTERNATIONAL EXPANSION

Phoenix Solar AG takes advantage of opportunities to establish a foothold in international markets, also through its worldwide network of subsidiaries, in order to achieve its growth goals by generating a higher proportion of its business in international markets.

The further expansion of the Phoenix Solar Group, including project development and the construction of photovoltaic power plants in foreign countries in particular, entails considerably higher risks than those associated with the Group's business in Germany. Such risks relate primarily to development expenses and times and to the completion of photovoltaic power plants. Especially in the case of increased activities in new markets, therefore, project delays and cost overruns compared to the original, deliberately conservative plans cannot be ruled out.

In addition, the formation of new subsidiaries in foreign countries heightens the need for local managers. That necessarily entails longer integration and acclimatisation times, during which optimal effectiveness still needs to be developed. Furthermore, an expansion of the company's business into countries beyond the European Union entails considerably higher risks arising from legal and political aspects. Generally speaking, there is also a risk that the potential of foreign markets could be misjudged, with the result that the company would become involved in foreign markets with very little potential. Such risks are difficult to assess and can lead to unforeseen cost burdens.

7.3.2 POLITICAL FACTORS

The condition and development of national photovoltaic markets are promoted or impeded to varying degrees by the laws and regulations in force. In the case of laws designed to create long-term economies of scale, such as the German Renewable Energies Act, every reduction in feed-in remuneration rates that cannot be offset by lower-cost procurement prices or lower sales prices lowers the achievable return of new photovoltaic plants, which reduces the attractiveness of such plants for potential buyers. Radical changes in the legislative framework could restrict further market growth or even cause markets to contract, which would endanger the continued operation of the company as a going concern. In order to mitigate the risks associated with dependencies on individual markets, Phoenix Solar AG systematically pursues a strategy of internationalisation. By that means, the company also counters the risks associated with the ongoing debate concerning further cut-backs under the German Renewable Energies Act, which can be expected to have adverse effects on the development of the German market, which is still the most important market for Phoenix Solar AG.

7.3.3 MARKET, COMPETITION AND EXTERNAL FACTORS

Global population growth and the rising demand for energy in emerging-markets and developing countries are leading to higher global energy demand. That trend, coupled with the projected scarcity of fossil fuels, will cause the price of fossil fuels to rise, creating a situation that is conducive to the expanded use of regenerative energy sources, which is an important opportunity for solar industry companies like Phoenix Solar AG.

A favourable effect can be expected to result from the continuous reduction of the costs of generating solar power, to be achieved through technical innovations in modules and components and through the exploitation of purchasing advantages arising from the bundling of procurement volumes within the Group.

Rising interest rates reduce the return of photovoltaic plants, which tend to be financed through borrowing to a considerable extent. If interest rates remain high for a longer period of time, that could dampen investors' interest in financing photovoltaic power plants.

Another factor affecting the availability of credit to finance photovoltaic power plants is the more restrictive lending practices of banks, which have become more risk-averse. This trend is causing considerable delays, in some cases, in the execution of planned projects. It can also be expected, moreover, that the process of finding suitable investors will become more difficult and time-consuming. If the financing promised to investors in photovoltaic power plants cannot be verified in accordance with plan, Phoenix Solar reserves the right to keep the corresponding power plants temporarily in its own portfolio and sell them to other investors, in consideration of all possible consequences.

If lengthier delays would occur in the process of selling large photovoltaic plants, leading to delayed cash flows, that could pose a risk to the liquidity management efforts of Phoenix Solar AG. The Group counters such risks by means of active working capital management and by employing funds from bridge financing facilities.

The strong expansion of the Group's business engenders high capital needs. The Phoenix Solar Group conducts rigorous liquidity controlling to limit the risk of liquidity shortfalls that could result from variations in future cash flows. To secure the Group's medium-term financing needs, moreover, Phoenix Solar took out a syndicated credit facility with a term of three years in financial year 2008. If the covenants associated with this loan are not fulfilled, the lending syndicate would be entitled to cancel the credit facility. The term of the existing loan agreement expires in November 2011. Negotiations on renewing the syndicated loan were begun in February 2011. As part of those negotiations, the Group is seeking to integrate the US subsidiary into its financing structure. If, contrary to expectations, the syndicated loan cannot be renewed by the end of November 2011, the Group's business strategy would have to be adjusted or the need for liquidity satisfied by alternative financing instruments.

7.3.4 PROCUREMENT

Due to the considerable lead times in production and the long delivery routes, especially for modules and inverters, procurement decisions need to be made at an early stage. However, the inherent volatility of the Group's sales markets, which is exacerbated in some cases by persistent political debates concerning changes to feed-in remuneration rates, makes it considerably more difficult to plan purchases of necessary goods at the exact time they will be needed. If errors of judgment are made in this process, therefore, the Group could end up with insufficient inventories or excessively high inventories. For that reason, the trend of weakening demand, especially in the German market as a result of the anticipated changes under the German Renewable Energies Act as of mid-2011, which would lead to lower remuneration rates, poses the risk of higher inventories.

In addition, the higher level of inventories presented in the consolidated financial statements of the Phoenix Solar Group as of 31 December 2010 poses a potential risk for financial year 2011. In consideration of the weak demand conditions that are normally in effect at the beginning of the year, resulting in a low level of new orders, the Group cannot expect to reduce these inventories quickly. Furthermore, both the general market trend and the trend of module prices are currently difficult to predict. If prices would decline suddenly and quickly, Phoenix Solar would be compelled to charge appropriate value adjustments against its inventories, in order to offer its products at market prices. Such a development would have negative effects on the Group's cash flows, financial position and results of operations.

To secure an appropriate supply of modules, Phoenix Solar has maintained a long-term supply contract with a module manufacturer for many years. If the parent company would be obligated under that contract to meet minimum purchase obligations at below-market prices, without being able to resell the delivered components at prices higher than its own procurement costs, that would have a substantially negative effect on the results of operations, cash flows and financial position of the Group. Furthermore, if the Group's contract partners would prove to be insufficiently flexible in renegotiating long-term con-

tracts, the existing module supply contracts could become so onerous for Phoenix Solar that it would have to recognise provisions for that purpose.

7.3.5 LEGAL AND TAX ASPECTS

In the fourth quarter of 2009, the competent tax authorities began to conduct a routine tax audit of Phoenix Solar AG for the period from 2005 to 2008. This tax audit, which is still being conducted, could lead to financial risks for the Group.

7.3.6 BUSINESS STRATEGY RISKS

The constantly growing competition by module manufacturers and energy utilities in the power plant business poses the risk that Phoenix Solar would only be able to offer partial services in this area or that it would be pushed out of the market, in full or in part, thereby eliminating part of the company's value chain. Such a development could also pose a sales risk for modules, especially in the case of modules purchased under long-term supply contracts. Due to uncertainties in the market, moreover, customer demand could decline markedly or customers could cancel their orders to a greater extent.

Continued strong market growth in Germany could lead to calls already in the near future to modify or even eliminate the German subsidy system for photovoltaic power plants. In view of the importance of the German market for the entire industry and particularly for the Phoenix Solar Group, the international revenues of which are still relatively low, such a development could pose a great risk.

7.3.7 BUSINESS GROWTH

The rapid growth of our Group associated with increased business volumes poses greater demands on the Group's financing and organisational structure, specifically with regard to centralised administrative functions. Because it is not always possible to expand appropriate administrative resources at the same rate as the company's operational growth, temporary organisational risks cannot be completely ruled out.

Phoenix Solar counters such risks by means of conceptual process management and internal control mechanisms. The internal audit function is exercised by an independent corporate staff department within the Executive Board division of finance. The audits conducted by internal audit are meant to verify the effectiveness of the internal control system (ICS). Aside from its past-directed audit activities, the internal audit function also performs an advisory and precedent-setting role, in that it also assesses the usefulness of the company's processes.

The vital processes of the entire Group (including its subsidiaries) are highly dependent on the reliability of IT systems. Because data security is a constant issue, the Group continuously reviews, updates and further develops its IT infrastructure. The introduction of a new ERP system during the course of financial year 2011 will help to link all the Group's divisions and functions more closely together and further optimise information processing.

In order to achieve the growth objectives of the Phoenix Solar Group, the successful recruitment of qualified employees at all the company's locations will continue to be a matter of fundamental importance in the future as well. As an increasing proportion of the Group's business is shifted away from the German core market to international markets, there is a heightened need for qualified employees at all the Group's international locations. Thus, successful recruitment is vitally important to the achievement of the Group's growth objectives. If the Group encounters setbacks in that area, that could have negative consequences for achieving the Group's objectives.

7.4 GENERAL ASSESSMENT OF THE GROUP'S RISK SITUATION

The general assessment of the above-mentioned risk areas leads to the conclusion that the Group is mainly exposed to market risks, risks related to its dependency on political developments and risks related to the development of prices and business quantities, both on the procurement side and the sales side. By comparison, the risks associated with internal production processes are considerably less important. The general risk situation of the Phoenix Solar Group continues to be limited and manageable, although the fact that the future development of market prices for photovoltaic modules and systems cannot be reliably estimated at the present time could increase the risk potential considerably. Based on the information currently available to the company, no risks that could endanger the continued operation of the Phoenix Group as a going concern, either individually or in combination with each other, can be identified at the present time.