Suggested changes to the temporary state aid framework to accommodate "start-ups"

Invest Europe comments

The note below is based on the European Commission press release from 12 June indicating a consultation on the revision of the Temporary State Aid Framework focusing on the treatment of start-ups.

Executive Summary

- The current definition of "undertakings in difficulty" in the General Block Exemption Regulation prevents businesses backed by venture capital and private equity, such as start-ups and scale-ups, to be eligible to state aid
- While an extension of the Temporary Framework to start-ups would be highly welcomed, policymakers should avoid restricting the exemption to businesses that are at most risk of failing, as opposed to those start-ups that have already passed a "market test" by being supported by venture capital and growth funds
- In order to avoid market disruptions, a start-up definition should not solely rely on a size criteria but could be based on other criteria, such as venture capital ownership
- Finally, we are concerned that current state aid rules rely on viability concepts that are not relevant for lenders to any long term equity-backed businesses, discouraging alternative sources of finance for businesses by effectively carving them out of support programmes.

Introduction

The European start-ups, scale-ups and medium-sized businesses supported by the European private equity and venture capital industry we represent are, as many others, impacted by the economic shock caused by the Covid-19 pandemic. Between 2015 and 2019, our industry invested capital and expertise in 39,451 businesses across Europe and most of these are or will be at risk of suffering from the coronavirus.

Unless in very specific circumstances, the General Block Exemption Regulation (GBER) will prevent Member States to provide support under their state aid programmes to "undertakings in difficulty" (UIDs), as defined in point 18 of Article 2 of the Regulation. This exclusion has been confirmed in the Temporary State Aid Framework recently put forward by DG Competition, which clarifies that only businesses that are in difficulty as a result of the Covid-19 crisis should be eligible to the new programmes set up by Member States.

While we fully agree with the principle that state aid should not be granted to businesses that are at risk of being insolvent, we are afraid that the definition as enshrined in the GBER excludes from the specific Covid-related aid companies that were not in difficulty at the onset of the crisis. Particularly problematic from this perspective are criteria (a) and (b) which describe as UIDs companies where more than half of their capital has disappeared as a result of accumulated losses. Different types of companies backed by our members will indeed fit this description even when they are not in difficulty.

First, many high growth SMEs, such as scale-ups supported by venture and growth funds are still at a stage of their life where they are not yet turning up a profit despite having been in operation for more than several years. It is indeed not rare for businesses held by long-term funds such as venture and growth to still not be viable after several years, as product and business development take many years before the business is fully developed.

Second, it is problematic that, in a venture and growth context, quasi-equity - for example in the form of preference shares or shareholder loans – is often not considered as subscribed capital, in the same way as ordinary shares and share premiums would, despite the market practice, the structure of these deals and the active involvement of the fund managers in the running of the businesses backed by their funds.

Third, the current definition will exclude many, otherwise performing, businesses that predominantly rely on debt financing under the steering of large buy-out and mid-market private equity funds. While the ratio between accumulated losses and the subscribed share capital may help determine the viability of a business supported through bank loans, it is entirely irrelevant in the context of private equity financing, where relevant metrics used by lenders to determine the company's outlook will typically be cash flow driven, such as the ratio between the company's net debt and its EBITDA and/or the one between the free cashflow and the debt service. If no action is taken to acknowledge the specificities of this financing model, the vast majority of private-equity backed businesses will fall outside of the scope of EU state aid rules irrespective of their viability.

Role of venture capital financing in the financing of start-ups

Over the past 5 years, **22,500 companies received seed, start-up or late-stage venture investments in the EU28**[1]. While not all start-ups will be backed by venture capital, every company backed by venture capital will be a start-up. **98% of the companies supported by VC were SMEs in 2019** and all of them were fast-growing businesses.

According to the EU Start-Up Monitor 2018, **around 25% of start-ups** receive venture capital financing. This is a significant number especially considering that many start-ups are still too small to (have yet) receive(d) equity support from venture capital (in that case, they usually remain reliant on own funds/angel investing). Meanwhile, venture capital are known to only choose those companies whose business model they deem to be viable – which means many start-ups who would like to receive venture financing may never receive it.

This is also one of the reasons why the failure rate of VC-backed companies is significantly lower than the overall start-up cohort, as venture fund managers will have assessed carefully the company's business model and other fundamentals. **In 2019**, for start-up portfolio companies established in the EU28 area, our data shows **20,4% write offs at the end of the venture investment** (that number will naturally be higher for seed capital…and lower for later stage venture).

As such, VC ownership is the best equivalent to a "market test" for start-ups ***and it would therefore be quite illogical if start-ups that are backed by VC would remain deemed in difficulty***. It is therefore essential for the European Commission to ensure its definition of start-ups does not exclude venture capital-backed companies and, potentially, for part of the definition to be based on commitments received from venture capital.

Scope of existing definitions

Size of companies

It may seem conceptually logical to choose to address start-ups **solely on the basis of their size**. This could be appropriate for many start-ups but may pose **an issue on the market at large.** This would be particularly problematic as these companies are the ones that have the biggest chance of success and whose achievement is most likely to translate into job creation.

[1] Investing in Europe: Private Equity activity 2019

While we do not have statistics on the average size of a venture capital-backed company, an analysis of the amounts invested by VC in 2019 compared to the number of companies that were supported show that the **investment committed on average per company and per year is €680.000 at seed stage[2], €2.1 million at the start-up stage[3], €4.9 million at late-stage venture[4] and €8.6 million at growth stage[5]**.

It is obviously difficult to directly correlate these numbers to the actual size of companies. However, based on the number of years of investment and the percentage of ownership the venture capital or growth fund takes in the company, our clear estimation would be that a majority of the companies that received seed or start-up funding (although not all of them) would be small businesses from a size perspective[6].

Unfortunately, it also becomes apparent that companies benefiting from late-stage venture capital, i.e. *scale-ups, growth capital companies and larger start-ups,* **will mostly be out of scope due to their size**, if the ceiling of allowed state aid is only restricted to small and micro businesses.

13, 983 companies have received late-stage venture and growth funding in the past five years in the EU28. In 2019, exactly **39%** of all the companies backed by non-buyout funds received such capital from late-stage venture and growth funds (11% of late-stage venture and 28% of growth). In volume, the amount of investment at risk of being excluded would be even more significant. In the past 5 years, late-stage venture represented **36%** of the overall venture capital investments. **A solution based on size would therefore exclude companies, which represent a very significant part of the market from accessing the loans, notably those that are most likely to create a high number of jobs.**

Other criteria

Another criteria the Commission could consider to determine the remits of a start-up could be its focus on innovation. While the EU definition of an "innovative business" currently contained in the GBER (Article 2, point (80))[7] would capture many venture-backed companies, it would **exclude fast-**

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[2] **Seed:** Funding provided before the investee company has started mass production/distribution with the aim to complete research, product definition or product design, also including market tests and creating prototypes. This funding will not be used to start mass production/distribution (Glossary Invest Europe/PEREP, 2019 Activity Report)

[3] **Start-up:** Funding provided to companies, once the product or service is fully developed, to start mass production/distribution and to cover initial marketing. Companies may be in the process of being set up or may have been in business for a shorter time, but have not sold their product commercially yet. The use of the capital would be mostly to cover capital expenditures and initial working capital

[4] **Later-stage venture:** Financing provided for an operating company, which may or may not be profitable. Later-stage venture tends to involve financing into companies already backed by VCs, typically in C or D rounds.

[5] **Growth:** A type of private equity investment (often a minority investment) in relatively mature companies that are looking for primary capital to expand and improve operations or enter new markets to accelerate the growth of the business.

[6] We only look here at the annual turnover/balance sheet criteria (max. €10 million). It may also happen that smaller companies active in the services sector will be excluded because they are deemed to have more than 50 employees

[7] According to the GBER, an 'innovative enterprise' means an enterprise:

(a) that can demonstrate, by means of an evaluation carried out by an external expert that it will in the foreseeable future develop products, services or processes which are new or substantially improved compared to the state of the art in its industry, and which carry a risk of technological or industrial failure, or

(b) the research and development costs of which represent at least 10 % of its total operating costs in at least one of the three years preceding the granting of the aid or, in the case of a start-up enterprise without any financial history, in the audit of its current fiscal period, as certified by an external auditor;.

growing start-ups in sectors other than ICT, biotechnology and healthcare (albeit those represent a large proportion of the VC investments). This is because the "innovative enterprise" definition presupposes a certain percentage of investment in R&D or in ground-breaking technology that is not at all relevant in some sectors, where innovation is incremental e.g. businesses developing personal protective equipment or apps using existing software to streamline sales in the retail sector.

Meanwhile, the eligibility criteria for "start-ups" set in Article 22 of the GBER is also much too restrictive and risks excluding companies that are still in their growth phase. As a venture capital manager invests on average over 6 years into a start-up, and as several rounds of financing will be needed for the company to grow to its final stage, this definition is much too restrictive. Even successful companies such as Skype and Spotify in the fast-moving tech sector took more than 8 years to grow. The "start-up" definition would therefore again exclude most late-stage investments, either because the product takes significant time to develop (as often in the healthcare and biotech sectors) or because the company continues to expand to new markets or create new products.

Finally, and as explained in the introduction, we are concerned that many late-stage businesses will also fail the "UID" definition due to the way they are financed by fund managers through quasi-equity, while lenders will usually consider quasi-equity in the same terms as equity from the purpose of these deals.

All of this demonstrates the importance of clarifying that commitments received from a venture capital should also be a relevant factor to determine that a company is a start-up. In other circumstances, there is a real risk that larger start-ups, contributing the most to jobs and growth, will be excluded from the exemption despite being the ones having overcome most challenges (and therefore the least likely to fail in normal conditions). We see no reason to exclude companies that are continuing to grow, either because they expand to new markets or create new products from access to state aid regimes, solely on the basis of their age or on a too narrow definition of relevant size.

National examples

It may be tempting to rely on existing national definitions of start-ups and scale-ups to clarify the scope of the exemption. However, these definitions are also in many cases solely focusing on the smaller end of the market. For example, they impose a limitation on the number of years a company must have been in existence or on its size at the time of the investments. While these limitations have their logic in normal conditions, they are not adapted to the current circumstances where many businesses normally on the growth path (and who would not typically seek state aid) have to face extraordinary liquidity issues.

Meanwhile, the equity support brought by many "start-up countries" (for example by France with its Programme d'investissements d'avenir or Germany with its future Start-Up Fund) to private companies through the venture capital funds that support them, irrespective of their age or specific characteristics of these companies, show that venture ownership is a relevant criteria to determine what is a start-up. We believe that this in itself creates a precedent, in the exceptional Covid-19 circumstances, to allow VC-backed businesses to also be entitled to receive liquidity support through bank loans.

The case of other private equity backed companies

As a reminder, part of the reasons companies owned by late-stage venture and growth funds are able to cope with the amount of debt that comes with its growth is because they receive funding by a closed-ended and long-term fund whose perspective is a, typically, five year horizon[8]. The concept of a long-term commitment to ensure growth over the years (and avoid daily market valuations to have the space to build or rebuild a company over time), is one that also applies to other private equity-backed businesses, even those that are not in a growth stage.

As we explained in our previous submissions, we believe that **criteria (a) and (b) of the UID definition**, which are typical to business receiving bank loans, **are not at all relevant for companies that are owned by private equity funds**. Due to their business model, private equity backed businesses will typically fail the criteria (a) and (b) test.

To assess the effective operational performance of private equity backed businesses, credit institutions, when considering the terms for lending to these businesses, will typically rely on other metrics than the debt/own capital one. One is the evolution over time of the ratio between the net debt of the company and its EBITDA. During the planned time of investment, EBITDA will be expected to rise at a certain pace while the level of debt will decrease. Another element to determine whether the company is in difficulty or not during the investment period is the ratio, calculated on a regular basis, between the company's free cashflow and the amount of debt that has to be serviced.

It is also essential to stress that the structuration of these deals through quasi-equity and equity will not have any impact on the cash flow of the company that has received capital from the private equity fund.

While we understand it may be difficult to reconsider elements of the existing UID definition, we believe the *de facto* **exclusion of certain types of equity-backed businesses also poses a significant concern regarding the coherence of EU state aid rules**, especially if small businesses much more at risk of failing start to be themselves covered within the scope, as it **favours some forms of financing irrespective of existing market practices**.

Most importantly, this ultimately increases the risk that viable companies will fail due to their inability to benefit from guaranteed loans (as banks seems to now prioritise loans that are guaranteed over others) while, at the same time, a higher share of the loans that are effectively guaranteed could default as businesses are more at risk of failing. This also represents a **significant step back to the EU's objective of promoting alternative forms of financing to banking**, for example as a part of the Capital Markets Union.

Given there are several ways to ensure that private equity-backed businesses that are effectively failing remain outside of the scope (for example by relying on successful audit reports or by relying other metrics), easing the existing definition in the sole context of the Covid-19 crisis should not lead to any market distortion concerns.

Conclusion

As explained in the beginning of this note, start-up and scale-ups businesses which receive support from venture and growth funds are much more likely to be successful than their counterparts, as venture capital managers' *raison d'être* is to pick the companies that have the most chance to

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[8] According to our statistics, the average holding period of a company backed by a growth fund over the past five years was around 5 and a half year.

overcome the obstacles any start-up is facing and, through that careful assessment, additionally increase these companies likelihood for survival and success.

All existing tests (whether size, innovation or a narrow “start-up definition”) to classify start-ups are at a risk of excluding a significant number of these companies (and, perhaps most importantly, the ones that had so far been the most successful and the ones that are ready to reap the benefits of many years of growth in terms of both employment and value for consumers). If the Commission’s political goal is to save the “start-up soldier”, then solely relying on an exemption of small and micro-businesses will in any case not be sufficient. Coupling it with the “innovative enterprise” criteria may however help capture additional start-ups.

Another simple and coherent approach to at least partly solve this issue would be to include a criterion based on venture capital and growth ownership on top of the already laid-out exemption for small and micro businesses. This would extend the eligibility criteria to companies that pose less risk than their counterparts – and therefore create the least disruption to the Single Market. Our market understanding is that most late-stage start-up and scale-up will have received any venture (or growth) financing.

While we understand, and fully support, the political motivation behind an extension to small and micro-businesses, excluding venture and growth-backed late-stage start-ups and scale-ups from the exemption solely on the basis of their size would give a very bad signal, as their size is in itself a testimony of their resilience. Excluding businesses backed late-stage venture and growth funds at the benefit of small and micro businesses would leave the focus on companies that would even in normal circumstances be most likely to fail, which seems to go counter the very spirit of state aid rules.

Meanwhile, as representatives of private equity funds, we reiterate our view that none of the companies they are backing would typically be able to meet the conditions set in the UID definition due to their business structure. We believe this is significant flaw of the regime that will lead to the failure of viable businesses if not addressed as part of the revision.