July 2021

On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Response to EC Consultation on Risk Finance Guidelines

By clarifying the conditions set out in the General Block Exemption Regulation (GBER), the EU Risk Finance Guidelines (RFG) may allow some start-ups and scale-ups to benefit from state aid support in areas where private market financing is insufficient. As such, clarification of these Guidelines may assist in fostering a more innovative business environment in the EU.

As the association representing all types of private equity funds, including venture and growth capital, we support the objectives of the current Guidelines, which have helpfully been tailored to the specificities of businesses our members provide private support to. Guidelines were incremental in allowing Member States to develop public schemes that ultimately fostered the development of a venture capital ecosystem in various European countries – and proposed changes will not put this into question. Nonetheless, we feel that improvements could be made to the framework to ensure that risk capital can more easily flow to all companies that effectively require it.

In this response, we comment on changes that have been introduced by the European Commission as well as present our own suggestions for Guidelines to fully play their role in allowing Member States to deliver aid to innovative and growing companies by providing targeted support to the private venture and growth funds that invest in them.

Given the scope of the Guidelines, we purposely did not comment on other concerns we have with the current state aid framework, such as with the definitions of undertakings in difficulties and of small and medium enterprises. However, we need to stress that tacking issues posed by these definitions would go a long way in truly solving the remaining issues innovative businesses supported by venture and growth funds currently face in accessing state aid.

1. Age of the company test

Relevant section of the Guidelines

26. Risk finance aid will not be considered compatible with the internal market under these Guidelines if awarded to undertakings in difficulty, as defined by the Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty. However, for the purposes of these Guidelines, ***SMEs that have been operating in any market for less than ten years following their registration that qualify for risk finance investments following due diligence by the selected financial intermediary will not be considered as undertakings in difficulty****, unless they are subject to insolvency proceedings or fulfil the criteria under their domestic law for being placed in collective insolvency proceedings at the request of their creditors;*

Avenue Louise 81
B-1050 Brussels, Belgium
T +32 2 715 00 20
investeurope.eu
info@investeurope.eu
VAT: BE 0424 557 716
IBAN: BE33 3300 5785 0046
BIC/SWIFT: BBRUBEBB
European Transparency
Register: 60975211600-74

Our specific comments on the change

We note that the European Commission wishes with this change to tackle uncertainties regarding the identification of the "first commercial sale" that have been pointed out during the fitness check evaluation.

While we are not opposed to such a change - and appreciate that the period was extended from 7 to 10 years to take into consideration the date of "first commercial sale" is always posterior to the date of registration - it will have a disproportionate impact on highly innovative companies in tech intensive sectors, such as biotech or healthcare.

Indeed, there are countless firms in these sectors where the date of commercial sale will occur more than 3 years after the date of registration and where the company will be far from being commercially viable 10 years after the date of registration (and may therefore be deemed in difficulty). For example, Carmat, a French company developing solutions for heart transplants, was created and registered in 2008 and did not until 2017 applied for its first CE marking and commercial authorisation – which it only obtained in December 2020.

This example among many others show that the rule change will make it harder for Member States to consider that innovative companies are not in difficulty – and may therefore limit their ability to support them. As demonstrated by a BPI France's study[1], encouraging investments in venture companies after 7 years remains useful and necessary. This study showed the percentage of venture companies which are between 7 to 10 years is significant (52% of enterprises realised their first commercial sale after 7 years) which confirm the failure of venture capital market for enterprises aged from 7 to 10 years (SA.55869).

A solution must therefore be found to ensure that the modification proposed does not disproportionately affect sectors where commercial sales typically only occur late in the life of the company. There are several options to avoid this serious unintended effected:

- allowing companies in tech intensive sectors to continue using the date of the "first commercial sale" as a starting point
- replacing the date of "first commercial sale", for all companies or for companies active in tech intensive sectors, by the first year where the company had a turnover above a defined threshold.

Regarding this second suggestion, we note that there are precedents. For example, paragraph 21 (b) of Case SA.40725, approved by the Commission, states that – for companies the research and development costs of which represent at least 10 % of its total operating costs[2] - the ten year eligibility period after the "first commercial sale" starts the first year after which the company reached a €250,000 turnover.

The problem of the proposed changes to the RFG outlines a wider issue – which could only be tackled with a change to the GBER: age is not always a relevant factor to determine which innovative companies should be eligible to risk finance. Indeed, it does not provide, *per se*, an indication on whether a company is able to scale up its production.

[1] SA.55869 (p.13), « Selon les autorités françaises, une étude récente de Bpifrance démontre que les initiatives pour inciter des investissements dans des entreprises innovantes qui ont plus de sept ans mais moins de dix ans restent utiles et nécessaires ».

[2] As per the sub-paragraph (b) of paragraph 80 of the GBER (definition of "innovative enterprise")

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, a definition based on the age is ultimately detrimental to all companies that require most time to grow – and which are usually the ones most likely to give Europe an hedge over other continents. Even successful companies such as Skype and Spotify in the fast-moving tech sector took more than 8 years to grow, even after their first commercial sale and after VC involvement.

Attention to this is all the more necessary as all eyes are now turning to the true European weakness in risk finance: the development of scale-ups. In sectors where these scale-ups are active, a seven or ten year-old company may face the same constraints - in terms of market failure, funding issues, lack of collateral - as an SME which has just entered a market and made its first sale.

With the current approach, there is a real risk that larger scale-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).

In order to determine if a SME is eligible for risk finance aid, the age of company test could in the future be replaced with a test based on the size of the investee company, which may be represented by the gross assets of the company or, failing that, the turnover.

Size criteria have the advantage of facilitating a clear assessment in terms of eligibility. The size of the investee company (or of the whole group – provided VC ownership is never considered equivalent to trade group ownership) would be a suitable measure for rapidly directing investments where the funding gap is most significant.

As it notes in its fitness check evaluation, the Commission has also already examined the criterion of *gross assets* in the decision *SA.23369 Venture Capital Trusts* (2009) as well as in the decision *SA.40991* (2015).

2. Definition of innovative mid-caps

19. 'innovative mid-cap' means a mid-cap that fulfills the criteria to be considered an 'innovative enterprise' within the meaning of the General Block Exemption Regulation[3], or has recently been awarded a Seal of Excellence quality label by the European Innovation Council in accordance with the Horizon 2020 work programme 2018-2020 or with Articles 1(19) and 11(2) of the Horizon Europe Regulation or has recently received an investment by the European Innovation Council Fund, such as an investment in the context of the Accelerator Programme as referred to in Article 43(6) of the Horizon Europe Regulation

We agree with the principle that the definition of an innovative mid-cap should be aligned with the one of "innovative enterprise" set in the GBER while also including existing labels that are specific to risk finance.

However, we find both the GBER definition and the proposed list of additional companies to be too narrow to cover all types of innovative companies.

[3] "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;"

GBER definition

The main concern is that the EU definition of an "innovative enterprise" includes many venture-backed companies but effectively excludes **fast-growing start-ups** in sectors other than ICT, biotechnology and healthcare (albeit those represent a large proportion of the VC investments).

For example, the second leg of the 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.

The need to extend the definition of "innovative enterprise" to a broader range of businesses also stems from the difficulties some innovative companies active in non-innovative sectors face when trying to access finance. In this regard, the Fi-compass' report "*Gap analysis for small and medium-sized enterprises financing in the European Union*" ("**Fi-compass Report**")[4] has shown that, whatever their size or age, SMEs entering new or uncommon sectors (such as circular economy, social economy, and/or the cultural and creative sector) and developing innovative technologies/products may have difficulties in accessing financing due to qualification as "non-innovative" of the relevant sectors.

Examples include an increasing number of SMEs which propose circular economy projects and develop new technologies in 'non-innovative' sectors such as consumer goods, textile or manufacturing. From the banks and other credit institutions prospective, financing the projects developed by such SMEs in these sectors may represent a risk, also as a result of the fact that financiers may lack the technical expertise required to appraise their underlying risks and profitability, without the company necessarily substantially improving the state of the art in its industry.

We encourage the European Commission to find solutions to ensure that the definition of "innovative enterprises" is as sector-neutral as possible.

Additional list of companies

Including companies that have received funding from the European Innovation Council (EIC) is a great way for all types of innovative companies, even those that fall outside the GBER definition, to be eligible to the advantages of such categorisation.

However, restricting such status only to companies that have received direct funding or a label from the EIC does not go far enough and may create some discrimination between these companies and others that either have receive support from a national innovative scheme or have received indirect funding through venture capital funds supported by the European Investment Fund.

Finally, solutions could be found for companies that have already received – or are about to receive - support from private market players such as venture capital or business angels to be more easily eligible to the "innovative" status. Indeed, those operators solely invest into businesses that are disruptive by nature

[4] See Fi-compass, Gap analysis for small and medium-sized enterprises financing in the European Union, final report, December 2019, pp. 23-26.

3. Other definition

"First loss piece"

(xii) 'first loss piece' means the most junior risk tranche that carries the highest risk of losses, comprising the expected losses of the target portfolio;

The existing definition used in the RFG, which has been kept, is more appropriate to the specificities of VC-backed firms than the one currently used in the GBER. We advise the European Commission to modify the GBER definition so that it mirrors the RFG one.

Independent private investor

"independent private investor" means a private investor who is not a shareholder of the eligible undertaking in which it invests, including business angels and financial institutions, irrespective of their ownership, to the extent that they bear the full risk in respect of their investment; upon the creation of a new company, all private investors, including the founders, are considered to be independent from that company;

The RFG's requirement that new investors be qualified as "independent private investors" generates a heavy administrative burden, which does not apply to other investors.

Moreover, the prohibition from co-investing with investors which already hold shares in the capital of the target company, including those which were present at the very beginning of the life of the company (e.g. business angels), is causing great concerns to the wider risk finance industry.

In order to allow public funds to invest in the same way as private investors, we ask that the process of selection and labelling of independent private investors to no longer be required. Indeed, other investors of the financial centre do not have to establish any labelling agreements. They only use legal acts governing the investment transaction.

Market economy operator

While we understand the aim of the Commission to streamline the Guidelines and avoid overlaps with other pieces of legislation (e.g. the Notice on the Notion of Aid (NoA)), we recommend maintaining Section 2.1 "The market economy operator test" in the Risk Finance Guidelines. Indeed, this would provide market players with a more comprehensive framework including all relevant rules and reflecting any change to the NoA in the Guidelines.

In particular, we suggest maintaining the definition of *pari passu* transactions in the Guidelines. However, the addition of a fourth criterion in relation to *pari passu* investments[5], which prevents private operators to indirectly benefit from State aid, increases administrative complexity and implies reinforced and more frequent controls.

[5] Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01) paragraph 87 point d: to consider a transaction 'pari passu', the following criteria should be assessed […] "whether the starting position of the public bodies and the private operators involved is comparable with regard to the transaction, taking into account, for instance, their prior economic exposure vis-à-vis the undertakings concerned (see section 4.2.3.3), the possible synergies which can be achieved, (143) the extent to which the different investors bear similar transaction costs, (144) or any other circumstance specific to the public body or private operator which could distort the comparison

Furthermore, Commission Decision 2005/137/EC on State aid C-25/2002 Walloon region's financial stake in Carsid SA, to which this additional fourth criterion refers, concerns large companies active in the steel industry and is not relevant to risk financing.

Contact

For further information, please contact Martin Bresson (martin.bresson@investeurope.eu)
Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.