8 December 2021

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

Response to EC Consultation on General Block Exemption Regulation revision

As the association representing all types of private equity funds, we support the objectives of the current General Block Exemption Regulation (GBER). The existing framework has successfully allowed Member States to provide risk finance aid to the start-ups and scale-ups our members support. Along with the Risk Finance Guidelines, the Regulation was instrumental in allowing Member States to develop public schemes that ultimately fostered the development of a venture capital ecosystem in various European countries.

Proposed changes to the Risk Finance Aid section of the GBER will not put into question the ability of Member States to support EU businesses through the venture and growth funds we represent. However, we find it could be more ambitious and better reflect the realities of private equity and venture capital investment.

In this response we suggest a series of changes which could easily be introduced to the framework:

- targeted amendments to the definitions of **undertakings in difficulty (UID)**, **SMEs** (in the sole context of this Regulation), **innovative mid-caps and independent private investors:**

The current **"UID" definition** captures in its scope viable businesses that are effectively not in difficulty but are unable to meet the losses/subscribed share of capital test due to the way they are financed. While these businesses do not seek State aid in normal conditions, the Covid pandemic has shown the shortcomings of the current definition can lead to situations where these businesses may require public support due to exceptional policy circumstances such as lockdowns, yet be unable to seek the aid they would deserve and be entitled to as all other performing companies.

The European **definition of an "SME"** fails to account for the relationship between a private equity portfolio company, the manager of the fund that supports it and the other companies within the said fund. This revision offers an opportunity to clarify and fine-tune the existing definition as far as risk finance aid is concerned.

Moreover, the definition of **innovative companies** is too narrow and disconnected from the market reality, solutions could be found to make it as sector-neutral as possible while extending it to businesses covered by other European or national innovative schemes.

Finally, the definition of **independent private investor** should be clarified and tailored changes could be introduced to some of the risk finance aid concepts. This would allow the rules to better fit with the realities of the venture capital market and, most importantly, to ensure that risk capital can more easily flow to all companies that effectively require it. This would include tweaks to the concepts of follow-on investments, replacement capital and first commercial sale.

All these elements are detailed in the response below.

1. CORE REQUEST: Definition of Undertakings in Difficulty (UID)

Relevant Article: Art. 2 (18) GBER

'undertaking in difficulty' means an undertaking in respect of which at least one of the following circumstances occurs:

- *(a) In the case of a limited liability company (other than an SME that has been in existence for less than three years or, for the purposes of eligibility for risk finance aid, an SME within 7 years from its first commercial sale that qualifies for risk finance investments following due diligence by the selected financial intermediary), where more than half of its subscribed share capital has disappeared as a result of accumulated losses. This is the case when deduction of accumulated losses from reserves (and all other elements generally considered as part of the own funds of the company) leads to a negative cumulative amount that exceeds half of the subscribed share capital. For the purposes of this provision, 'limited liability company' refers in particular to the types of company mentioned in Annex I of Directive 2013/34/EU (1) and 'share capital' includes, where relevant, any share premium.*
- *(b) In the case of a company where at least some members have unlimited liability for the debt of the company (other than an SME that has been in existence for less than three years or, for the purposes of eligibility for risk finance aid, an SME within 7 years from its first commercial sale that qualifies for risk finance investments following due diligence by the selected financial intermediary), where more than half of its capital as shown in the company accounts has disappeared as a result of accumulated losses. For the purposes of this provision, 'a company where at least some members have unlimited liability for the debt of the company' refers in particular to the types of company mentioned in Annex II of Directive 2013/34/EU.*
- *(c) Where the undertaking is subject to collective insolvency proceedings or fulfils the criteria under its domestic law for being placed in collective insolvency proceedings at the request of its creditors.*
- *(d) Where the undertaking has received rescue aid and has not yet reimbursed the loan or terminated the guarantee, or has received restructuring aid and is still subject to a restructuring plan.*
- *(e) In the case of an undertaking that is not an SME, where, for the past two years:*
  (1) the undertaking's book debt to equity ratio has been greater than 7,5 and
  (2) the undertaking's EBITDA interest coverage ratio has been below 1,0.

What is the issue?

Criteria (a) and (b) of the UID definition, which are typical to businesses receiving bank loans, **are not at all relevant for companies that are owned by private equity funds**. Due to the way that they are structured and financed, private equity backed companies will typically meet the criteria (a) and (b) test, meaning that they are technically considered an 'undertaking in difficulty', even though in economic terms they are not.

Why is this an issue?

The proposed EU test, although legally clear, is incompatible with the objective way in which the industry assesses and determines whether a private equity backed business is in difficulty or not, with a longer-term, multi-year horizon rather than a relying on a snapshot of the previous or current financial period.

To assess the effective operational performance of these businesses when considering their lending terms, credit institutions will typically rely on other metrics than the debt/own capital referred to by the GBER.

The most used metric is (to be checked/confirmed) is that of 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. The other alternative metric used 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 must be serviced**.

Part of the reason companies owned by late-stage venture and growth funds can 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**. 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 applies to all private equity-backed businesses. We are also 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. The structuring of these deals through quasi-equity and equity will also not have any impact on the cash flow of the company that has received capital from the private equity fund. Thus, the non-application of criteria a) and b) when assessing the UID status of a private equity backed company, would not have any undue impact and would not distort competition, since these are viable undertakings which would in any case continue to operate on their relevant market(s).

Case Study – Company X

X is a high growth French company founded in 2013 to address one of the most persistent medical challenges since the inception of surgical procedures: to reconstruct damaged tissue and restore its natural function. X is supported by a pool of financial investors among which Sofinnova Partners and BPI France.

Although X was healthy (€42 million cash raised since November 2019), X was considered (as shown in table A of Exhibit 1) as a UID (as of December 31, 2019) under the General Block Exemption Regulation and therefore could not be eligible to (given the current state of its financial statements as of December 31, 2019), under the Temporary Framework, the French State guaranteed loan (PGE) mechanism.

Proposed changes

We would suggest broadening the "UID" definition to also take into consideration the nature of some types of investments. For this, two options could be considered:

1) clarify that for private equity-owned undertakings, a narrower set of the UID criteria should apply in light of the nature of the undertaking's ownership

Proposed suggestion: ***For the purposes of this definition, only points c) to e) of Article 2 (18) shall apply where 25% or more of the company's capital is held by a closed-ended investment fund, subject to compliance with the Interest limitation rule of Article 4 of Directive 2016/1164*.**

Such an amendment would recognise that companies under a fund manager's long-term ownership can face losses that represent more than half of the subscribed share capital without it effectively being in difficulty.

The risk that such a caveat would lead failing companies to become eligible to state aid is very limited for the following reasons:

- companies that are owned by these managers have **already met a market test,** since the manager will only have invested in them provided it was hoping to ultimately sell the company at its investors' benefit.

- most importantly, the applicable **insolvency, rescue/restructuring aid and debt to equity ratio criteria** under c), d) and e), will in any case ensure that any company (owned by such funds) which would effectively be an undertaking in difficulty would not be given access to state aid and public support.
- These types of companies would usually be beneficiaries of State aid in only very exceptional cases, such as the Covid pandemic, where companies' business model is affected by an external shock in the same way as all other types of businesses.

2) Ensure that quasi-equity investment[1] instruments qualify as own funds

Proposed suggestion: ***For the purposes of this definition, quasi-equity investment instruments as defined in Article 2 (66) of Commission Regulation (EU) No 651/2014 shall be taken into account as part of the own funds of the company where relevant.***

When considering the business model of venture capital and private equity backed companies, it may be possible to consider the sum of equity and quasi-equity, which may fall within the definition of "own funds", and disregard ratios related to 'subscribed capital' in the strictest sense of the term.

Indeed, the notions of share capital and share capital pay-up obligation applied by Member States may differ. Linking the definition of UID to such ratio unnecessarily and inefficiently complicates the assessment under the UID status' criterion. By contrast, the quasi-equity criterion is commonly used as a global solvency indicator in the banking sector and by investors. Where the sum of equity and quasi-equity is positive, companies should not be considered as UID.

2. CORE REQUEST: Defining the features of an eligible company to risk finance (Article 21.3)

3. Eligible undertakings shall be undertakings that at the time of the initial risk finance investment are unlisted SMEs and fulfil at least one of the following conditions:
(a) they have not been operating in any market;
(b) they have been operating ***in any market for less than 10 years following their registration*** *and/or, in the case of innovative enterprises, seven years after their first commercial sale.* ***For eligible undertakings that have taken over the activities of another enterprise or were formed through a merger, in which case the eligibility period also encompasses the operations of that enterprise or the merged companies. For eligible undertakings that are not subject to registration, the eligibility period is considered to start from either the moment when the enterprise starts its economic activity or the moment when it becomes liable to tax with regard to its economic activity, whichever is earlier;***
(c) they require an initial risk finance investment which, based on a business plan prepared in view of a ***new economic activity****, is higher than 50 % of their average annual turnover in the preceding 5 years.* ***Investments aimed at significantly improving the environmental performance of the activity in line with Article 36 (2) and other environmentally sustainable investments as defined in Article 2(1) of Regulation (EU) 2020/852 of the European Parliament and of the Council shall be considered new economic activities if their initial funding requirements are above [30 %] of the average annual turnover in the preceding 5 years.***

The proposed eligibility criteria, while broadly appropriate, would pose several implementation issues, either because of the definition of what is an SME or because of the age limit set in the legislation.

[1] Article 2, point 66 of the GBER defines 'quasi-equity investment' as "a type of financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity and whose return for the holder is predominantly based on the profits or losses of the underlying target undertaking and which are unsecured in the event of default. Quasi-equity investments can be structured as debt, unsecured and subordinated, including mezzanine debt, and in some cases convertible into equity, or as preferred equity".

a. <u>An unlisted SME…</u> *(as defined under Annex I of the GBER)*

What is the issue?

The EU definition of an "SME", which is cross-referred into many EU legislative pieces including the GBER and the Risk Finance Guidelines, has for a long time been considered detrimental to companies backed by private equity and venture capital.

The two main reasons for this stem from:

(i) the use of the "linked enterprise" concept, which determines that any SME (including venture owned) which is deemed linked to another is not eligible to the SME status (unless the two enterprises are together meeting the SME criteria); and

(ii) the reference to venture capital *companies* (indeed private equity and venture capital AIFs may take the legal form not only of companies but also mutual *funds*).

Why is this an issue?

The concept of a linked enterprise is obviously relevant to ensure companies within trade groups cannot benefit from SME related advantages. However, it has the (largely unintended) consequence that SMEs in which a (venture or private equity) manager fulfils one or more of the four criteria set out in Article 3, paragraph 3 (a) – (d) of Annex I of the GBER are considered part of said manager's group (along with the manager itself and the other portfolio companies supported by the fund) and a presumption of dominant influence applies.

Case study – Company "MEDICAL"[2]

The company "MEDICAL" (3 employees, turnover EUR 3,000, balance sheet EUR 2.4 million) was created in 2017. It was funded by a venture capital fund which currently owns 83% of its capital. It is at risk of losing its SME status and, as a consequence, of losing the benefit from national aids and subsidies ("Projets Structurants pour la Compétitivité" programme, part of BPI's "Investissements d'Avenirs" Programme).

MEDICAL was created to develop a device preventing serious heart failures. It is a very young - and small - company, which develops a solution to a key medical issue.

Due to the fact that a venture capital fund owns more than 50% of its capital, MEDICAL may not qualify for SME status. This implies dramatic consequences for MEDICAL. Indeed, this may limit or even prohibit its access to aids and subsidies, even though the aim of these programmes is to promote the financing of upcoming technologies and the development of projects which are key for the competitiveness of France and of the EU.

Our view is that companies backed by venture capital and private equity still do not share the same advantages as companies that are part of a trade group, as shown in the table below, and should not be treated in the same way.

Private equity ownership vs. trade group ownership

The significant differences between private equity ownership and a conglomerate / trade group relate to:

- *the lack of ability, for a private equity backed SME, to rely on the success of the fund or of other companies within the fund*

[2] The case study comes from our sister association France Invest and is based on a portfolio company owned by one of their member firms.

- *the desire of the private equity firm, as of the start of the investment to exit the company in the foreseeable future*
- *the lack of integration of different portfolio companies / businesses within or across funds*

This means there is an absolute absence of strategic interest: portfolio companies owned by a private equity fund are not at all linked to each other in the way an industrial group is and the private equity firm does not have an overarching plan for all of them. This translates into the following characteristics:

- *Separate accounts*

A manager will maintain separate accounts between its firm and the company it invests in, as documented in the financial contract between the private equity firm and its investees.

- *No centralised management*

Private equity backed companies do not enjoy joint administration of services or joint legal advice and are treated completely separately.

- *No right to receive aid from its investors*

Private equity backed companies which suffer economic loss generally do not receive financial aid from the private equity manager or other portfolio companies. Because of the separate accounts maintained by the manager, the companies will generally also not have access to portfolio-wide funds, such as cash pool.

- *No involvement in day-to-day management*

The private equity manager typically does not get involved in the day-to-day management of the firm. It usually gets involved at the level of the board, always with the objective of increasing the value of the company.

- *Number of investors in the entity*

Private equity firms act as intermediaries for the investors into the fund. The investors typically participate as limited partners in investment funds and normally do not have the ability to exercise control.

- *Absence of consolidated financial statements*

Typically, no consolidated financial statements exist for the various portfolio companies held by different investment funds that are part of the same private equity firm.

Proposed changes

An amendment should be introduced to ensure that, when owned by a private equity (including venture capital) structure, a company always remain eligible to state aid. This would acknowledge differences between private equity ownership and trade groups.

This objective could have been achieved through a change to the SME Recommendation, which Annex I of the GBER copies. Although such a change was potentially envisaged, the recent SME Definition Evaluation clarified that no modification of the Recommendation was to take place in the medium-term[3].

While closing the door to a modification of the definition, the Evaluation did however point out that companies that are backed by venture firms with a majority ownership would "*lose the possibility to*

[3] SWD(2021) 279 final.

access EU funding and other benefits reserved for SMEs" due to the way the current definition is drafted. It then pointed out that "*issues of a specific nature could be better examined within their particular policy context, while recognising the need to ensure consistency and equal treatment in view of the horizontal SME Definition*".

Given:

a) that the only rationale for not acting in the broader context of the SME Recommendation was the perceived limited impact on SMEs overall, taking into account all fields of law
b) the recognition that there is a real impact on start-ups and scale-ups in some specific cases such as where the capital of such start-ups and scale-ups is held by PE/VC firms,
c) the acknowledgment that the issue could be examined in other contexts,

there is a **legitimate, justified and proportionate case for Annex I of the GBER to be modified to avoid the confusion between private equity and trade group ownership**. To ensure consistency, we propose that such a modification be restricted to the private equity model meeting the criteria defined above.

Considering this, we would therefore suggest the following changes to Article 3, paragraph 3 of Annex I of the GBER:

There is a presumption that no dominant influence exists if the investors listed in the second subparagraph of paragraph 2 are not involving themselves directly or indirectly in the management of the enterprise in question, without prejudice to their rights as shareholders.

Enterprises which received capital from a venture or private equity fund shall not be deemed linked to that fund or to other enterprises in which that fund has invested provided that the fund can show that it has had an exit strategy since the time it acquired its interest the enterprise in question, there are separate accounts between the manager and the enterprise in question, and the enterprise in question has no ability to receive financial aid from that fund or the other enterprises in which that fund has invested.

Terminology issues: the use of the "venture capital company" term

Further to the issue laid out above, another reason why the EU definition of an "SME" has long been considered detrimental to companies backed by private equity and venture capital is the use of the term "venture capital ***companies"*** to determine eligibility for venture-backed businesses. Indeed, venture capital AIFs may take the legal form not only of companies but also of mutual funds. As a result, a SME whose capital is held by a venture capital mutual fund cannot obtain public subsidies. The reference should therefore be clarified in order to encompass all relevant types of legal forms.

b. …of a certain age

Invest Europe is a strong supporter of the flexibility introduced in the definition of eligible SMEs in the new Article 21.3) of the GBER. The proposed framework reflects more adequately the realities of the early lifecycle of many businesses. However, and while the timeframe identified was suitable for some sectors, it still presents an eligibility hurdle for others.

Growth takes time and is a continuous process, not an end point. An SME is as likely to encounter a transformational growth opportunity or an acceleration of its business activity which requires significant financing after seven years following their first commercial sale, as it is in its start-up phase. Managing the growth of a business is one of the hardest challenges a management team faces. The seven-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.

Why is this an issue?

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, even after their first commercial sale and after VC investment.

It is therefore appreciated that the Commission has now proposed a new approach, where the 7-year after commercial sale period (for innovative companies only) and the 10-year after registration period are alternative to each other.

Such an approach will ensure that:

- innovative businesses which require time to do a first sale (for example, a healthcare company which require many clinical trials for pharma pipeline products) are captured under the 7-year treatment
- scale-ups active in highly competitive sectors have a bit more time to grow after their registration under the 10-year treatment

Proposed change

While we **support the Commission's approach**, we would argue that setting a threshold of EUR 250,000 of turnover to justify when this "first commercial sale" is deemed completed would help clarify the rules. This objective could be achieved by amending Article 2, point 75 and clarifying that the first commercial sale only applies subject to this minimum threshold of turnover achieved.

c. …or which require an initial risk investment

Relevant Article: Art. 21, paragraph 3, section c)

(c) they require an initial risk finance investment which, based on a business plan prepared in view of a ***new economic activity****, is higher than 50 % of their average annual turnover in the preceding 5 years.*

What is the issue?

This criterion is essential as it allows SMEs which are not eligible under point (b) (referred to above) to achieve their transformation, something that is of deep relevance given the green and digital challenges all businesses face.

Our experience is that after nearly a decade of implementation the conditions attached to this proviso does not allow SMEs to make use of it and to meet their needs of risk financing

Feedback we have received show that, first, the 50% threshold is seen as too high as it implies huge financing needs, which may not be credible considering the size of the company. Second, the reference period of 5 years is seen as too long as reliable business plans can only cover a 3-year period.

Finally, in respect of the concept of "new economic activity", it is not clear if this refers to (a) a new business activity which potentially will give rise to a new market, or (b) a new business activity of the company, which already exists in the market. While it appears from context this is the latter, we would suggest to clarify this in the text.

Proposed change

For reasons explained above, we would suggest the following addition to the wording of Article 21, paragraph 3, section (c):

(c) they require an initial risk finance investment which, based on a business plan prepared in view of a new economic activity, ***on the same or on a new market***, is higher than **20** % of their average annual turnover in the preceding **3** years

3. CORE REQUESTS: Definition of innovative mid-caps

Commission proposal regarding Article 2, point 80 of the GBER

"(80) 'innovative enterprise' means an enterprise that meets one of the following conditions:
(a) it 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;
(b) its research and development costs 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;
(c) it 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 adopted by Commission Implementing Decision C(2017)7124* or with Articles 2(23) and 15(2) of Regulation (EU) 2021/695 of the European Parliament and of the Council** 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 48(7) of Regulation (EU) 2021/695 of the European Parliament and of the Council.

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 definition and the proposed list of additional companies to be too narrow to cover all types of innovative companies.

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 the 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, including those that would otherwise fall outside the GBER current 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 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.

We suggest enlarging it to labels awarded or funding granted by other European or national public institutions (e.g. the European Innovation Council (EIC) or, in France, BPIfrance or ADEME) and to certifications by independent experts (e.g. auditors). Indeed, certification by independent experts may prove more affordable (the cost of a BPIFrance label may be quite high for small start-ups), quicker and less burdensome (the administrative process in relation to the EIC may prove complex for some managers which may find it difficult to complete), in other words more efficient.

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.

Proposed change

Considering this, we would at least suggest the following amendment:

(c) it 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 adopted by Commission Implementing Decision C(2017)7124 or with Articles 2(23) and 15(2) of Regulation (EU) 2021/695 of the European Parliament and of the Council** 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 48(7) of Regulation (EU) 2021/695 of the European Parliament and of the Council,* ***or has recently received or been declared eligible to receive an***

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

investment by a similar European or national public body, directly or indirectly through a financial intermediary.

4. Definition of independent private investor (Article 2 point 72)

Relevant Article: Art. 2 (72))

"(72) 'independent private investor' means an investor who is private and independent, as set out in this point. "Private" investors will typically include banks investing at own risk and from own resources, private endowments and foundations, family offices and business angels, corporate investors, insurance companies, pension funds, private individuals, and academic institutions. […] "Independent" means that a private investor is not a shareholder of the eligible undertaking in which it invests.

What is the issue?

The new definition of independent private investor, although not exhaustive, does not include private equity and venture capital funds, despite these being a key provider of risk finance.

Proposed change

We would suggest amending the existing paragraph to reflect the importance of private equity and venture capital as sources of risk finance:

*(72) 'independent private investor' means an investor who is private and independent, as set out in this point. "Private" investors will typically include banks investing at own risk and from own resources, **private equity and venture capital**, private endowments and foundations, family offices and business angels, corporate investors, insurance companies, pension funds, private individuals, and academic institutions. […] "Independent" means that a private investor is not a shareholder of the eligible undertaking in which it invests.*

5. Other parameters of Risk Finance Aid

Follow-on investments

Relevant Article: Art. 21, paragraph 4

4. The risk finance aid may also cover follow-on investments made in eligible undertakings, including after the 7-year period mentioned in paragraph 5(b), if the following cumulative conditions are fulfilled:

a) the total amount of risk finance mentioned in paragraph 9 is not exceeded;

b) the possibility of follow-on investments was foreseen in the original business plan;

c) the undertaking receiving follow-on investments has not become linked, within the meaning of Article 3(3) of Annex I with another undertaking other than the financial intermediary or the independent private investor providing risk finance under the measure, unless the new entity fulfils the conditions of the SME definition.

What is the issue?

The inclusion of follow-on investments in the scope of the GBER during the previous revision was a welcome development. However, we still have concerns with the qualifying conditions set in paragraph (b): the possibility of follow-on investments to be foreseen in the original business plan.

Why is this an issue?

The condition is understandable but is difficult to apply in a venture capital context. Although the business plan at the time of the initial investment made by a venture fund will provide important information about the anticipated development of an undertaking, these are constantly revised and refined as the business and the markets in which it operates evolve.

While with venture investing there is almost always an intention, and indeed an expectation that, to achieve the stage of development for which the investment has initially been made, a further injection of capital (of an amount and for a purpose which is broadly identified) will be required, the exact timing, amount and specific purpose of this further investment can and will evolve over time as the business grapples with the reality of the market it faces.

Moreover, the existing condition is unsatisfactory and tends to reward businesses which produce rather vague, broadly drafted business plans, whilst unfairly penalising firms which have (often for good business reasons) attempted to be more specific in their planning. The former will generally find it easier to take advantage of the follow-on investment provisions, whereas the latter may be unable to do so, purely because of the way their original business plan was drafted.

It would be better to recognise that follow-on investments should be allowed for those businesses where a further injection of capital (of an amount and for a purpose which is broadly identified) has been foreseen and expected from the start to achieve the stage of development for which the investment has initially been made.

Proposed change

We would suggest the following amendment to indent b of paragraph 6:

the possibility of follow-on investments was foreseen in the original business plan ***or the business model foresaw that further injections of capital may have been necessary to achieve a certain stage of development***

<u>Replacement capital</u>

Relevant Article: Art. 21, paragraph 7

7. For risk finance investments in the form of equity and quasi-equity investments in eligible undertakings, a risk finance measure may cover replacement capital only if the latter is combined with new capital representing at least 50 % of each investment round into the eligible undertakings.

What is the issue?

Conditions for the use of "replacement capital" in the GBER (Article 21.7) are at odds with broader policy objectives of overcoming market failures in SME finance and encouraging SME job creation. Restrictions on replacement capital can not only distort the natural activities of a company, but go even further, by potentially removing part of the financing chain.

Why is this an issue?

This rule risks penalising minority shareholders who will not be able to transfer their shares of the company to another shareholder and will have to remain in the company's capital. In particular, this is the case of minority shareholders (i.e. business angels) who will be obliged to remain in the capital of eligible companies longer than expected. This measure also leads to a dilution of the founding shareholders in the capital of the company. This rule is likely to be misunderstood by founding shareholders who will be obliged to be diluted in the capital.

Proposed change

In this context, we suggest that this measure be abolished or, failing that, that the percentage of new capital combination be limited to 10% of the capital of the company.

*7. For equity and quasi-equity investments in eligible undertakings, a risk finance measure may provide support for replacement capital only if the latter is combined with new capital representing at least **10 %** of each investment round into the eligible undertakings.*

"First loss piece"

Relevant Article: Art. 21, paragraph 10 (a)

13. A risk finance measure shall fulfil the following conditions:
[…]
(c) in the case of asymmetric loss-sharing between public and private investors, the first loss assumed by the public investor shall be capped at 25 % of the total investment;

We support the definition of "first loss pieces" set out in the draft Risk Finance Guidelines and believe that it should also be introduced in the GBER at the occasion of its current review. Indeed, the terminology used in the Guidelines and in the GBER for the most junior risk tranche that carries the highest risk of loss should be made consistent to avoid uncertainty for market players.

Meanwhile, there could be additional flexibility regarding the maximum amount of loss that could be assumed by the public investors. While the 25% figure may work in a lot of cases, it may be relevant to increase it slightly to cover for all potential cases (while keeping it under half of the losses)

Proposed change

We suggest inserting the following definition into the GBER text:

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

We would also suggest increasing the maximum share of loss sharing to 40%:

*(c) in the case of asymmetric loss-sharing between public and private investors, the first loss assumed by the public investor shall be capped at **40** % of the total investment;*

Total outstanding amount of risk finance investment

Relevant Article: Article 21 paragraph 8

The total outstanding amount of risk finance investment referred to in paragraph 5 shall not exceed EUR 15 million per eligible undertaking under any risk finance measure. In order to calculate this maximum risk finance investment amount, the following shall be taken into account:
(a) in the case of loans and quasi-equity investments structured as debt, the nominal amount of the instrument;
(b) in the case of guarantees, the nominal amount of the underlying loan.

While we have no comment on the proposed threshold that determines the maximum amount of risk finance investment, it may be interesting, to promote aid to scale-ups, to introduce a clarification that the maximum amount shall be reset after a given number of years – allowing businesses that have received a certain amount of support to receive additional aid would it be deemed justified by the national authorities. Two years would be an appropriate period from that perspective.

Proposed change

We suggest making the following amendment:

The total outstanding amount of risk finance investment referred to in paragraph 5 shall not exceed EUR 15 million per eligible undertaking under any risk finance measure. In order to calculate this maximum risk finance investment amount, the following shall be taken into account:
(a) in the case of loans and quasi-equity investments structured as debt, the nominal amount of the instrument;
(b) in the case of guarantees, the nominal amount of the underlying loan.

This amount shall be reset after [x] years.

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.

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