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Competition *policy brief*

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A new rule book for Risk Finance State aid

1. State aid control 2.0

The Commission is conducting a complete overhaul of its State aid rules. Following the principle of "trust and verify", the new rules will massively cut red tape for innocuous aid measures. At the same time, measures that may seriously harm competition or fragment the internal market will be assessed, monitored, and evaluated more carefully. This will allow the Member States and the Commission to promote good aid and to focus attention on the cases that matter.

2. Risk Finance – the challenge

The funding gap

SMEs are by and large still heavily dependent on traditional bank lending. Lending is, however, still limited by the refinancing capacity, risk appetite and capital adequacy of banks. The financial crisis has exacerbated problems flowing from such over-reliance on bank lending - approximately one third of SMEs were unable to receive the necessary finance in recent years. Such a failure in finance markets translates into a "funding gap", which hinders companies during the seed and start-up stages, and later during their development and growth stages.

> **In a nutshell**
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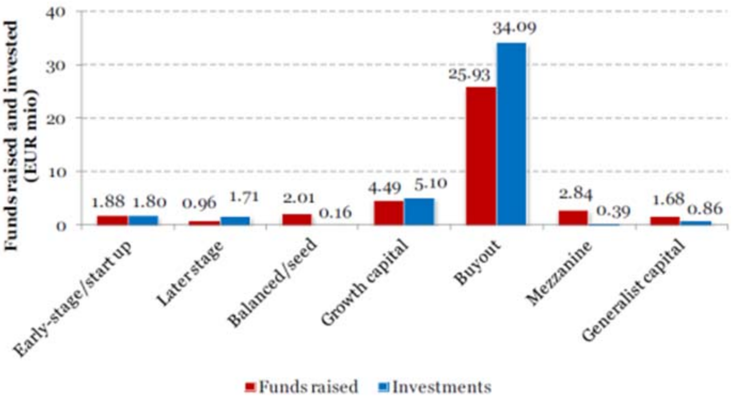
> The Commission is boldly reacting to changing market realities. New State aid rules will permit a more rapid and generous distribution of risk finance aid to SMEs and mid-caps. This is an important contribution to the European Union's efforts to re-launch economic growth during difficult times for many SMEs



Source: EVCA Yearbook 2012, Activity data on fundraising, investments and divestments by private equity and venture capital firms in Europe. © EVCA, http://www.evca.eu

The table provides a detailed breakdown of the gap between funds raised versus the funds invested across investment strategies of investment funds based on development stages in 2011.

The data underlines that growth capital and buy-out investments are the main types of financing for SMEs and mid-caps by investment funds. It also shows that investments in growth capital and the above-mentioned later stage investments are, unlike in the case of the early and start-up stages, higher than the funds raised. This indicates that the demand for growth and late stage venture capital to be invested in SMEs and mid-caps was higher than the supply.

The world has changed

The existing risk capital rules, put in place in 2006, allow Member States to make equity financing available to companies with perceived high-growth potential during their early growth stages. Only SMEs are eligible for this kind of aid, and only until they have reached their growth phase.

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A number of additional restrictions apply on the possible forms of financing, aid instruments and funding structures.

The Commission recognises that nowadays it is much more difficult to get access to finance than was foreseen when the current rules were drawn up.

3. A new rule book

Following extensive consultations with Member States and stakeholders, the Commission is now taking a bold step by setting up a simpler, more flexible and generous state aid framework for the provision of risk finance to SMEs and mid-caps. The new rules should attract and channel private financing to support the public policy goals of economic growth and job creation, which is particularly important in times of economic crisis.

The new rules aim at enhancing the incentives of private sector investors - including institutional ones – to invest and increase their funding activities in this critical area of SME financing. They go hand in hand with other EU initiatives designed to promote wider use of financial instruments in the context of new support programmes such as Horizon 2020 or COSME.

The new rule book consists of two parts. The first is a revised block exemption regulation covering a multitude of aid measures, including risk finance aid. Once adopted, by the summer of 2014, it will be a key pillar of the entire new State aid architecture. The second is a new set of Guidelines, adopted on 15 January 2014, specifically dealing with risk finance measures. The principal new features of the new rule book are:

a. Block exemption: radically enlarged scope

The current block exemption rules cover risk capital aid schemes for SMEs (up to 250 employees) in their seed and start-up phases. For SMEs in the expansion phase, on the other hand, the safe harbour applies only to small companies, or medium-sized companies established in assisted areas. Beyond these limits, Member States need to notify their schemes to the Commission. The current rules do not allow risk capital aid for SMEs in their growth stage.

Once adopted, the block exemption regulation will have a radically enlarged scope and cover a much wider range of companies, irrespective of their location in assisted or non-assisted areas, including SMEs from seed/start up and expansion stages and SMEs in later growth stages, small mid-caps (up to 499 FTE) and innovative mid-caps (up to 1500 FTEs and with R&D and innovation costs representing 10% of total operating costs).

Example: Under the current block exemption, a medium size company in a non-assisted area (a large part of the "old" Member States), would only be eligible to receive aided risk capital investment up to its start-up phase, i.e. before the first commercial sale and when not yet generating a profit. In the future, such a company could receive aided investment under the block exemption.

The new risk finance regime will provide the framework for seamless support of new ventures from their creation to their development into global players, so as to help them overcome the critical stages – the so-called “valley of death” - where private financing is either unavailable or not available in the necessary amount or form.

Importantly, covering more measures by the block exemption means cutting red tape for companies and granting authorites.

b. Thresholds aligned with market realities

Under the current proposal, risk finance measures of up to EUR 15 million per SME will be block-exempted. This overall amount has to be seen as *one-off* aid covering the full development cycle of the target SME (compared to the current *annual* tranches of maximum EUR 1.5 million in GBER and EUR 2.5 million in the Guidelines).

In addition, the new Guidelines set out compatibility conditions for amounts above EUR 15 million, without imposing any specific cap, as long as the aid measure is granted in cases where market failures have been convincingly demonstrated. This will enable, among others, R&D-intensive companies and companies in industries with high upfront investment costs to access the necessary amount of finance right from their creation, through a sequence of investment rounds, without being constrained by the current restrictions on maximum annual tranches.

This new regime is a better reflection of market practices, as it allows capital replacement operations as long as they are combined with the injection of new fresh capital into the company. This should make it easier for investors to exit, which in turn gives them a bigger incentive to invest at an earlier stage.

Example: An R&D-intensive biotech company, requiring EUR 10 million upfront investment to develop its product, would have to wait seven years under the current block exemption (EUR 1.5 million * 7 years = 10.5 million) or four years under the Guidelines (EUR 2.5 million * 4 years = 10 million). Under the future block exemption, this company could receive EUR 10 million upfront, which could later be complemented by further EUR 5 million aided follow-on investments to be sequenced according to the needs of the company, to help it grow to a sustainable stage where it can attract private financing on its own.

c. More flexibility, more clarity

The new rule book will cater for a wider range of financial instruments. The current Guidelines require 70% of the budget to be provided in the form of equity. However, companies need different forms of financing, depending on their development stage, type of sector and the specific interests of the owners. Therefore, the new Guidelines abolish this requirement and allow for a wider range of financial instruments (equity, quasi-equity, loans, guarantees or hybrid instruments), based on the principle of free choice in terms of mix of financial instruments. This will be more in line with market practices.

The current Guidelines also require a private participation rate of least 50% in non-assisted areas and 30% in assisted areas. The new risk finance regime will abolish the distinction between assisted and non-assisted areas. Instead, it will tailor the private participation ratio according to the inherent riskiness of the development stage of the beneficiary.

This means that measures with lower levels of private participation will be possible in territories or sectors where private investors are particularly reluctant to invest due to a proven market failure – irrespective of whether such measures take place in assisted areas or not. This flexibility will ensure that Member States can more efficiently support company creation.

For SMEs who have not yet made their first commercial sale, the private participation requirement will be as low as 10%, to take account of the reluctance of private investors to provide funding at this stage. As the target companies become more established, the required rate of private investment increases.

The current block exemption does not cover fiscal incentives to private investors. Although tax incentives can be approved under the current Guidelines, there are no specific compatibility conditions and each measure necessitates an individual assessment in light of the specific circumstances of each case.

The new regime will, on the one hand, introduce flexibility by bringing tax incentives to natural persons (including certain business angels) under the scope of the block exemption, once adopted. On the other hand, it will set out detailed rules for fiscal incentives to corporate backers investing directly or indirectly into the equity of SMEs, thereby steering the available private investment towards the achievement of public objectives.

Example: Today, if a Member State wanted to set up a block-exempted scheme providing risk capital investments to small, young and innovative SMEs established in a non-assisted area, it would need to attract at least 50% private investment. However, such companies are considered among the riskiest possible investments. So in certain Member States it is very difficult, if not impossible, to attract the necessary private contributions. In the future, Member States will be able to provide as much as 90% of the investment to such companies before their first commercial sale, or up to 60% if they are within 7 years from their first commercial sale. This ensures that public support is able effectively to correct market failures, and can help viable companies reach a development stage where they are more attractive to private investors.

d. Responding to supply side constraints

Recognising the specific constraints on the supply side of the SME-financing market, the new Guidelines will set up a framework to support alternative trading platforms that trade in SME shares, such as the Alternative Investment Market (AIM) in the UK. This way, Member States will be able to support the creation of funding channels alternative to traditional bank lending.

4. Block exemptions based on experience

Over the years, the Commission has gathered valuable experience through the individual assessment of notified risk capital cases, as well as through multiple consultations with Member States and other stakeholders on the operation of the current rules.

The new rule book for risk finance state aid builds directly on this experience. In fact, the envisaged wider range of block-exempted measures covers measures where the Commission is confident that they target commonly accepted objectives, address a well-defined market failure, are appropriate, proportionate, and limit distortions of competition to the minimum.