Quasi-equity finance for SMEs

A fi-compass model financial instrument

March 2022

DISCLAIMER

Abbreviations

Abbreviation	Full name
CPR	Common Provisions Regulation (No. 2021/1060)
EIB	European Investment Bank
ERDF	European Regional Development Fund
GBER	General Block Exemption Regulation
GGE	Gross grant equivalent
HF	Holding Fund
MA	Managing authority
SME(s)	Small and medium-sized enterprise(s)
VC	Venture Capital
QE	Quasi Equity
SPR	CAP Strategic Plans Regulation (No. 2021/2115)

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This document aims to describe models managing authorities may use for quasi-equity financial instruments co-financed with shared management funds. The model financial instruments are intended to provide a number of examples pointing to the potential for managing authorities to use quasi-equity financial instruments in the 2021-2027 programming period. The document does not constitute any sort of guidance and the use of the models remains entirely under the responsibility of the managing authorities who have to ensure the correct application of the Common Provisions Regulation (CPR) under their own specific circumstances.

1. Introduction

Quasi-equity financial instruments co-financed with shared management funds can help address specific cases of market failure that cannot be covered by other financial instruments such as standard debt and equity financial instruments. Quasi-equity can be structured in different ways, varying between being closer to equity or debt finance according to the level of ownership acquired and the exposure to loss in the event of default. The risk profile will also change with the duration of capital commitment and the remuneration conditions. This document presents the main quasi-equity investment types and their potential to use shared management funds and support different types of final recipients. Furthermore, the publication includes an off the shelf model for a quasi-equity financial instrument, namely: a subordinated loan.

Definition of quasi-equity

Quasi-equity investments are defined in Article 2 of the General Block Exemption Regulation (Commission Regulation (EU) No 651/2014 of 17 June 2014) (GBER) as follows, as follows:

'quasi-equity investment' means 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.

The risk-return profile for quasi-equity typically falls between debt and equity in a company's capital structure. Quasi-equity is also known as mezzanine capital or mezzanine finance. For shared management funds, the rules for equity apply to quasi-equity financial instruments.

Debt and equity capital offer to their contributors different frameworks as regards incentives and remunerations. The former is a combination of low risk and low return; the latter is closer to a high-risk/high-return type of approach. An intermediate solution between these two extremes is quasi-equity, which can also attract lenders who are more open to risk but whose investment guidelines or articles of incorporation do not allow them to contribute equity. Such financing can be structured and adapted to suit the specific needs of the investment and can, as necessary, incorporate larger share-type or loan contract components.

Quasi-equity investment has played an important role in Member States as part of a package of measures to support businesses affected by the Covid-19 pandemic. As well as providing a solution to short term liquidity challenges, quasi-equity investment can help support companies to maintain investment both during the initial downturn caused by the crisis and the period of recovery afterwards.

Jargon buster – common expressions

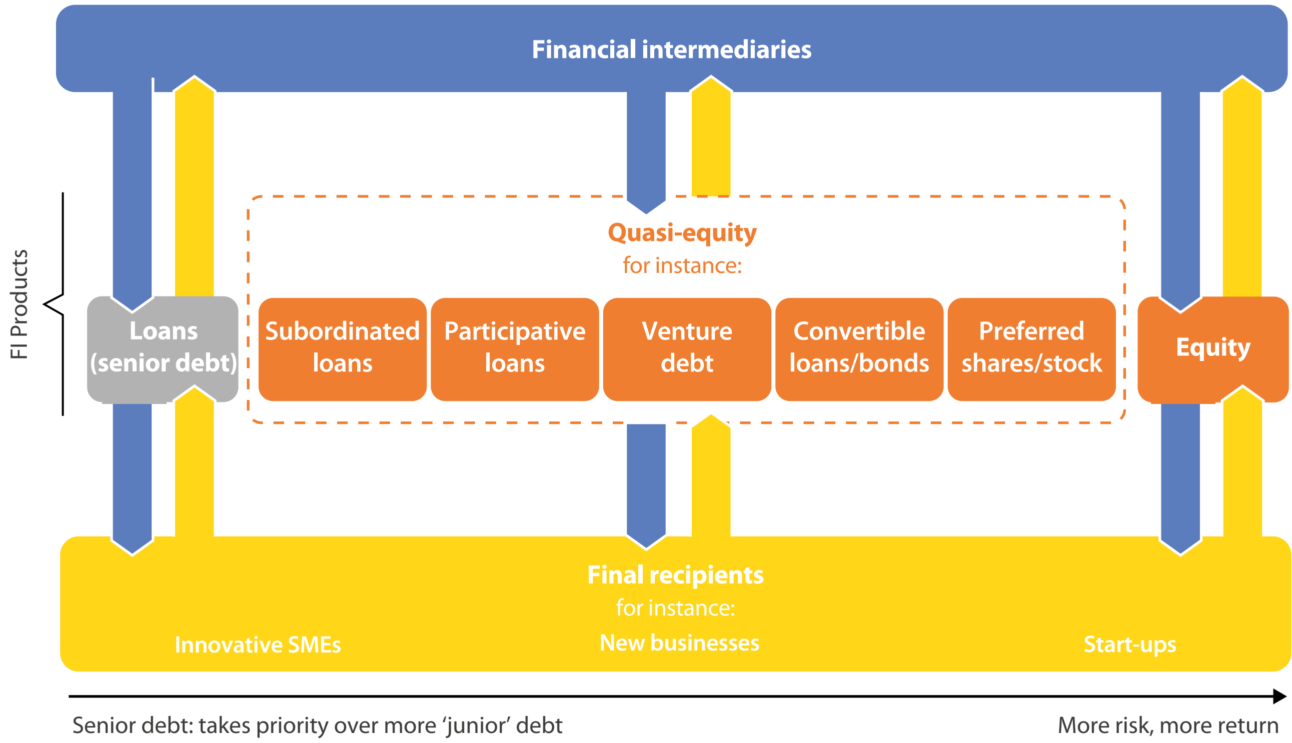
Bullet/balloon repayment	A lump sum repayment of a loan, usually at maturity
Collateral	Assets offered by a borrower as security for a loan
Equity kicker	A warrant issued to an investor, often in return for a reduced interest rate
Senior loan	A loan benefiting from a higher ranking priority over other creditors in case of liquidation
Grace period	Period following the advance of the loan where no interest and/or capital repayments need be made
Secured loan	A loan benefiting from collateral giving the lender priority over other creditors
Warrant	The right to acquire equity at a certain price within a defined time limit
Subordinated Loan (Junior)	A loan with a lower ranking priority over senior loans in case of liquidation

2. Main types of quasi-equity

The following main types of quasi-equity financial instruments can be distinguished:

- **Subordinated loans:** These loans have a lower repayment priority than senior loans but a higher one to preferred shares or equity. In the event of default all other lenders are repaid before the holders of subordinated loans. Since the interest payments as well as the capital repayments are subordinated, the risk of loss in the event of default is substantially higher than for senior loans but lower than for equity. In addition, generally, there is no collateral (security) required so interest rates are higher to cover the higher risks. It is unsecured debt or debt which is junior to secured debt.
- **Prêt Participatif:** subordinated loans under which the lender is remunerated by both a base interest rate and participation in the profitability of the company. The loan product was developed in France to support growing SMEs and provides quasi-equity support, allowing the company to access capital financing without diluting its equity. Typically, a prêt participatif is used by the company to finance productive investments, for example in new plant and machinery or development of a new product line.
- **Venture debt:** This type of subordinated debt financing provides non-dilutive equity risk capital that is remunerated based on the company's performance, just as an equity investment is. The financing structure includes bullet repayment and remuneration linked to the equity risk. Loans can be secured and unsecured and provide different level of subordination. This type of debt financing is typically used as a complementary method to equity venture financing and it addresses the specific needs of innovative companies. The financing does not dilute the founders' ownership stake, complementing the equity capital. When the financing body makes a venture debt investment, it typically also acquires the right to purchase shares in the company, whilst at the same time granting options to the current shareholders to enable them to retain their share of ownership.
- **Convertible loans/bonds:** debt where the initial investment is structured as a debt claim, earning interest. The debt is either repaid, or, at the discretion of the investor, it can be converted into equity – ordinary or preferred shares – at a predetermined conversion rate. A convertible bond is essentially a bond combined with a share option where the holder may exchange the bond for a predetermined number of shares at a predetermined price. Because convertibles can be changed into shares they have lower interest rates.
- **Preferred shares/stock:** Equity that ranks senior to common shares upon profit distribution and upon liquidation. Preferred stocks entitle the holder to a fixed-rate dividend, paid before any dividend is distributed to holders of ordinary shares. Holders of preferred stock also rank higher than ordinary shareholders in receiving proceeds from the liquidation of assets if a company is wound up. The holders do not have the right of strategy and direction of the company. Preferred shares are characterised by high risk and high return.

Figure 1: Main types of quasi-equity financial instrumentsTypical benefits of quasi-equity



3. Typical benefits of quasi-equity

Quasi-equity is not typically used as permanent capital, but instead used as solution-oriented capital that performs a definitive purpose, which may be replaced over the medium-term with a more conservative, less expensive type of financing. In addition, quasi-equity is a long-term (patient) source of financing that enables businesses to accomplish their goals for growth.

The typical benefits of quasi-equity are the following:

- Quasi-equity enables businesses to benefit from a leverage effect beyond what banks accept to lend, to have a loan longer than a usual senior loan, with the possibility to pay interest and capital at maturity, with a higher interest rate with the possibility for some instruments to exercise buy options on some shares of the company;
- It provides some flexibility in terms of cash flow management; the repayment of principal and of interest are defined according to specific and *ad hoc* rules and occur after those of senior debt;
- It addresses specific risk capacity constraints in a particular market segment. It allows to finance an investment which would not have been possible only with senior debt and equity; and
- For co-investors, there are higher returns compared to pure debt instruments.

Quasi-equity financial instruments might also bear some challenges:

- These investments are more difficult to administer than normal loans (high set-up and operational costs), more time-consuming and cost more;
- Short-term financing is not possible, since returns are feasible only in the long term;
- Any ancillary services such as management expertise would be an expense for the company;
- There are typically a lower number of investors and final recipients; and
- Compared to debt instruments, they may be less attractive to final recipients as they may involve loss of control when bonds are converted into equity.

Innovative companies – driving Europe's economic growth

An innovative enterprise is defined in Article 2 GBER as 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.

The EIB publication, Innovation Overview 2020[1], describes the importance of innovation to the EU economy. New technologies such as artificial intelligence, quantum computing and advanced manufacturing will play a key role in the future EU economy, creating new employment opportunities and boosting productivity of EU Member States. The 2021-2027 ERDF programme includes the specific objective 'Developing and enhancing research and innovation capacities and the uptake of advanced technologies' and financial instruments can play an important role in supporting this activity.

Both SMEs and mid-caps are important innovators and different quasi-equity (QE) products are adapted to support their needs. For example, the EIB's Venture Debt product, supported by the European Commission through the Horizon 2020 and EFSI initiatives, targets European companies with up to 3 000 employees in the field of Biotech & Life sciences, Software & ICT, Engineering & Automation, Cleantech and Renewables. The minimum commitment under the Venture debt fund is EUR 7.5 million and the EIB investment can cover a maximum of 50% of the total investment costs.

Investments in innovation can support both the development of new 'cutting edge' technologies and the introduction of modern technology and processes to new territories.

1 https://www.eib.org/en/publications/innovation-overview-2020

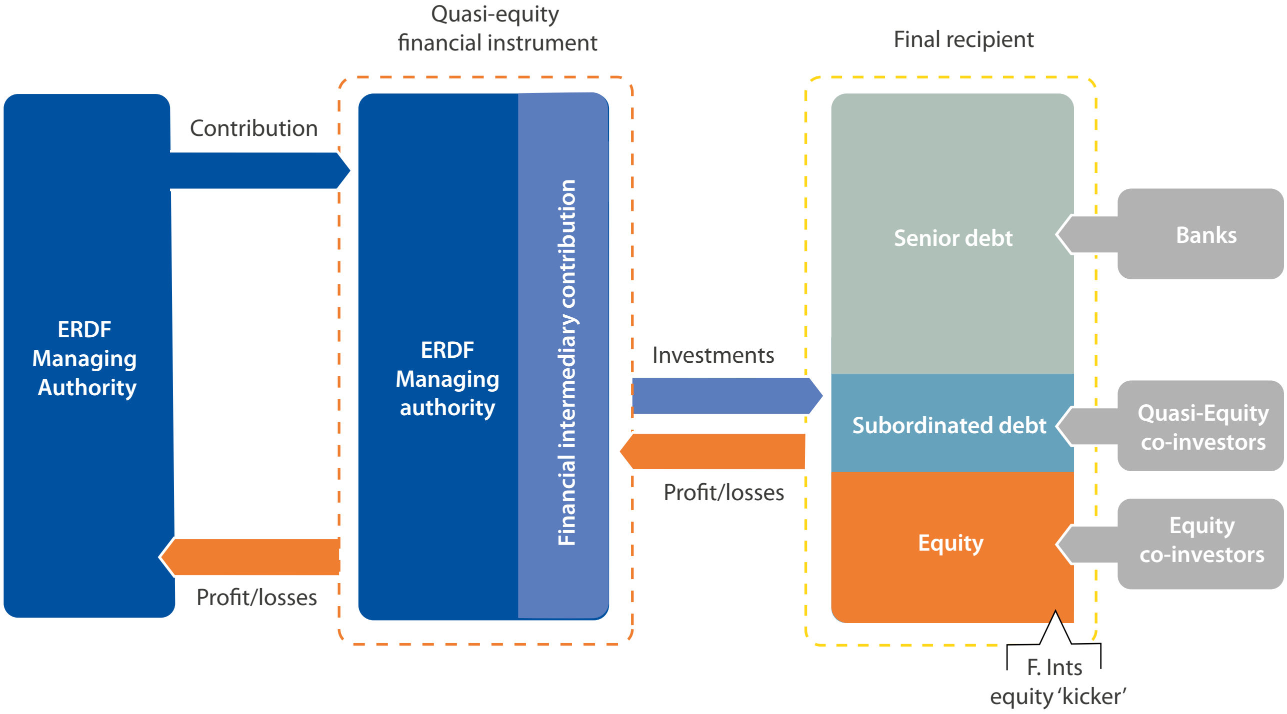
4. Subordinated long-term loans for innovative SMEs and mid-caps

Subordinated loans/debt, often also called junior debt, rank junior to other forms of debt and therefore have a higher interest rate. Subordinated debt is often repaid as a bullet payment (interest and repayments at maturity), although both interest and principal repayments may be amortised (with or without a grace period). Additionally, this debt can be structured with an equity kicker which would reduce the interest rate. This equity kicker gives to the creditor the right (not the obligation) to exchange part of the debt to equity in the company. This would allow the creditor to participate in the success of the company, although also leads to a dilution of the old shareholder structure.

This form of quasi-equity financing provides an opportunity to access additional capital to those companies that cannot raise any further senior debt and are unable or do not want to raise equity. Subordinated loan can also take a form of a bond issue and is characterised by the fact that it is reimbursed after senior debt has been repaid. As a result, QE products are well adapted to support innovative companies that require additional capital to enable them to bring new products to market, financing the commercialization at a time when little or no revenue is being generated. As well as SMEs, larger mid-cap companies may benefit from QE support to enable them to bring forward new investment in technology, product lines and expansion into new territories.

The below off the shelf model has been produced by fi-compass to illustrate how a quasi-equity financial instrument could be designed to support final recipients with resources from the shared management funds in line with the Common Provisions Regulation (2021/1060) (CPR). This document does not constitute formal guidance and managing authorities should take their own advice on the application of the CPR to their own specific circumstances.

5. The fi-compass model Quasi-equity financial instrument



Structure of the financial instrument

When using this model, European Regional Development Fund (ERDF) programme resources are contributed by the Managing Authority (MA) or Holding Fund (HF) to the financial intermediary to be invested, along with the financial intermediary's own resources (and private co-investors) by way of subordinated loans in a portfolio of innovative SMEs.

Both interest and capital repayments are subordinated to the senior debt providers meaning that the senior debt repayments are always fully discharged before payments are made in respect of the subordinated loans. The pricing of the subordinated loan reflects this risk and as additional consideration, the financial instrument may include an 'equity kicker', the right to convert a small part of the subordinated loan into an interest in the final recipient company's equity.

Aim of the financial instrument

To support innovative businesses at the 'start-up' 'early growth' and 'scale-up' stages of their development.

The product may complement equity instruments also being implemented in the sector, including potentially as part of a combined equity/quasi-equity financial instrument being managed by a single financial intermediary under a single funding agreement.

The subordinated loan will be designed to meet the financing gap identified in the ex-ante assessment carried out by the managing authority under Art 58(3) CPR 2021/1060. Typically, it will meet the financing needs of companies seeking medium to long term investment, with limited collateral without significantly diluting the owners' equity.

The financial instrument may be delivered in a Holding Fund (HF) structure in which case the managing authority would contribute the ERDF programme resources to the HF, which would then commit the resources to the financial intermediary selected to implement the financial instrument.

Venture debt

Venture debt is a type of debt financing obtained by early-stage companies and start-ups, typically used as a complementary method to equity venture financing. Venture debt can be provided by both banks specialising in venture lending and non-bank lenders.

Venture debt is usually provided to start-ups that have already successfully completed several rounds of venture capital equity fundraisings and is usually a large ticket size (EUR 7.5m - EUR 50m). Target companies that have some history of operations but still do not have sufficient positive cash flows to be eligible to obtain conventional loans. The financing is primarily used by such companies to reach anticipated milestones and to acquire the capital assets that are necessary to achieve them.

Typically a Venture Debt Fund has an Investment Strategy aligned with the VC market and products with features adapted for high growth companies such as bullet repayments and flexible collateral requirements. In some cases, a Venture Debt investment will include an equity 'kicker' in the form of warrants entitling the investor to acquire shares in the target company.

State aid

At the level of the financial intermediary and the HF:

- State aid is normally excluded when one of the following conditions is satisfied:
  a. the financial intermediary and the managing authority or Holding Fund carry out the investment on a pari-passu basis, i.e. under the same terms and conditions, at the same time, they bear at any time the losses and benefits in proportion to their contributions (pro-rata) and there is an economically significant participation of the financial intermediary in the subordinated loan;
  b. the remuneration (i.e. management costs and/or fees) of the financial intermediary and the holding fund reflects the current market remuneration in comparable situations, which is the case when the latter has been selected through an open, transparent, non-discriminatory and objective selection procedure; or
  c. the financial advantage of the programme public contribution to the instrument is fully passed on to the final recipients in the form of an interest rate reduction and/or a decrease in collateral requirements.

At the level of the final recipient:

- State aid at the level of final recipient is excluded where the subordinated loan fulfils the conditions set out in the Reference Rate Communication[2]. Where subordinated loan does not fulfil the conditions of the Reference Rate Communication, it is not considered market-conform and State aid cannot be excluded. In this case, here are some possible grounds to ensure compliance with State aid rules :
  a. *De minimis* Regulation[3] Support, which complies with the applicable *de minimis* Regulation, is deemed not to meet all the criteria laid down in Article 107(1) TFEU. The total amount of aid calculated with the GGE cannot exceed EUR 200 000 over a 3 years fiscal period. In addition to the threshold, also all other requirements of the applicable *de minimis* Regulation need to be fulfilled.

2 Communication from the Commission on the revision of the method for setting the reference and discount rates (2008/C 14/02).

3 Commission Regulation (EU) No 1407/201334 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to de minimis aid.

b. Under the *de minimis* Regulation, the gross grant equivalent (GGE) of the aid is calculated as follows:

GGE of the loan = (Nominal amount of the loan (EUR) × (Cost of funding (Reference Rate) + Cost of risk (Reference Rate) – Any fees charged by the managing authority on the programme contribution to the financial intermediary) × Weighted average life of the loan (Years) × Risk sharing rate

c. General Block Exemption Regulation (GBER): Article 21 of the GBER may apply to quasi-equity investments, provided that they comply with all the conditions of Article 21 of the GBER, including the conditions on the type of final recipients benefiting from the aid and the minimum level of private finance participation.

d. Risk Finance Guidelines

If a financial instrument involves State aid that does not meet the conditions allowing for an exemption from notification, prior to implementing the measure the Member State concerned must submit a State aid notification.

Products

The subordinated loan product typically has the following features:

- *Eligibility criteria for SMEs:*
  - SMEs or mid-caps, as defined in the Commission Recommendation 2003/361/EC concerning the definition of micro, small and medium-sized enterprises, as amended, restated, supplemented and/or substituted from time to time;
  - Economically viable / not in difficulty within the meaning of art. 2.1 of the EU Directive On State Aid For Rescuing And Restructuring Firms In Difficulty (2004/C 244/02) as amended;
  - The Recipient is not subject to collective insolvency proceedings nor fulfils the criteria under its domestic law for being placed in collective insolvency proceedings at the request of its creditors, as set out in art. 4.3 (a) of the De Minimis Regulation;

- *Subordinated loan criteria:*
  - Newly originated;
  - targets: a) Establishment of new enterprises; b) Early stage-capital (seed capital and start-up capital); c) Expansion capital; d) Capital for the strengthening of the general activities of an enterprise; e) Realisation of new projects; and/or f) Penetration of markets or new developments by existing enterprises;
  - Transfer of Benefit: The financial intermediary shall acknowledge that the financial product is provided with the ultimate purpose to enhance access to finance for final recipients and shall originate loans at better pricing and collateral requirements compared to a similar debt financing instruments not covered by the financial product. The main features of the transfer of benefit could include a reduction in interest rate and/or collateral requirements (recognising that subordinated loan already has reduced collateral requirements) and/or other reductions for e.g. administrative charges;
  - Location of the final recipient: The final recipient is established and/or operating in one or more of the region as per Article 108(2) CPR under the programme providing the resources;
  - Phased disbursement linked to investment milestones or upfront commitment for working capital;

- Typical duration –Maturity of the loan: 5 – 10 years including a grace period of min 2 years for repayment of capital;
- Collateral – a second charge over the final recipient's assets ranking behind the senior debt;
- The investments to be supported by the loan are expected to be financially viable (as assessed by the financial intermediary in accordance with its internal procedures) and have not been physically completed or fully implemented;
- The loan originated from the financial intermediary to the Recipient is not be in the form of a convertible loan;
- The Recipient is potentially economically viable (as assessed by the financial intermediary in accordance with its internal procedures);
- The loan does not refinance or restructure an existing loan;
- Unlike equity, the financial intermediary does not participate in the management or key business decisions of the company;
- The amount of the loan allocated to the financing of the acquisition of land shall not exceed 10% of the initial principal amount of the loan.

Pricing of the subordinated loan

Subordinated loans may be either amortising loans where the interest and capital is repaid in regular instalments during the loan period or a lump sum repayment at the end of the loan period. The latter products are known as bullet/balloon loans where the interest is 'rolled up' and repaid as a lump sum, along with the principal at the end of the loan period.

The loan is priced by the financial intermediary in accordance with its internal procedures, having regard to the level of risk and collateral associated with the investment. Typically, for SMEs in the start-up or early growth stage, the risk premium for a subordinated loan compared with senior debt will be in the range of 200-400 basis points (or 2-4%).

The ERDF programme resources may be contributed at a discount, which can be passed on to the final recipient, subject to compliance with the applicable State aid framework. To avoid crowding out of the wider financing market the discounted interest rate of the subordinated loan should avoid competing with products offered by senior debt providers in the market. This should be assessed as part of the ex-ante assessment.

Prêt participatif – a subordinated loan linked to investment returns

A specific type of subordinated loan that was developed in France, the prêt participatif product links the interest payable to the success of the underlying investment. Typically, the borrower will pay a lower base interest rate (which can be zero) and an additional interest rate linked to the revenues generated by the borrower, typically paid as bullet repayment(s) associated with achievement of milestones. However, the balance between base and additional interest rate can vary between different loan products.

Under the national legislation that was introduced to support the product, the investor ranks behind all other creditors in the event of the insolvency of the company. This means that a prêt participatif investor can only take action to recover sums due from the borrower once all other creditors including tax authorities and senior debt providers have been repaid. In this way, the loan product acts more like an equity investment from the borrower's perspective, linking the cost of investment (i.e. the lender's return) more closely to the performance of the company.

Duration	The lending period of the financial instrument shall be set in order to ensure that the programme contribution as referred in Article 68 of CPR 2021/1060 and Article 80 of CAP Strategic Plans Regulation (No. 2021/2115) (SPR 2021/2115) is used for loans disbursed to final recipients no later than the end of the eligibility period. The typical duration to create the portfolio of loans is recommended to be up to four years from the date of signature of the funding agreement (between the managing authority/HF and the financial intermediary).
Management costs and fees	The subordinated loan financial instrument is a loan instrument. However, in view of the quasi-equity nature of the product, the management cost and fees paid to bodies implementing a HF or financial instrument, selected through a direct award, shall be subject to the following thresholds in accordance with Art, 68(4) CPR 2021/1060 and Article 80(5) of SPR 2021/2115: • For bodies directly appointed to manage a Holding Fund including a quasi-equity financial instrument a threshold of 7% • For bodies directly appointed to manage a quasi-equity financial instrument a threshold of up to 15%. Where bodies implementing a holding fund and/or specific funds are selected through a competitive tender in accordance with the applicable law the amount of management costs and fees shall be established in the funding agreement and shall reflecting the result of the competitive tender.

Quasi-equity support for business in Occitanie, France - the PRET PARTICPATIF FOSTER TPE-PME

The financing needs for SMEs in France's Region Occitanie in the post Covid-19 recovery phase are focused on (i) short-term liquidity to face imminent shortage and working capital needs, and (ii) long-term funding to support long-term investments, enabling local entrepreneurs to gain or at least maintain their level of competitiveness.

Thanks to comprehensive national and regional support schemes, most French Banks have responded to the initial need for emergency financing. However, this short-term support is expected to be phased out, worsening SMEs' capacity to access to finance. Furthermore, the demand for longer terms financing is only partially met by banks with products that typically have limited loan maturity, i.e. between 5 to 7 years and by loan funds, which are marginal in size, more expensive, and limited to financing needs above EUR 1.5/2m.

Therefore, with REACT-EU resources, the Region decided to address this financing gap by implementing the QE product, PRET PARTICPATIF FOSTER TPE-PME to support SMEs' tangible and intangible investments through quasi-equity as well as working capital financing. Region Occitanie also wanted to make it possible for local entrepreneurs to benefit from a grace period of at least 2 years (in line with the French regulatory framework for Prêts Participatifs). This will provide the region's businesses the ability to honour their pre-existing financial commitments and reimburse national and regional Covid-19 support funding they may have received while also enabling them to pursue investment at the same time to continue to enhance their competitiveness.

In this case, the EIF have chosen to implement the QE product through a portfolio guarantee instrument which supports financial intermediaries to create a portfolio of subordinated loan QE investments. The main features of the QE product PRET PARTICIPATIF FOSTER TPE-PME are as follows:

Target	• SME as defined in the Commission Recommendation 2003/361/EC concerning the definition of micro, small and medium-sized enterprises (OJ L124, 20.05.2003, p.36), as amended, restated, supplemented and/or substituted from time to time. • established and/or operating within Region Occitanie, which have been impaired by COVID19.
Purpose	• Investment in tangible and intangible assets as well as working capital. • Loan shall be newly originated (refinancing and the restructure an existing loan is not possible)
Maturity	• Min 12 months – no constraint in terms of maximum maturity.
Grace period	• Minimum 2 years
Recovery	• Only when senior creditors (such as the State or the employees, senior loan creditors etc.) are paid in full or have surrendered their claims
Guarantee rate	• 80% of the outstanding loan amount • Free of charge
Leverage	• min 9x the public contribution (ERDF & Region), i.e. a leverage on ERDF representing min 15x
State aid	• De-minimis Commission Regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty to de minimis aid (OJ L352, 24.12.2013, p. 1).

Notes

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