fi compass ERDF

Factsheet

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ERDF equity financial instruments

European Commission

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Abbreviations

Abbreviation	Full name
AIFMD	The Alternative Investment Fund Managers Directive
CPR	Common Provisions Regulation
EC	European Commission
EFSI	European Fund for Strategic Development
EIB(G)	European Investment Bank (Group)
EIF	European Investment Fund
ERDF	European Regional Development Fund
EU	European Union
FA	Funding Agreement
FInt.	Financial Intermediary
FoF	Fund of funds
GBER	General Block Exemption Regulation
HF	Holding Fund
IFI	International Financial Institution
LBO	Leveraged buyout
MA	Managing authority
MFF	Multiannual Financial Framework
MS	Member State
NPBIs	National Promotional Banks and Institutions
PE	Private equity
RDI	Research, Development and Innovation
SMEs	Small and medium sized enterprises
VC	Venture capital

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1. Executive summary

This factsheet aims to present key features of equity financial instruments, together with industry best practice, to support managing authorities and other fi-compass stakeholders seeking to implement equity financial instruments in the future. In addition, relevant fi-compass resources will be highlighted for users to access to find further information on the topics featured in this factsheet

SMEs represent over 99% of the total number of businesses in the EU, and equity investment in the form of **Venture Capital (VC) and Private Equity (PE)** provides an essential source of finance for SMEs and growing companies. Equity financing plays an important financing role, in particular for **'entrepreneurial' businesses** seeking to develop innovative products, establish new markets and/or to expand into new territories.

High-risk start-ups and high growth companies require significant long-term investment but have neither immediate cash-flows to service debt payments nor sufficient collateral. Through addressing this need, equity finance can be key to creating **sustainable high quality innovative businesses in emerging sectors** including digital technology (including green or climate tech), healthcare and biotechnology.

Berlin – ERDF equity financial instruments supporting innovative start-ups

IBB Ventures, an equity fund set up by the regional investment bank Investitionsbank Berlin (IBB) is one of the reasons why today the city is a hub for start-ups. With a team of eighteen people IBB Ventures currently invests alongside private investors in eighty early stage companies.

There are two ERDF backed venture capital (VC) funds in Berlin investing in innovative companies in the areas of technology and creative industries, for a period of circa three to seven years, with a potential for a medium-term exit. The use of ERDF to co-finance the VC funds, has enabled resources to be mobilised to boost the availability of risk capital to start-ups, contributing to meeting Berlin's innovation policy goals.

For further information, see the video case study, Supporting innovative start-ups on the fi-compass website.

At present **access to equity financing varies considerably** across different Member States, with a number of sectors and territories in need of a significant increase of the supply of equity financing. In particular, countries with a relatively small equity financing market are often characterised by a balancing low level of demand from entrepreneurial companies.

The continued growth and development of equity markets in Member States is critical to the future competitiveness and prosperity of the EU.

This highlights the potential for **ERDF financial instruments to play a decisive role in stimulating** both private sector co-investment and increasing innovative economic activity as the availability of finance incentivises entrepreneurs to bring forward new ventures for investment.

Equity ERDF financial instruments have successfully been established in a number of Member States supporting key priority sectors including **SMEs**, **start-ups, innovative companies and scale-ups**, larger SMEs seeking investment for the next phase of their expansion. An off the shelf model of a co-investment facility has proved to be a robust framework for implementation of financial instruments by Member States.

In these Member States, equity financial instruments have been proven successful in stimulating an **equity finance ecosystem** in the country concerned. The commitment by managing authorities of ERDF to support equity funds has attracted investors, fund management professionals and entrepreneurs to the region concerned, taking advantage of the new financing opportunities to establish innovative and growing businesses, creating, in turn **sustainable high quality employment** for local people.

ERDF equity funds in Berlin – supporting innovative new companies

Some of the successful final recipients that have benefited from equity investment and support from the ERDF equity financial instruments managed by IBB Ventures include:

Blinkist

Blinkist, is a subscription service that provides both written and audio summaries of bestselling non-fiction books. Users can browse books within categories which include Entrepreneurship & Small Business, Politics, Marketing & Sales, Science, Economics, History, Communication Skills, Corporate Culture and more. They also provide a free app which provides users with a random daily pick. An early investment by the ERDF co-financed Venture Capital (VC) Fund enabled the founders to attract other investors that has allowed them to grow their business to over 18 million subscribers.

The Female Company

The Female Company, has developed a retail platform for sustainable products that cover the whole life cycle of womanhood. The company is built around 'femhealth' education with a strong community of 500k monthly active users. As well as receiving investment from IBB Ventures to fund the growth of their team and development of new product lines, the founders of the Female Company have benefited from IBB Ventures' large network of entrepreneurs helping them to find creative solutions to typical challenges faced by founders of start-up enterprises.

nuventura

The engineering start-up **nuventura** has developed a new type of switchgear that is more sustainable. Traditionally, gas-insulated switchgear has contained a very harmful greenhouse gas called Sulphur hexafluoride or SF6. Nuventura has developed new technology that uses dry air in place of SF6, providing a more sustainable solution that does less harm to the environment. As funding for deep technology, hardware industry solutions is difficult to find, the early support from the ERDF equity financial instrument managed by IBB Ventures was crucial to the early success of the new company.

For further information, see the video case study, Supporting innovative start-ups on the fi-compass website.

2. Introduction to ERDF equity financial instruments

2.1 Definition of Equity as financial instruments

Equity investment is medium to long-term finance provided in return for a share in the ownership of potentially high growth companies. An equity investment is defined by the European Commission[1] as:

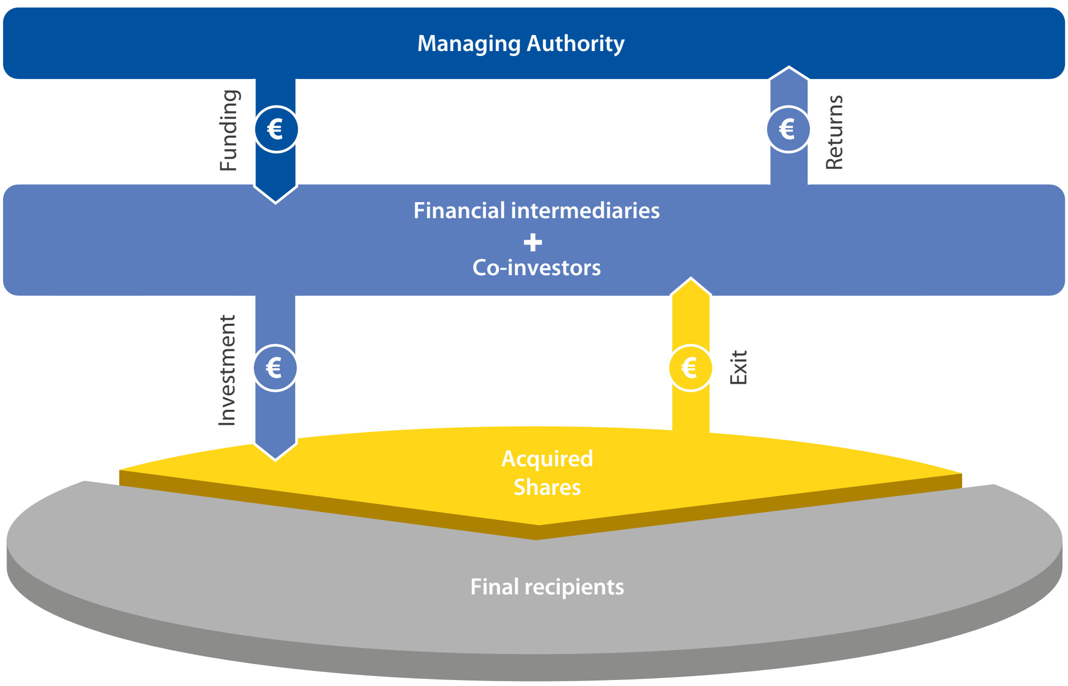
> *'Provision of capital to a firm, invested directly or indirectly in return for total or partial ownership of that firm and where the equity investor may assume some management control of the firm and may share the firm's profits.'*

Embracing both Venture Capital (VC), which invests in start-up and early stage companies and Private Equity (PE), which targets more mature growing companies, equity investment provides a vital source of finance for growing companies in the EU. ERDF financial instruments have proved to be effective tools to establish and extend equity investments in Member States, supporting companies in sectors as diverse as digital healthcare, circular economy, online commerce and geothermal heat generation.

2.2 Purpose of ERDF equity financial instruments – supporting growing companies

The fi-compass publication, 'Financial Instruments products', provides an introduction to equity investment. Figure 1 shows how a typical equity investment works.

Figure 1: A typical equity investment



1 Guidance for Member States on Financial Instruments – Glossary.

ERDF resources are committed by a managing authority to an equity fund (managed by a financial intermediary (or equity fund manager)) that then identifies and invests the resources, alongside funds committed by other investors, into target final recipients. In return for the investment the equity fund receives a share of the ownership of the company.

Depending on the size of the investment, the Fund Manager may be granted rights to participate in the company's strategic management (for example through a seat on the Board of Directors) and, additionally may provide further support to the management team with a view to securing the growth of the company. After a period of growth and development (typically four to ten years), the Fund Manager will seek to exit the company by selling its shares, securing a financial return on the equity investment and enabling the company to further develop its economic and financial viability.

With its primary goal of supporting financially viable and sustainable businesses, ERDF equity financial instruments can play an important role in the economic and social landscapes of Member States.

The potential positive impacts[2] of equity financial instruments investments may include:

- Fostering innovative technology-based business initiatives;
- Encouraging innovation and entrepreneurship, supporting people realising their business concepts;
- Creating tangible value through direct investments in young and innovative companies with high growth prospects;
- Supporting companies overcome challenges and secure a more sustainable future, preserving businesses and the jobs and communities that depend on them.
- Helping to create and preserve jobs, and enabling people to develop skills in new areas and technologies;
- Creating services and products that enhance the wellbeing of EU citizens by investing in companies at the forefront of innovation;
- Providing innovative companies with access to finance without requiring collateral;
- Providing entrepreneurs with business advice and guidance to enable them to better grow the value of the business.

Member States that have used ERDF resources to set up equity financial instruments have benefitted from the impact of both the direct investments made by the Fund Manager and the indirect benefits of the growth of the equity investment ecosystem in the country. In territories with historic lower levels of equity investment, an ERDF equity financial instrument can act as a catalyst, attracting new investors, professionals and entrepreneurs to the region.

2 https://www.investeurope.eu/about-private-equity/

La Financière Région Réunion

The La Réunion region entrusted the European Investment Fund (EIF) to set up the 'La Financière Région Réunion' (FRR) fund of funds with resources from the European Regional Development Fund (ERDF) with a mandate to implement and manage two financial instruments to support small and medium sized enterprises (SMEs), including micro-enterprises. The region has established under separate financial intermediaries a loan fund of EUR 62 million (including private co-financing) and an equity fund with EUR 10 million to co-invest alongside private investors.

The ERDF equity fund has been able to support local enterprises in developing their businesses through advisory and mentoring services, provided alongside their investments to help develop the companies' expansion into new territories, supporting export activities as well as to provide better understanding of the different financing options.

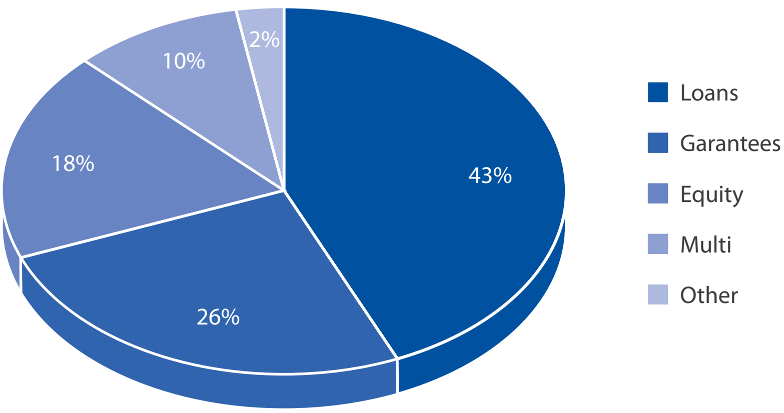
For more information, see the fi-compass case study, La Financière Région Réunion - Financial instruments to support SMEs, France.

2.3 The growth of ERDF equity financial instruments

The summaries of data published by the European Commission in 2021[3] shows how the use of ERDF equity financial instruments has grown significantly during the 2014-2020 programming period. The Fund's capacity to finance projects with higher risk profiles, attract other public and private resources and focus on the most relevant market failures in a given territory (in terms of SMEs' sizes, risks or industrial sectors for instance), make it a very useful resource in the set-up of equity instruments.

By the end of 2020, out of the EUR 22.4 billion total ERDF programme resources committed to FIs, EUR 4.5 billion was related to FIs providing equity, supporting over 3,000 SMEs. The average programme amount committed to equity FIs was EUR 21 million.

Figure 2: Programme amounts committed to FIs by product[4], as of end 2020,

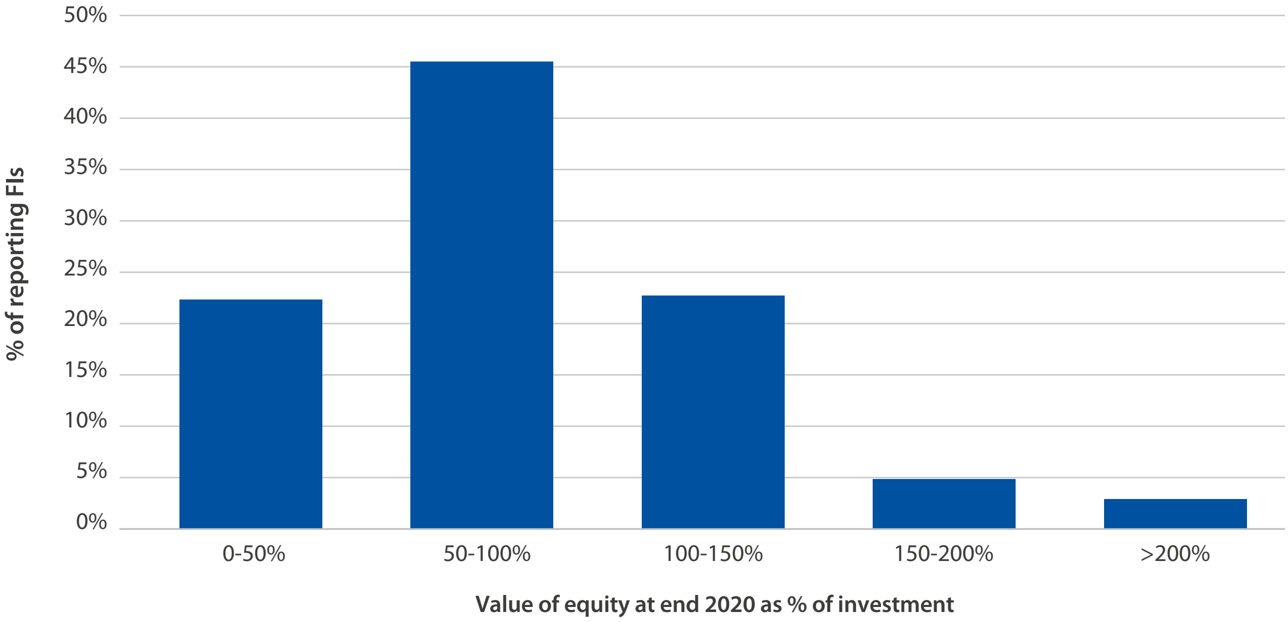


3 Financial instruments under the European Structural and Investment Funds – Summaries of the data on the progress made in financing and implementing the financial instruments for the programming period 2014-2020 in accordance with Article 46 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council. Situation as at 31 December 2020.

4 The total amount committed for FIs is higher than the total amount included in the figure as not all the committed funds are already allocated to specific products, especially in the case of amounts for which the fund of funds still need to choose financial intermediaries.

The average equity investment in a final recipient was EUR 370 000, ranging from EUR 100 000 in Finland to over EUR 1.9 million in the Netherlands. As of December 2020, equity payments to final recipients of EUR 760 million, had been made mobilising additional private finance to achieve total investments of over EUR 2.3 billion. The value of equity participations[5] at the end of 2020 was EUR 1.3 billion, or 71% of the programme resources paid to final recipients by those FIs (over EUR 1.8 billion or 92% of total equity investments.

Figure 3: Reporting FIs by value of equity participations as a share of investment value at end 2020



In the fi-compass publication, 'Gap analysis for SME financing in the European Union', published in 2020, the potential use and value added of financial instruments for SME equity financing is further considered. It found that use of ERDF equity financial instruments highly varies between Member States. On the one hand, in some countries, the development of large and/or comprehensive equity financial instruments may stimulate demand and lead SMEs and entrepreneurs to propose new project concepts that can be financed later on. On the other hand, in other countries, more targeted equity financial instruments may support the dynamism of some economies and/or translate in practice to an interest from the managing authorities or from the SMEs to innovate in new sectors that may be considered as 'too risky' by the current investment funds (e.g. circular economy).

The Gap analysis report concludes that financing gaps for equity finance remains high and that ERDF financial instruments have an important role to play in addressing the needs. It highlights how for equity funds, 'financing should be considered on a country-by-country basis and take into consideration the fact that the demand and supply sides are particularly interconnected in this market.'

5 The value of equity participations in enterprises made by venture capital funds or co-investment facilities depends on the performance of the enterprises and may increase or decrease over the period of investment. Actual reflows from the capital investment will only be available with an exit, which may happen many years after initial investment. In order to have information on the progress over time, the managing authorities report on the value of equity participations. The amount to be reported should be the book value of the investment at the end of the reporting year which, depending on the applicable accounting rules, is calculated as: 'Book value = nominal value of investments +/– fair-value movement – impairments of assets'.

3. Background to equity financial instruments: a market perspective

3.1 Equity support for 'high growth' SMEs in the real economy

SMEs represent over 99% of the total number of businesses in the EU, account for more than half of Europe's GDP and play a key role in adding value in every sector of the economy. They are essential to EU's competitiveness and prosperity, as well as economic and technological sovereignty[6].

Equity financing plays an important role in the SME market, especially for high-risk start-ups and high growth companies that require significant long-term investments and which do not produce immediate cash-flows which would allow servicing debt payments nor require the need for collateral. This class of 'entrepreneurial' businesses can be distinguished from others by their aspirations and potential for growth, rather than by their current size. Such businesses are aiming to grow rapidly to significant scale-up their activities.

Typically an equity investor will seek to invest in companies that offer the prospect of significant turnover growth within five years. Investors will also look for companies with an experienced and ambitious management team that is capable of turning their business plan into reality. Where these requirements are met, equity funds can support companies through investment at all stages of their development, from start-up to buy-out. By their nature, therefore, equity funds only support a sub group of SMEs. Many small companies which are profitable and provide a good standard of living and stable employment for their owners and employees, cannot be considered as 'high-growth or innovation oriented' businesses attractive to equity investors. Nevertheless, despite these limitations, equity financial instruments play an important role in supporting innovative and high growth businesses as part of a diverse response to the range of needs in a region's SME sector.

The fi-compass report on financing gaps for EU SMEs points out that only 11% of SMEs currently consider equity financing relevant for their businesses. Many SMEs prefer debt financing over equity financing; either because of lack of knowledge about the characteristics of the equity financing market (i.e. purposes, actors, and financial products for instance), or because of very limited / immature equity markets in their regions (leading to limited interest from the SMEs or relevance for them). As part of the Commission's strategy to support and empower European SMEs[7], the ESCALAR[8] initiative seeks to ease European SMEs' access to finance, by creating a mechanism to boost the size of venture capital funds and attract more private investment, to help high-potential enterprises to grow.

6 Unleashing the full potential of European SMEs.
7 An SME Strategy for a sustainable and digital Europe.
8 The European Scale-up Action for Risk capital (ESCALAR) is a pilot programme launched by the EIF using EFSI resources to address the financing gap experienced by high growth European companies (scale-ups).

3.2 Equity investments vs debt/loan financing

An equity investment is very different from senior debt or a loan from a lender, such as a commercial bank. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of the underlying investment. In contrast, an equity investor receives a stake in the company and, as a shareholder their return is dependent on the growth and profitability of the final recipient's business.

Typically a senior debt[9] provider's rights to interest and capital repayment of the loan, are secured either on business assets or the entrepreneur's own personal assets. As a last resort, if the company defaults on its repayments, the lender can enforce its security, for example to put the business into receivership, or enforce personal guarantees given by the owner(s).

By contrast, equity investments are not secured on any assets and, as a result, the equity fund faces the risk of failure just like any other shareholder. The equity fund is an equity business partner and is rewarded by the company's success, generally achieving its return through realising a capital gain through an 'exit' in which it sells its shares.

Figure 4: Overview of the differences between equity investment and senior debt[10]

Equity investment	VS Senior Debt
Medium to long-term finance.	Short to long-term.
Investor takes a share of ownership in the company.	Investors takes a creditor position in the issuing company with no link with ownership.
Committed until 'exit', subject to investor participation on the company's Board.	Commitment subject to compliance with loan terms e.g. loan facilities may be repayable if covenants are not met.
No interest is paid, return on investment through a capital gain on sale of shares.	Interest payable regardless of results.
Provides a flexible, capital base to meet a company's future growth plans.	Provides a source of finance to meet short or longer term needs of the company.
Good for cash flow, as no capital or interest payments.	Requires stable good cash flow to service interest and capital repayments.
The returns to the private equity investor depend on the business' growth and success – the more successful the company, the better the returns of investors.	Depends on the company continuing to service its interest costs and to maintain the value of the assets on which the debt is secured.
No security is given to investors. If the business fails, equity investors will rank alongside other shareholders, after the banks and other lenders, and stand to lose their investment.	Security is usually required up to the value of the loan. If the business fails, the lender has first call on the company's assets through enforcing its security/collateral.
A business partner, sharing business risks and rewards, with hands-on advice and managerial expertise to assist business growth and sustainability.	Assistance available varies considerably across debt products and providers. Typically a senior debt provider would not provide hands-on advice and managerial expertise.

9 To simplify comparison, private equity is compared with senior debt, even though the former is generally provided as part of a financing package.
10 British Private Equity & Venture Capital Association (BVCA) and PwC, A Guide to Private Equity

In addition to the direct benefits of equity finance, companies often seek equity backing to secure other benefits, including:

- **Knowledge benefit**: many equity investors with broad experience and knowledge assist in company management decisions as an advisor or a mentor.
- **Network benefit**: equity investors may provide their portfolio businesses with access to a strong business network in terms of supply chain, vendors, suppliers, customers, service providers or any other supporting entity.
- **Financial benefit**: the equity investment may improve the cost of capital for companies. Indeed, despite equity financing having a higher cost than debt – equity investors normally demand a higher risk premium in comparison with debt lenders – this instrument may be an attractive capital option for businesses as it does not create additional default risks[11]. Also, equity financing may offer an easier way to raise a large amount of capital faster, in particular if the company does not have extensive credit history established with debt providers.
- **Certificate benefit**: before investing, equity investors will screen the company's performance through a detailed and professional due diligence process. Following the investment the company will be required to adopt high quality accounting and reporting practices. Due to these factors, other potential investors and trading partners can treat the successful fundraising as an indication of the high quality of accounts and certifies a sign of greater health of the company. This high quality can be used as a promotion for the branding of the company.

Nasekomo, Bulgaria - final recipient story

Bulgarian start-up, Nasekomo is the first insect-based sustainable food production company in South-East Europe. They have positioned their facilities in a region where input materials for the production are abundant and in low demand all year around. Nasekomo is a very innovative project composed of a very active R&D department which works independently or in collaboration with leading academic institutions and business partners to develop processes and technologies that will propel forward the insect industry as well as Nasekomo.

Supported by a EUR 1.5 million equity investment from two European Regional Development Fund equity financial instruments, the growing biotechnology company used the investment to finance to further R&D and the industrialisation of production. The company is currently closing a much larger financing round (EUR 40 million in total) with the participation of international investors that values the company at EUR 50-100 million with the purpose of building a 4 000-ton factory in central Bulgaria. The early commitment by the ERDF backed equity investors in the first funding round has been key to enabling the company to attract the initial private sector co-investment in their business.

For more information, see the fi-compass blog post, Nasekomo: sustainable food from insects and the fi-compass case study, FMFIB: Fund Manager of Financial Instruments in Bulgaria – a multi-sector fund of funds.

11 Debt is a cheaper source of financing, as compared to equity. Companies can benefit from their debt instruments by expensing the interest payments made on existing debt and thereby reducing the company's taxable income (i.e. tax shields). Tax shields are crucial to companies because they help to preserve the company's cash flows and the total value of the company. However, at some point, the cost of issuing additional debt will exceed the cost of issuing new equity. For a company with a lot of debt, adding new debt will increase its risk of default, the inability to meet its financial obligations. A higher default risk will increase the cost of debt, as new lenders will ask for a premium to be paid for the higher default risk. In addition, a high default risk may also drive the cost of equity up because shareholders will likely expect a premium over and above the rate of return for the company's debt instruments, for taking on the additional risk associated with equity investing. https://www.cfainstitute.org/en/research/financial-analysts-journal

3.3 Equity market analysis – market conditions in EU macro regions

The fi-compass report, 'Gap assessment of SME equity financing in the European Union', includes a quantification of the equity financing gap in EU Member States. As the equity market is generally more volatile than the debt market, quantifying equity financing gaps as stable over a short period of years proves challenging. Nevertheless, reported equity financing gaps do provide an indication of equity market conditions in each country or group of countries. The results for the different EU macro regions considered in the fi-compass report are set out below.

3.3.1 DACH macro-region: Austria and Germany

Both countries appear in quite similar situations with similar low 'equity financing gap to GDP ratios' (3.2% in Austria, 2.9% in Germany). Their percentages of SMEs that were unsuccessful seeking equity finance are also quite similar and low (2.6% in Austria, 1.9% in Germany). VC funding seems available in this macro-region (with the 'second best' availability of 62%, following France at 75%). These elements indicate that these two countries present healthy equity markets where investment funds are present and active, as well as where demand for equity financing is overall covered by the current supply.

3.3.2 France and Benelux macro-region: Belgium, France, Luxembourg, and the Netherlands

Three of the countries have quite similar 'equity financing gap to GDP ratios' (6.2% in France, 5.3% in the Netherlands, 3.4% in Luxembourg) and percentages of SMEs that were unsuccessful in raising finance (2.7% in the Netherlands, 2.4% in France, 2.3% in Luxembourg). Belgium appears to be in a different situation with a higher 'equity financing gap to GDP ratio' (15.1%) and a higher percentage of SMEs that were unsuccessful in raising finance (4.5%), implying that more structural difficulties exist on this market and that FIs may add value on a broader scale. VC financing is particularly available in this macro-region with high 'net availability of funding' (75% in France, 61% in Benelux); equity funds are very active but sometimes insufficient to cover a given demand. In that perspective, the equity financing gaps (especially in France and in the Netherlands) may be an indication of a lack of supply from the equity funds to cover a particularly dynamic demand for equity financing in some sub-sectors, regions, and/or types of SMEs / projects.

3.3.3 Nordics macro-region: Denmark, Finland, and Sweden

The data for Sweden shows quite a large equity financing gap, a high 'equity financing gap to GDP ratio' (20.7%) and the largest percentage of SMEs that were unsuccessful in raising equity finance in the EU (10.5%). In contrast, Denmark and Finland present a situation closer to the France and Benelux macro-region. In addition, the 'net availability of funding' in this macro-region is similar to the one in the British Islands macro-region. Accordingly, it can be concluded that (i) the very high interest from Swedish SMEs for equity financing is currently not satisfied by the market, (ii) an overall relatively high percentage of SMEs were unsuccessful in their requests in 2018 (3.8% in Denmark and 3.1% in Finland), and (iii) there are some difficulties from existing equity funds to answer the requests from the SMEs occurred, not necessarily because they lack supply / volume but more probably because the different markets are dynamic and generate projects that the equity funds are currently not able to assess and/or finance.

3.3.4 South macro-region covering Spain, Greece, Italy, Malta, and Portugal

The South macro-region is the one presenting the main challenges concerning the development of equity financing markets. Before the EquiFund[12] ERDF equity financial instrument became operational, Greek SMEs seem to experience specific difficulties when looking for equity financing and, with a few exceptions, the economy seems to have a very limited access to this market (fearing rejection or not considering this type of financing at all). Spain and Italy represent quite large economies where the equity financing gaps are quite small, the 'equity financing gap to GDP ratios' are among the smallest (1.8% in Spain, 0.2% in Italy) and the percentages of SMEs unsuccessful at raising equity finance are among the lowest (0.8% in Spain, 0.1% in Italy). Portugal presents a very similar situation (an 'equity financing gap to GDP ratio' of 1.3% and 0.5% of unsuccessful SMEs). In Malta, the equity financing market for local SMEs is still under development.

The different elements characterising this macro-region indicate a limited supply of finance by equity funds – mainly due to a limited demand – which may give the impression that the current demand is almost covered, but more probably illustrates that demand for equity financing needs to be stimulated in these countries (in parallel to technical / financial support to the supply side in order to ensure that an appropriate volume of equity financing is available once the demand side is stimulated). Finally, it is to be noted that the 'net availability of funding' in this macro-region is relatively low (47%), indicating a potential lack of available volume of equity financing.

3.3.5 Central, Eastern and South-Eastern Europe (CESEE) macro-region: Bulgaria, Cyprus, Czech Republic, Estonia, Croatia, Hungary, Lithuania, Latvia, Poland, Romania, Slovenia, and Slovakia

Bulgaria, Czech Republic, Hungary, and Poland present a similar situation to the countries of the South macro-region, with low 'equity financing gap to GDP ratios' and low percentages of SMEs unsuccessful at raising equity finance), indicating a similar need for public support on both the demand and supply sides.

Croatia, Slovakia, and Slovenia present a quite high 'equity financing gap to GDP ratio' (7.5%) and a relatively high percentage of SMEs unsuccessful at raising equity finance (3.8%), indicating more developed equity markets where demand is higher but where SMEs still cannot easily access equity financing.

A third sub-group within this macro-region may be isolated: the Baltic countries (including Estonia, Latvia, and Lithuania) with one of the highest 'equity financing gap to GDP ratio' (10.7%) and percentage of SMEs unsuccessful at raising equity finance (4.4%). This indicates a situation relatively similar to the Nordic macro-region, as well as potentially an overestimation of the needs from the SMEs in comparison to the actual investable projects that equity funds would be keen to invest in.

Romania appears to be in a stand-alone position (with an 'equity financing gap to GDP ratio' of 4.8% and a percentage of SMEs unsuccessful at raising equity finance of 2.7%), indicating that Romanian SMEs may be more active in their requests for equity financing but still have difficulties in accessing such type of financing.

12 fi-compass case study, Equity financing for SMEs in Greece.

3.3.6 British Islands macro-region: Ireland and the UK

Ireland has a significantly lower 'equity financing gap to GDP ratio' (3.8%) than the UK (11.1%). The two countries are, however, similar with regard to the relatively high percentages of SMEs unsuccessful at raising equity finance (5.0% in Ireland and 4.2% in the UK). In addition, VC funding appears quite 'available' in the macro-region. These elements indicate that the equity financing markets in both countries are quite dynamic.

techstart NI – ERDF Seed and Start-up investor in Northern Ireland

InvestNI, the economic development agency in Northern Ireland set up a range of equity and loan financial instruments to support growing businesses in the region during the 2014-2020 programming period. The equity fund manager, techstart NI was selected to manage separate loan and grant operations to support local companies through seed and start-up investment rounds.

They offer three types of support, advice and business development, a proof of concept grant and start-up equity investment. This allows them to identify and support entrepreneurs through the crucial early phases of the development of their businesses. Typically a proof of concept grant may be up to EUR 10 000. About 10% of the recipients of the grant go on to receive equity investment which is usually in the range of EUR 50k to EUR 2 million.

For more information see the video case study 'ESIF equity financial instruments in Northern Ireland'.

4. Equity financial instruments: key market features

4.1 Equity investors

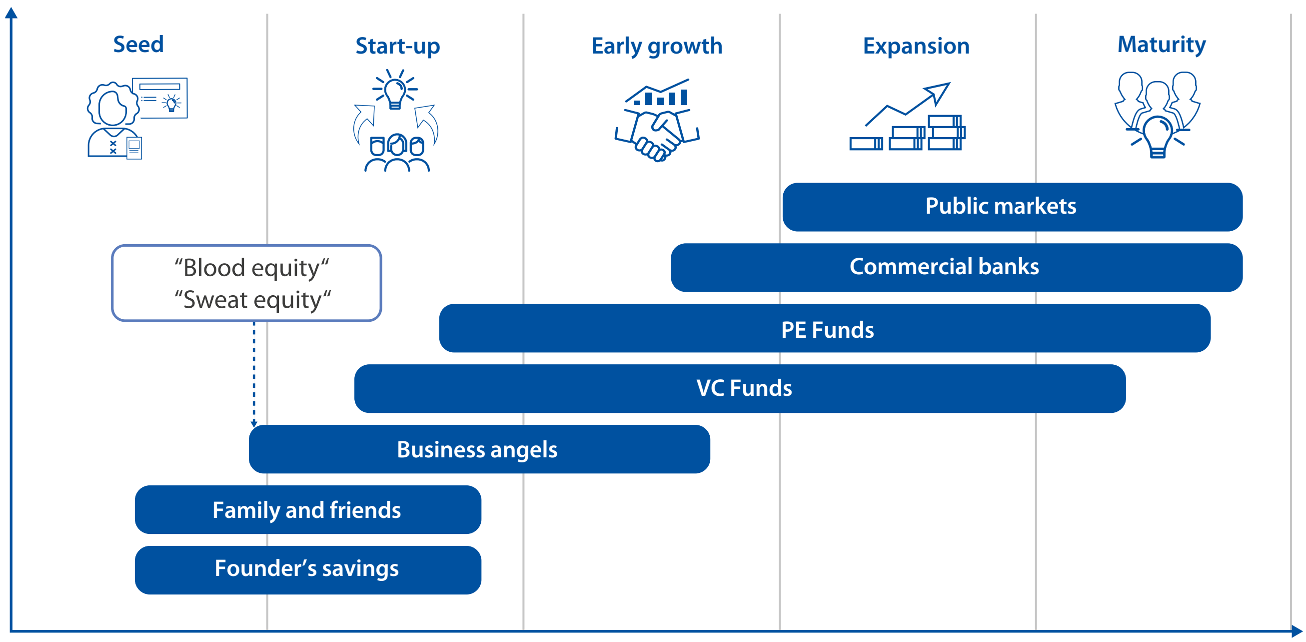
Equity funds typically involve several investors that commit resources to be managed by the fund's management team with the core mission to **increase the return on investment for the investors involved**. To achieve this, equity funds first identify companies with high growth potential that fit their investment criteria. After making the investment, equity funds use their influence to develop and enact a series of management strategies to improve the companies' profitability and grow the business. This can include reshaping the management team and board of directors, reducing costs and adding/enhancing products and services.

Equity investors are found in a wide range of sectors, in particular in high-innovation sectors such as Technology, Healthcare and Biotechnology.

Equity investors can range from the entrepreneur's family and friends to a large private equity house. An early-stage company that only needs a small investment may be able to meet its needs from the families and friends of the entrepreneur/founder and employees (so called 'blood' and 'sweat' equity). Business Angels can play a vital role in supporting growing businesses as they seek their first external investment. Typically high net worth individuals, Business Angels can provide patient equity to start-ups, together with know-how, advice and contacts.

As companies continue to grow their investor profile will develop. Larger, growth-stage business will need investors with more money, such as venture capital funds. Larger companies might turn to private equity or large corporations. This may happen before acquisition or a stock exchange listing (IPO). Figure 5 shows the different types of investors and the stage in a company's life-cycle where they may be most needed.

Figure 5: Types of equity investors through a company's life-cycle



In general, equity investment capital comes primarily from institutional investors (i.e. pensions and mutual funds, insurance companies, venture capital and private equity funds, corporates – which invest money on behalf of their clients – and government funds) and high net worth individuals. These investors have the capacity of providing substantial capital for extended periods of time that is invested directly in companies or through funds managed by fund managers.

Equity investment funds typically work within agreed parameters concerning their use of investors' money. For example, an equity fund will have a maximum size of any single business investment (typically a percentage of the total fund size). Once money is committed, however, investors do not have control over management of the fund, which is solely the responsibility of the fund's management team, although most firms have an investor advisory council, which provides a consultation forum for investors.

Equity investment funds exercise influence or control over portfolio companies through their representation on the companies' boards of directors. Typically, equity investment funds also ask the CEO and other senior managers of a business in their portfolios to personally invest in it as a way to ensure their commitment and motivation. In return, the operating managers may receive large rewards linked to profits when the business is sold[13].

Equity investments are usually made with a fixed investment horizon, typically ranging from four to ten years, at which point the equity fund hopes to profitably exit the investment. Exit strategies include IPOs and sale of the business to another equity fund or strategic buyer.

Roboze, Italy - final recipient story

Roboze is an ambitious growing company from Southern Italy that is shaping a worldwide 'manufacturing as a service' network. Roboze specialist technology, enables the production of high volume end use parts for the most extreme applications in energy, electrical mobility, defence and other precision manufacturing industries. Roboze has operations in 25 countries in the world.

Supported by a EUR 3 million investment from an ERDF equity financial instrument set up in Italy by the Ministry for Universities and Research, the company has been able to recruit additional staff and further develop its technology.

Together, with its customers and partners, Roboze is at the forefront of a new industrial revolution that is sustainable and future oriented. As well has the ERDF investment, Roboze has attracted investment by other leading VC funds, enabling it to attract top notch industry executives.

For more information, see the fi-compass video case study, ESIF financial instruments in Italy - MIUR.

13 Harvard Business Review, Felix Barber and Michael Goold, The Strategic Secret of Private Equity, 2007.

4.2 Governance structure

A typical equity investment fund is a limited partnership, a type of legal structure available in many EU Member States[14]. Other jurisdictions adopt different legal structures, although the principles of participation are often similar.

The equity investor can either be a 'limited partner' or a 'general partner', based on its role, capital gain and liability within the equity fund.

In a traditional pooled fund structure, all the investors contribute to a single fund which is then invested in a portfolio of companies, with the risk and return shared on a pari-passu basis between all investors across the portfolio.

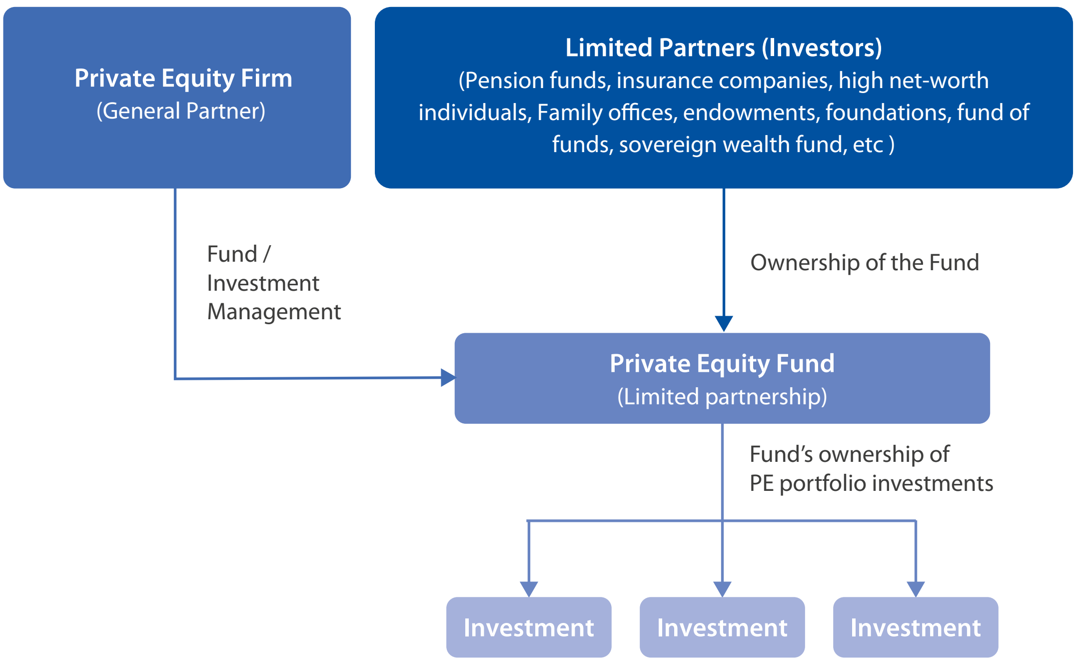
This model is widely used in the market and accounts for most of the capital at work in the industry. However, fund managers have developed their offerings to cater to the changing needs of investors. For example, under a co-investment model, a fund manager may invest in companies alongside other investors through separately managed accounts.

Equity partner types

Limited Partners (LPs) are institutional / high-net-worth investors seeking income and capital gains associated with investing in a fund. These investors do not take part in the fund's active management, and are protected from losses beyond their original investment as well as legal actions taken against the fund.

General Partners (GPs) are in charge of managing the investment and divestment processes within the fund. Unlike the LPs, they can be legally liable for the actions of the fund. GPs earn a management fee for their services, as well as a share of the profits of the divestments made within an equity fund – the so-called 'carried interest'.

Figure 6: Example of PE management structure



14 Removing obstacles to cross-border investments by venture capital funds - Glossary and expert group report.

4.3 Different financing needs throughout the lifecycle

The financing needs of SMEs change throughout their lifecycle and depend on various factors such as their age, the maturity of their products, their growth strategy and their capacity of absorption. Depending on these factors, grants, debt, equity or a combination of these different types of financing can be the more relevant type of funding.

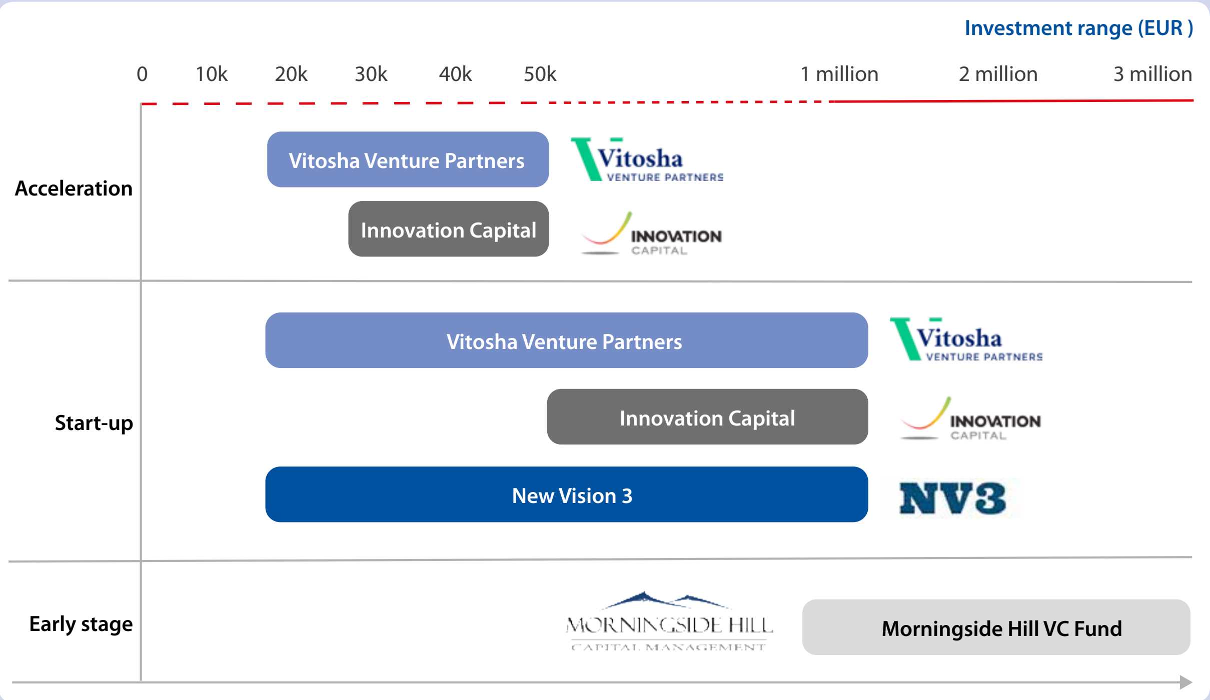
Equity financial instruments in Bulgaria – from Seed financing to Scale-up

Four equity financial instruments set up by the Fund Manager of Financial Instruments in Bulgaria (FMFIB) to support innovation and competitiveness were designed to complement a separate large-scale guarantee instrument to support lending to SMEs that had been established under the SME Initiative. The financial instruments aim to provide equity and quasi-equity investment to both start-up and growing businesses.

As a result the FMFIB financial instruments seek to provide equity and quasi-equity investment to support new business ideas, start-ups and early stage companies, with the VC Fund providing growing companies seeking to expand with access to additional investment. Figure 15 shows how the financial instruments ensure that support is available to Bulgarian companies at all stages of their business life-cycle.

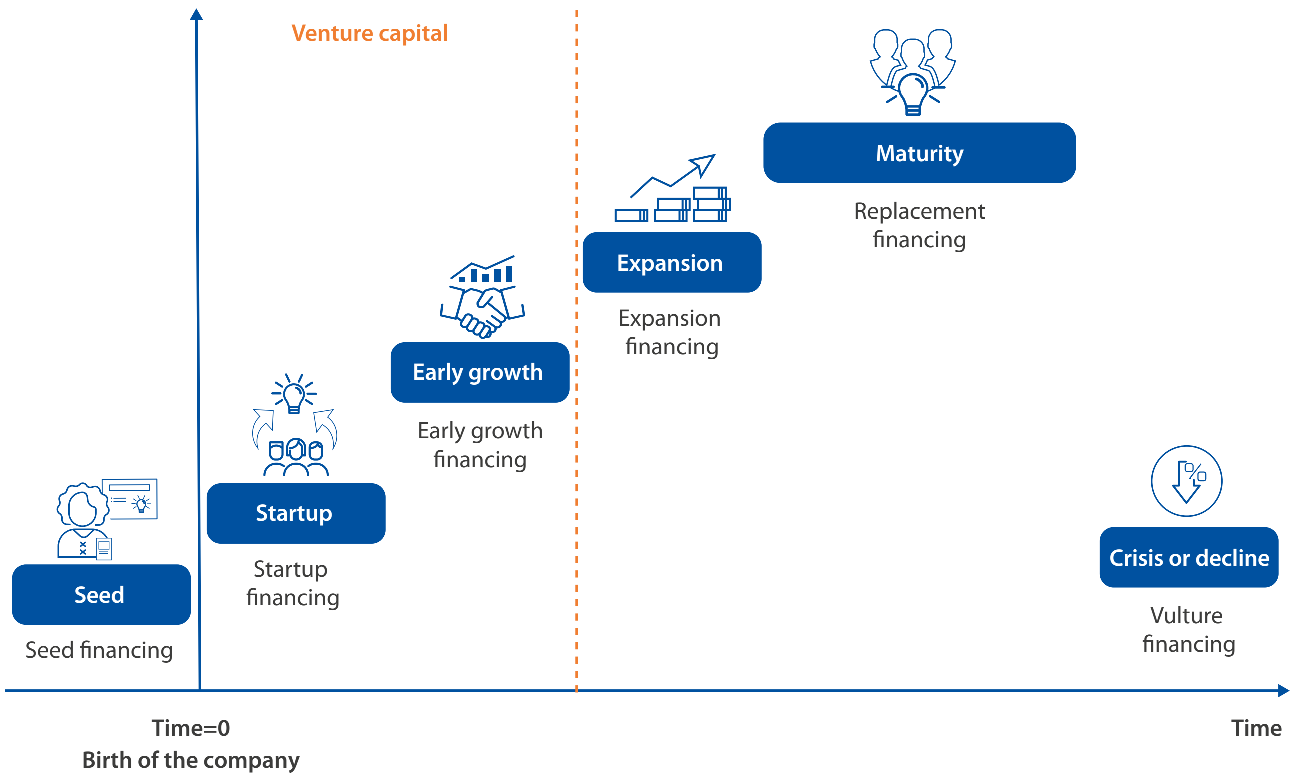
A feature of the FMFIB 'Innovation and Competitiveness' financial instruments, is the overlap of the Investment Strategies between the financial instruments with several different funds targeting investments in similar types of businesses. This results in greater flexibility of the investment approach implemented by the fund managers but also allows for a degree of competition between the different funds, ensuring financing is made available at the most advantageous terms for the target companies. It also allows market specialisation, with different fund managers targeting SMEs in different sectors. For example, the two sub-funds managed by Vitosha Venture Partners are specifically focused on SMEs in the technology sector whereas Innovation Capital and New Vision 3 manage funds targeted at all types of SME with growth potential.

For more information, see the fi-compass case study, FMFIB: Fund Manager of Financial Instruments in Bulgaria – a multi-sector fund of funds.

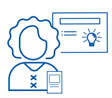


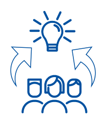
The types of equity investment normally depend on the stage of a company's development (new vs. mature) and on the investment model (co-investor in the fund portfolio or in individual investments, on a deal-by-deal basis). Investments are often described by the relevant phase, namely Seed, Start-up, Early Growth, Expansion, Mature age, and Crisis or Decline, as it is shown in Figure 7 below.

Figure 7: Business lifecycle and equity investment types[15]

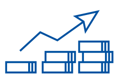


Each of these stages can be linked to a different category of equity investment, different market and different risk-return profile, as follows:


Seed: the first phase of the business life-cycle, when the founding entrepreneurs start to create and develop the business idea. The corresponding equity investment is **seed financing**.


Start-up: this phase entails the concrete outset of business activities. For this phase, the equity investment is called **start-up financing**.


Early Growth: also known among equity practitioners as 'the financing of the day after', this is the stage when a company begins to grow. The equity investment is the **early growth financing**.


Expansion: as the name suggest, this phase entails a company's sales growing steadily and consistently. The corresponding equity investment is called **expansion financing**.

Normally, equity investors invest in companies that are in any of the first four phases.


Maturity: after growing at a rapid pace in the Expansion, the rate of sales stabilizes in this phase. The equity investment is called **replacement financing**.

15 Stefano Caselli and Giulia Negri, Private Equity and Venture Capital in Europe. Markets, Techniques, and Deals, Academic Press, 2nd ed. (3 Jan 2018).

4.4 Investment rounds

As a business progresses through the different stages of its development, it raises investment through a succession of funding rounds.

The goal of a company seeking equity financing is to identify and attract the right investors to provide investment capital in the business. Preparation is crucial for securing a successful investment round, an activity that is often time-consuming and effort-intensive for any company in its development, start-up or early growth stage. To achieve a positive outcome of a funding round, companies must identify clear funding objectives, build up their business case in a coherent and concise way, and outline the reasoning behind their choices. This in turn facilitates the identification of investors to target and to clarify what their requirements are in terms of investment[16].

For potential equity investors, before any round of funding begins, a valuation of the company is carried out. Assessments are made from several different factors, including management, proven track record, market size and risk. One of the key distinctions between funding rounds has to do with the valuation of the business, as well as its maturity level and growth prospects. In turn, these factors impact the types of investors likely to get involved and the reasons why the company may be seeking new capital.

Generally speaking, the equity fundraising process follows three stages[17], namely:

- **Pre-offering** (before approaching investors): in this phase, the company should first clearly define its desired funding strategy and its terms and conditions. It should research, document and project accurately key business facts and figures, as investors will naturally evaluate market potential, business model, marketing strategy, budgets, etc. in the offering stage. The company should then find the right investors, potentially getting support from a financial advisors, and eventually create a compelling pitch to present to these potential investors.
- **Offering** (liaising with investors): this step of the equity fundraising process is often referred to as 'presentation roadshow'. At this stage, interested investors will normally want to carry out due diligence on the business.
- **Closing** (securing partnership with investors).

Typically each funding round is given a letter, such as A, B, C, etc. to signal that each round follows another. The letter identifies which number of rounds a company is on – e.g. "B Round" would entail the second round of funding a company has had. The type of funding round also depends on the type of shares are being offered, such as ordinary or preferred shares.

4.4.1 Seed and angel rounds

The seed round usually happens when a company is at the initial idea stage, or once the founder has a prototype or proof of concept, as well as some kind of sign that a demand exists for the good or service that could be marketed. An angel round often occurs when a company is just launching, if not before. Most likely, such a company would require an investment to support its business because it probably would not be generating a sufficient cash flow to cover all the day-to-day operating costs. Seed rounds and angel rounds may sometime merge, generating a hybrid of the two.

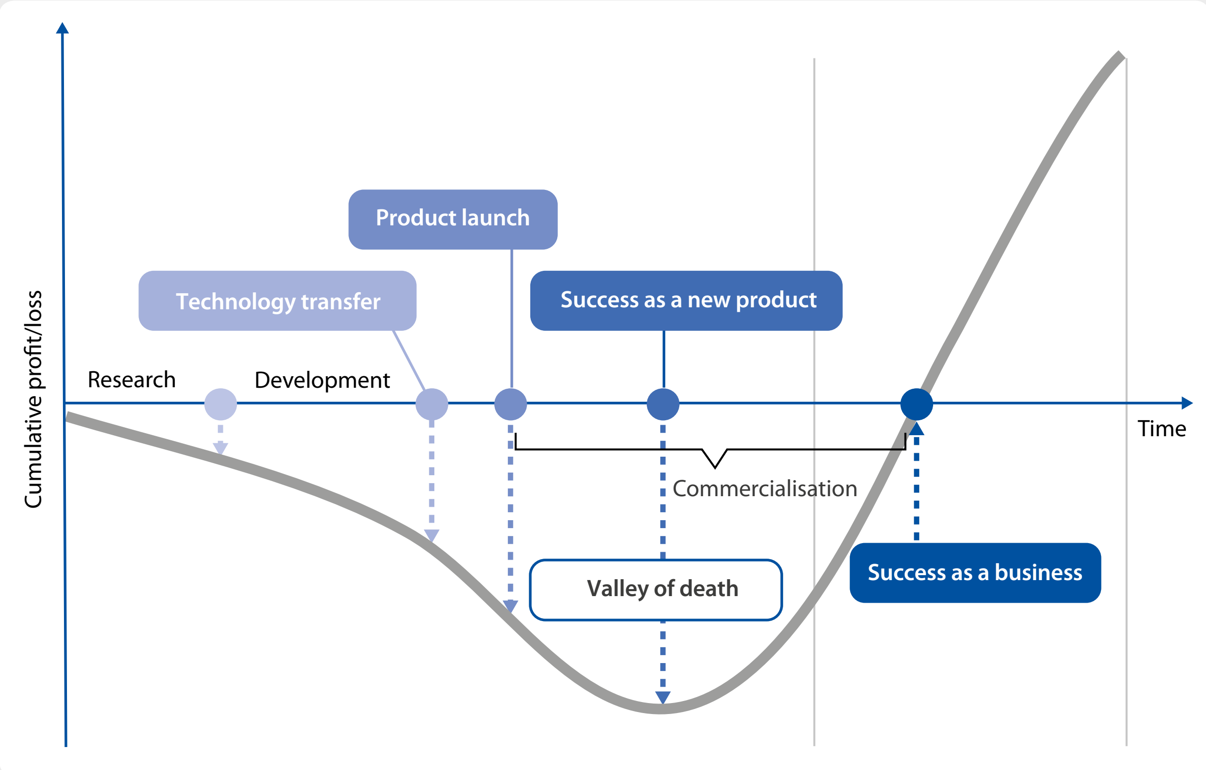
16 https://insights.nordea.com/en/business/prepare-for-a-funding-round/
17 https://medium.com/swlh/how-to-prepare-your-company-for-its-seed-round-829e24304666

Seed and angel investment rounds normally include a consistent share of equity funding originating from friends and relatives. Nevertheless, it can also include money from angel and seed investors who are focused on early-stage companies. It should be also noted that at this very risky and complex stage, funding for new ventures and start-ups is often made available through national and/or EU grant and/or financial instrument programmes.

Typically, investors provide smaller amounts in exchange for equity, because the company will have little or no track record and the risk is higher than for a more established company.

The Death Valley Curve

The Death Valley Curve describes the time span from when a start-up receives an initial capital contribution, to when it begins generating revenues. During this window, the company depletes the initial equity capital provided by its shareholders and may face challenges to raise additional financing since its business model has not yet been proven. The term, commonly used in the PE/VC jargon, originates from the shape of a start-up company's cash flow burn when plotted on a graph.



The Death Valley Curve proves extremely challenging for most start-up companies because several expenses (e.g. renting office space, paying employees, marketing, R&D, etc.) must be borne before a new product or service can begin generating revenue.

Generally speaking, the longer the Death Valley Curve, the more difficult it can be for a company to invest in growth initiatives and begin scaling its business – and the more likely it is that the company will fail prematurely.

Surviving the Death Valley Curve marks a significant milestone in the life of a start-up, signalling to investors that the company has survived its start-up phase and stands a better chance of reaching maturity.

4.4.2 Series A Round

As with the previous round, investing at this stage is usually regarded as high risk since the company is still at the start-up stage with no track record and a lot to prove. Following the issuance of share options by the company (usually to founders and employees), it will often offer a Series A round of shares in return for funding.

Business Angels may be interested, but venture capitalists may also invest at this stage. Business Angels normally invest their own capital and may be often high net worth individuals. VCs and other institutional investors tend to invest other peoples' money, thus they usually only invest in companies with a proven track record to reduce their risk.

4.4.3 Series B Round

Series B rounds are the second round of funding by equity investors. By this stage, companies will likely have a higher valuation than in previous phases as well as a track record, thus decreasing the investment risk. This implies, in turn, that the cost to invest will be higher.

At this stage, investors will seek to identify signs of growth in revenue, consumers/users, and product/service success.

4.4.4 Series C Round

Typically, a Series C round is required when a company is ready to go for rapid growth. At this stage, a company usually:

- Has become a proven success in its market;
- May wish to make acquisitions of competitors;
- Increases its market share;
- Scales up or develops new products or services.

Zotcar, collaborative car rental in La Réunion - final recipient story

Zotcar has developed an innovative digital and collaborative car rental solution tailored to the Reunionese market. Instead of parking their car at the airport, travellers can offer their vehicle for rental whilst they are away. The company manages the rentals and the car owner receives 50% of each rental.

The business was incubated in the Technopole de La Réunion. Thereafter, Zotcar moved into NEXA, a second incubator who introduced him to the fund manager of the ERDF venture capital fund. Despite being an island, La Réunion benefits from a vibrant networking activity, including regular events such as 'start-up weekends' where entrepreneurs compete for prizes based on their business ideas.

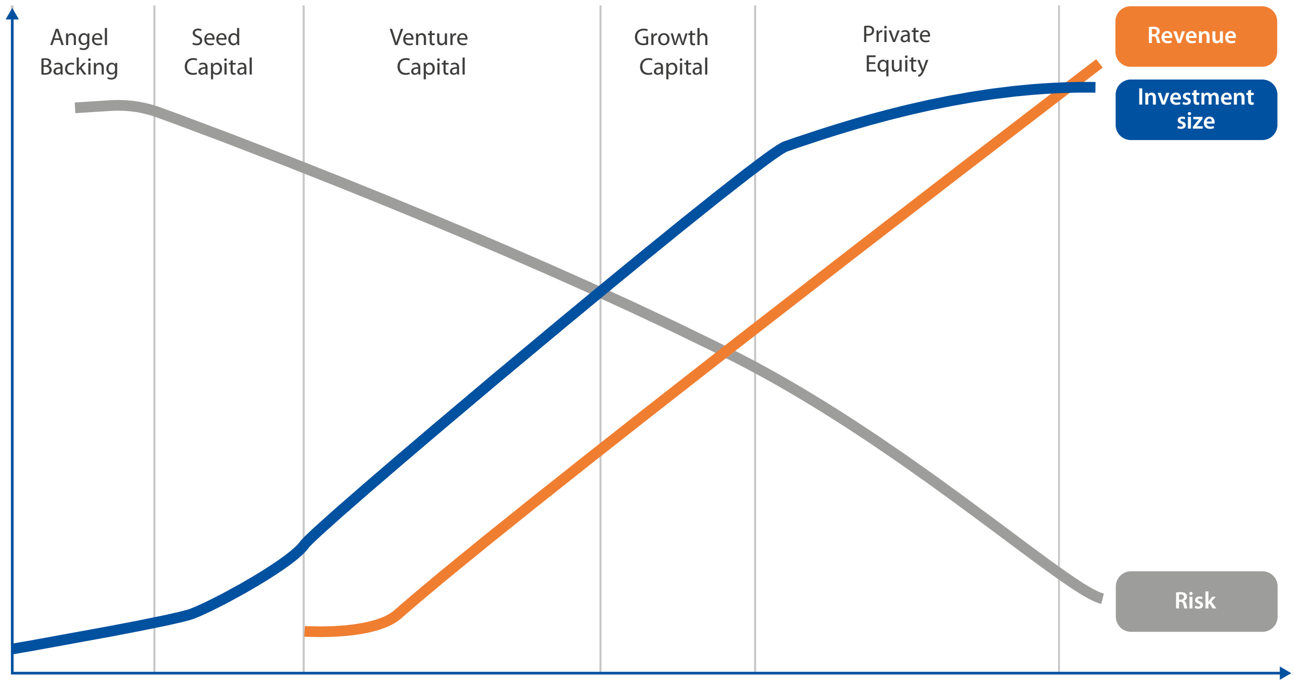
In June 2019, the start-up secured a EUR 540k equity investment from Essor PME La Réunion, an ERDF equity financial instrument set up to finance any enterprises in the Island of La Réunion. The company uses the investment to strengthen its R&D and operational team, acquire additional equipment, as well as replicate its economic model outside La Réunion.

For more information please read the fi-compass blog post, Zotcar: the leading private car rental in La Réunion.

4.5 Venture capital vs. Private equity

Equity investment as a generic asset class term encompasses a multitude of different investment strategies, as Figure 8 shows. However, when used at the investment level there are key differences between venture capital (VC) and private equity (PE) investments; foremost of which is the maturity of the portfolio companies in which they invest.

Figure 8: Differences between venture capital and private equity



Venture capital investments are characterized by providing capital to young, start-up, or early stage businesses that are or have the potential to grow quickly. VC investments are usually made through iterative rounds of financing with additional capital provided as growth/return on investment is achieved. PE investments are typically in larger, more mature businesses with proven financial record. Further differentiating traits include:

- Risk: VC investments are higher risk than PE, due to the unproven nature of the businesses invested in.
- Ownership stake: VC firms typically acquire minority stakes whereas PE firms acquire controlling stakes.
- Structure: VC firms often make pure equity investments whereas PE firms use equity and debt.
- Investment amount: PE investments are typically larger than VC investments as they acquire ownership stakes in more mature businesses.
- Value creation: VC investments rely on company growth and valuation of the business increasing, whereas PE investments rely on both growth and financial engineering including multiple expansion, debt settlement, cash generation, and so on.

As the industry has grown and firms have broadened their offerings for investors, lines have blurred. Some VC firms have moved into expansion and growth areas, and some firms also provide debt financing (venture debt) to pre-revenue companies. Some traditional PE firms are also moving down the chain, raising dedicated funds focused on early-stage start-up investments.

The current EU SME definition[18] is also an important factor in the equity ecosystem. Only companies that do not have a majority or controlling investment from a VC firm are able qualify for SME status. For an equity-backed portfolio company, SME status is important as it allows the firm to be eligible for EU and government support programmes. Moreover, the regulator is typically trying to make it easier for SMEs to operate by either providing them with regulatory exemptions or by placing fewer requirements on the investors that back them. For example, the Alternative Investment Fund Managers Directive (AIFMD[19] provides an exemption for SMEs from certain disclosure requirements[20].

4.6 Exit strategies

When the time is right, equity investment managers liquidate or dispose of their investment portfolios: this last crucial step in the equity investment process is called 'exit strategy'. The successful exit of an investment is key to meeting the objectives of an equity investor to secure a financial return through the support of a company with high innovation potential, at the same time enabling the company to realise its potential and consolidate its economic and financial viability.

Exit can significantly influence the final return on investment and, if managed correctly, can generate attractive returns for professional investors who ultimately support equity funds, such as pension funds and insurance companies that use the proceeds to pay for the pensions of millions of European citizens.

When deciding to exit, equity funds take one of four routes:

- **Total exit** from the business, through a trade sale to another buyer, leveraged buyout (LBO) from another PE firm, or a share buyback.
- **Partial exits**, such as through a private placement, where another investor buys a piece of the business or corporate restructuring, where outside investors get involved and increase their position in the business by partially buying out the equity fund. Corporate venturing, where management increases its ownership in the company, is a further option for a partial exit.
- A **flotation or IPO** is a hybrid strategy of both total and partial exit, involving the company being listed on a public stock exchange. Typically, only a fraction of a company is sold in an IPO, ranging from 25% to 50% of the business. When the company is listed and publicly traded, equity funds exit the company by slowly releasing their remaining ownership stake in the business.
- **Liquidation and sale of assets** provides an exit strategy in the event that the company has failed and is defaulting, providing a mechanism for realising the value of underlying assets of the company.

18 COMMISSION RECOMMENDATION of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (2003/361/E)

19 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 Text with EEA relevance.

20 https://www.investeurope.eu/policy/key-policy-areas/sme-definition/.

SAS JEREMIE LR – securing a successful exit of investment in innovative technology company in Occitanie, France

The ERDF equity fund was set up in 2013 under the JEREMIE initiative by the managing authority for Languedoc-Roussillon, now part of the Occitanie region of France. Managed by equity fund manager SORIDEC, SAS JEREMIE Languedoc-Roussillon is a co-investment venture capital vehicle which takes equity in technology-based small and medium-sized enterprises (SMEs) active in different sectors inter alia, health, information technology, robotics and services for the environmental and manufacturing sectors.

In 2013, the financial instrument invested EUR 650k in a technology company Matooma that was developing SIM cards for use in connection with 'Internet of Things' technology. In 2019, the equity fund was able to exit the investment at a significant profit following the Trade Sale of the company to a larger organisation.

Speaking in 2019, Bertrand Religieux, board member of the fund manager IRDI Soridec, remembers very well the first time he met the company. "We met Matooma founders in 2013 at the early beginning of the company.

We were quickly convinced that the product market fit was very good, as the CEO knew all about the Internet of Things (IoT).

We decided to lead the first financing round and then invested EUR 650k of our funds on a EUR 1 million equity round". At the time, the company had around 10 employees. Today, the company employs about 50 people and has increased its turnover by a factor of ten. "We were proud to fuel this outstanding project and team and help them in their winning strategy to establish Matooma as a European leader in their market," adds Religieux.

Under the terms of the sale, the company will continue to develop and grow from its base in Montpelier in the South of France. The sale by the ERDF equity fund of its stake in the company has also resulted in a significant return on the original investment. These resources can now be reinvested to support new enterprises in the region, highlighting how the revolving nature of EU shared management funds financial instruments delivers real added value to managing authorities.

For further information on the Matooma exit please read our blog post, Matooma: a European success story backed by an ERDF financial instrument.

For more information about financial instruments in the Occitanie region of France please see the fi-compass case studies, FOSTER TPE-PME-AGRI a new generation multi-sector fund of funds, Occitanie, France and SAS JEREMIE Languedoc-Roussillon.

4.7 Risk management by funds

Equity investment has earned its popularity amongst investors because of its track record of high returns, which is not easily achieved through more traditional investment options. However, these high potential yields result from a different risk profile which is generally significantly higher than other asset classes due to the nature of its underlying investments, i.e. start-up or early-stage companies whose growth is only 'potential', especially those that are still in their early stages. As with other investment asset classes, risk and reward are inextricably entwined – the reward for taking on risk is the potential for a greater investment return.

For investors new to equity investment, this 'capital risk' can be a barrier preventing commitment of resources due to concerns that there is no guarantee that the small companies in which equity funds invest will grow at all. Failure is much more common among start-up companies, with only one or two out of a dozen making a significant return for the business itself and its investors. An ineffective management team, a new product launch that fails, or a promising new technology that becomes obsolete due to competition can lead to significant losses for equity investors. Although other asset classes carry market risk, default risk is lower with more mature companies.

Nevertheless, despite the higher risk of failure, equity investment funds offer investors a sustainable investment model offering long term returns to investors. This is achieved through the diversification of portfolio in which losses resulting from the failure of portfolio companies are off-set by high rates of return from successful companies in the portfolio.

The impact of diversification on risk

Diversification reduces overall risk while increasing the potential for overall return. The degree of diversification of an equity investor's portfolio influences the risk profile significantly and should be taken into account when measuring long-term risks for portfolios of funds. However, investors should also be aware that short- and medium-term cash flows can become highly correlated during market downturns.

The continuous monitoring and management of diversification is an important component of an investor's risk management framework. Experience shows that diversification over vintage years is one of the most effective ways of mitigating risks. Others are stages (e.g. buyouts, mezzanine, VC), and industries (e.g. ICT, life sciences).

Diversification reduces the long-term risk of an equity portfolio and for large portfolios is expected to increase the median returns (although it also reduces the potential for extraordinary returns). However, experience obtained over several market cycles shows that cash flows tend to become highly correlated during market downturns. Therefore, even funds following different strategies or with exposure to different geographies can, in extreme situations, become subject to similar degrees of liquidity risk in the short- and medium-term.

5. Equity financial instruments: ERDF perspective

ERDF managing authorities and their stakeholders have successfully used equity financial instruments to address financing gaps for potentially high growth companies in their regions. Resources from ERDF Operational Programmes and other public funds have been deployed through financial instruments to address a range of different needs including:

- Supporting the creation of an equity investment ecosystem in the region for the first time – attracting investors, fund managers and professionals to create venture capital and private equity funds. This in turn helps to generate additional demand, stimulating entrepreneurial activity in the region;
- Scaling up the existing equity investment market in the region, using ERDF resources to attract additional private sector investors and extending equity investment into new markets and territories; and
- Boosting innovation pathways, providing start-ups with access to finance in succession to or in combination with grant support programmes for entrepreneurs.

EU shared management funds provide an opportunity to address the current deficit of equity finance both at an EU level and individual Member States. Through well designed and targeted financial instruments, equity investment operations can play an important role in stimulating economic and social development in Member States, adding value to the economy, creating employment and delivering new services/products both inside the EU and beyond.

As a general rule, healthier and sustainable companies invest more in innovation, create more jobs and contribute more to economic growth. As a result, equity investment plays an important role in the prosperity and competitiveness of the European Union.

Ex-ante assessment for financial instruments, Sweden

In 2014/15 the managing authority of Sweden undertook an ex-ante assessment into the use of financial instruments to increase the level of venture capital investment available in the country to support SMEs.

The study, which involved significant engagement with the market recommended the creation of nine financial instruments, eight regional venture capital funds and a national CO_2 fund aiming to support the shift to a low carbon economy in the country. A fund of funds was also recommended as a way to manage the implementation of the financial instruments.

For further information on the ex-ante assessment process undertaken by the managing authority read the fi-compass case study, Ex-ante assessment for financial instruments, Sweden.

5.1 Policy framework for ERDF equity financial instruments

ERDF aims to strengthen economic, social and territorial cohesion in the European Union by correcting imbalances between its regions. The new ERDF Regulation (Regulation EU 2021/1058) for the 2021-2027 period entered into force on 1 July 2021 and has the objective to support the following five priorities through its investments:

- A Smarter Europe, through innovation, digitisation, economic transformation and support to small and medium-sized businesses;
- A Greener, carbon free Europe, implementing the Paris Agreement and investing in energy transition, renewables and the fight against climate change;
- A more Connected Europe, with strategic transport and digital networks;
- A more Social Europe, delivering on the European Pillar of Social Rights and supporting quality employment, education, skills, social inclusion and equal access to healthcare;
- A Europe closer to citizens, by supporting locally-led development strategies and sustainable urban development across the EU.

The majority of the investment will target the first two priority areas and Cohesion Policy will also continue to promote job creation in SMEs, provide support to the health sector, improve preparedness related to unexpected emergencies, and fully develop the economic potential of tourism and culture sectors.

With the inclusion of an additional EUR 47.5 billion from the Next Generation EU fund, the EU has allocated more than EUR 370 billion to its economic, social and territorial cohesion policies for the 2021-2027 period. The package of Cohesion Policy legislation also includes the new regulation on the Just Transition Fund (Regulation EU 2021/1056) which is a key element of the European Green Deal and the first pillar of the Just Transition Mechanism (JTM). It aims to alleviate the social and economic costs resulting from the transition towards a climate-neutral economy, through a wide range of activities directed mainly at diversifying the economic activity and helping people adapt in a changing labour market.

Financial instruments (including equity) remain an important tool, supporting investment under the 2021-2027 MFF. ERDF, CF and ESF+ shared management resources will support investment in jobs and growth through support for research and innovation, digital transition, the European Green Deal, integrated and sustainable development and the promotion of social rights. With the enhanced flexibility for use of financial instruments under the new Common Provisions Regulation (Regulation EU 2021/1060), including in combination with grant, it is expected that Member States will increasingly use equity investments (as well as guarantee and loan) for the implementation of their Operational Programmes.

5.2 Target sectors of ERDF equity financial instruments

5.2.1 Start-ups

Start-ups are key to Europe's future economy and society. They are crucial players to achieve the goals of the EU Green Deal, as well as Member States' research, development and innovation (RDI) agendas, and digital transition. This class of enterprises is important in any innovation ecosystem aiming to deliver breakthroughs to the market. Start-ups and scale-ups are also key in creating new jobs and sustainable European prosperity[21].

Despite many innovative and promising start-ups in EU Member States, very often these companies remain small or, after scale-up relocate elsewhere, even outside Europe, to seek investors. Equity financing – potentially in combination with grants – can provide a solid support in closing the funding gap for highly innovative companies, unlock additional private investments and enable them scale up in Europe. Investing in early stage companies through equity can create a virtuous circle that ultimately attracts more investments in the future. Furthermore, its role has become even more important today, as the coronavirus crisis had a very strong impact on many SMEs in the EU, including many innovative start-ups.

VC funding, provides equity investment, support and guidance to start-ups with high-growth potential, indicatively supporting product development, business strategy, go to market and commercialisation. More precisely, VC is the capital injection in an innovative start-up company having a very high potential of growth but facing barriers to accessing traditional funding channels, because of the many uncertainties and risks, as well as lack of collateral[22]. As a condition of its investment, a VC fund may acquire control over certain key decisions of the start-up.

Besides pure financing, venture capital firms also provide technical expertise, business know-how and access to networks for potential partners, team members, and future rounds of funding, ultimately helping start-ups fuel sales, increase productivity, as well as build their corporate infrastructure and distribution system. VC fund managers also provide founders with advice and guidance, as well as making hiring easier and reducing innovative companies' overall risk.

5.2.2 Research and Innovation companies

Europe is a fertile ground for innovation in several sectors, including environmental technologies, sustainable mobility, energy, health, agri-food, aerospace, smart, secure and sustainable communities, etc., given the presence of global tech companies, prevalent world class research institutions and academic excellence. At the same time, traditional financial actors are often averse to funding projects in highly innovative sectors due to the high risks, contributing to creating a market failure hindering the functioning of the EU innovation system, notwithstanding the existence of projects with high potential.

21 European Startup Network, Action Plan to Make Europe the new Global Powerhouse for Startups.
22 https://www.bbva.com/en/we-need-to-eliminate-barriers-for-smes-to-widen-their-funding-sources/.

With its drive towards to innovation, operational improvement and long-term growth, equity plays a critical role in fostering the potential of businesses and entrepreneurial projects in the many fields of innovation. Indeed, equity investment is expanding in this sector, becoming a larger source of capital across buyout, growth, and venture strategies[23].

When addressing businesses in the innovation sector, equity investment funds target researchers and innovators, who are still at the idea formation and research stage. The fund managers are expected to scout universities and RDI centres throughout the country in order to identify business opportunities and support the entrepreneurial ventures of researchers.

In many cases, final recipients are at the very earliest stage of developing their idea into a business. Typically an equity investor will take a stake in an entrepreneurial venture that seeks to commercialise the research projects and activity of aspiring innovators. The size of the investment depends on a number of parameters such as the capital needs of the company, its development stage and its valuation.

In addition to providing capital to help the innovators to launch their product or idea, the equity fund provides the portfolio company with technical and managerial skills, experience, access to new markets and new contacts to help the development of the idea into a business.

5.2.3 Scale-ups

Growth equity capital providers invest in SMEs in their growth phase and larger companies with established businesses and strong sales that have the potential for significant growth in the future – the so-called 'scale-ups'. This class of enterprise often include larger enterprises that have a business plan with dominant focus on R&D and/or innovation.

Energy transition in The Hague

The city of The Hague set up a Holding Fund, HEID which manages two ERDF backed financial instruments known as the ED Fund (which invests in low carbon projects) and the FRED Fund (which supports local entrepreneurs). The two financial instruments have a flexible investment strategy which allows them to respond to specific needs that arise in the City.

One of the early investments made by the ED Fund was an equity investment in the company developing a major geothermal heat station in the City. This support by the ERDF financial instrument enabled the heat station to be safeguarded and, together with further investment, brought into operation. The heat station will provide low carbon heat to over 4 000 homes in the city's southwest neighbourhoods.

Additionally, the City of The Hague has ambitious plans to become carbon neutral by 2030. To achieve this target, over 250 000 homes and 30 000 other buildings must be converted from gas to renewable energy sources. Following the success of its ERDF financial instruments, plans are being developed to use a new generation of financial instruments to mobilise public and private investment and deliver financing at the scale needed to support the Energy Transition and other policy priorities of the city.

23 Invest Europe, Private Equity: Driving European Growth. Policy Priorities 2019-2024.

Equity financing can be attractive to growing companies, providing finance up-front to the entrepreneurs to be used to invest in the growth of the business. The resources are contributed free of interest and/or obligation to make repayments (unlike loan finance). Typically the financial intermediary will hold the equity interest for between five and ten years, after which they will look to realise a return on their investment through the sale of their interest, for example through an Initial Public Offering (IPO) where the shares of the underlying portfolio company are offered to the public after quotation on a stock exchange, or a trade sale, where the business is acquired by a larger company.

At this business growth stage, investors usually support enterprises ready to expand and compete at the international level, by providing financing, networking and professional expertise. Growth capital fund managers have expertise to help companies to expand through export, internationalisation and digitalisation, and many other ways.

5.3 Supporting the growth of an equity ecosystem

The development of the equity industry has helped refine and develop the established framework within which equity investments take place. Different investors and fund types are required to meet the equity needs of companies as they move through the life-cycle of a growing company. Alongside the development of equity funds, ancillary activities including awareness raising, technical support, professional services (such as finance and legal) and entrepreneurial skills need to be nurtured to help create a sustainable 'equity ecosystem'.

What is an equity ecosystem?

In order to establish a sustainable, thriving VC/PE sector in a region it is essential to attract and connect a range of different organisations, resources and expertise. At the heart of a thriving equity ecosystem are **entrepreneurs** seeking to establish innovative enterprises with high growth potential and the investors seeking to finance the growth of these companies. Skilled **fund managers** connect **investors** and entrepreneurs identifying investment opportunities and mobilising capital to SMEs, at the same time directly supporting the growth of their portfolio companies. In addition, wider professional services, including **legal and financial advisors, public sector (including EU level) support, Business Angels and financial institutions** are all important factors that can contribute to the success of a region's VC/PE sector.

The implementation of ERDF equity financial instruments has proved to be a powerful tool for managing authorities seeking to stimulate the development of the equity ecosystem in their region. The selection process for financial intermediaries has resulted in the creation of 'first time teams' of fund managers, often experienced professionals relocating (back) to the country. The set up and implementation of the funds in turn requires support from local professional teams, creating opportunities to boost capacity within advisers to work with equity instruments. As funds are launched, the availability of finance stimulates demand, incentivising entrepreneurial activity and creating opportunities for investors both from inside and outside the managing authority's region.

Figure 9 summarises the different needs and opportunities for the different actors in a thriving equity finance ecosystem. It highlights the complexities of a mature equity ecosystem and the multiple economic and financial activities and stakeholders involved.

Figure 9: Summary of the equity ecosystem

Seed	Start up	Early stage	Expansion	Maturity
1. Concept Prototype 2. Research 3. Project plan 4. Design specification 5. Prototype	Marketing/ sales	Accelerated growth	Growth	Growth, profit
Seed round Grants, goods & services, loans, equity (seed capital)	**First round** Goods & services, loans, equity (start-up capital)	**Second round** Loans, equity (early stage capital)	**Third, fourth, ...** Loans, equity (expansion capital)	**MBO, MBI, IBO, LBO Merger, acquisition and turnaround** Loans, Mezzanine, equity (later stage capital)
Public sector, sponsors, founder & friends & family, banks, business angels, corporate investor, Venture capitalists	Sponsors , founder & friends & family, banks, business angels, corporate investor, Venture capitalists	Management team, corporate investor, Venture capitalists	Management team, banks, mezzanine providers, corporate investor, Venture capitalists, IPO	Public sector, management team, banks, mezzanine providers, corporate investor, Venture capitalists, institutional Investors, IPO
License or sale	(Trade) sale	(Trade) sale	(Trade) sale, IPO, buy out	(Trade) sale, IPO, buy out

- Company's life cycle
- Finance
- Financiers
- Exit

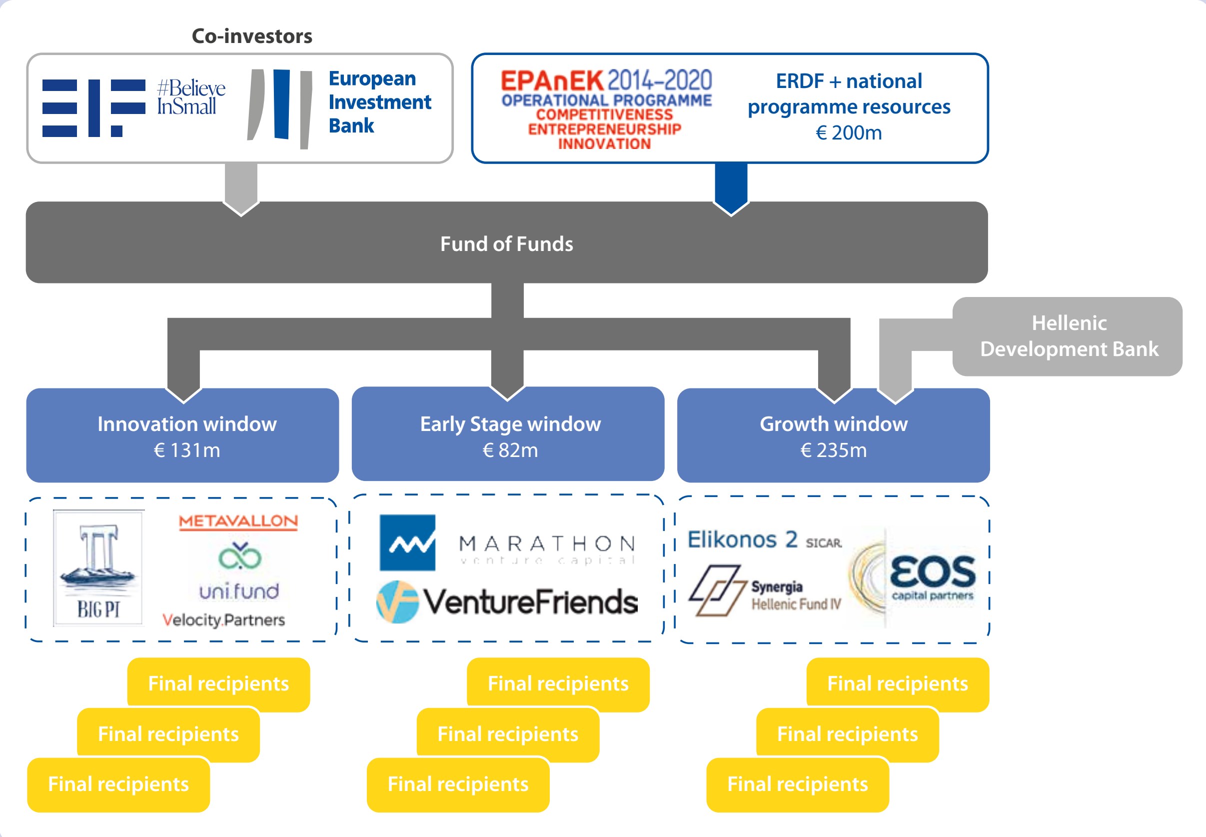
M&A= Mergers & acquisitions
IPO= Initial public offering
MBO= Management buy out
MBI= Management buy in
IBO= Investor buy out
LBO= Leveraged buy out

Experience gained in EU Member States over previous programming periods have allowed lessons to be learned and best practice to be developed regarding the use of ERDF financial instruments. The importance of the initial design of the instruments is a key factor, ensuring that flexibilities such as asymmetric risk/return distributions and layered funds are used to attract co-investment where the instrument is supporting high risk areas.

EquiFund, Greece – creating an equity investment ecosystem in Greece

EquiFund is an ERDF fund of funds in Greece with an overall volume of EUR 448 million and nine equity financial instruments. Its mission is to provide access to equity financing to companies that are established or have a branch in Greece and to accelerate the development of venture capital (VC) and private equity (PE) in Greece. It is co-financed by the European Regional Development Fund (ERDF), national funds and resources from the European Investment Bank (EIB) and the European Investment Fund (EIF). The MA entrusted the EIF to act as fund of funds manager of EquiFund, which selected the fund managers to manage the funds within three investment windows: the 'Innovation window', the 'Early Stage window' and the 'Growth Stage window'.

Design of EquiFund, Greece



One of the key strategic objectives of the Greek government in establishing EquiFund was to stimulate the growth of the Venture Capital/Private Equity market in Greece. To do so it was necessary to cultivate the development of an 'ecosystem' of a range different types of organisations that are needed to create a dynamic and thriving sector in the country.

All but one of the nine fund manager teams selected to manage EquiFund financial instruments are so called 'first time teams'. This has created opportunities for recruiting additional fund management expertise into the market, attracting in some cases specialists to return to Greece, enhancing the capacity within the country. The financial intermediaries have, in turn attracted significant interest from private investors. Over 150 investors both institutional and non-institutional have been attracted to participate in the different EquiFund financial instruments.

The professional sector supporting the VC/PE sector has also grown, together with the awareness within the business community of the potential for equity financing to support the growth of businesses. The communication campaign of the fund of funds, augmented by activities of the individual fund managers has been critical to the success of this activity.

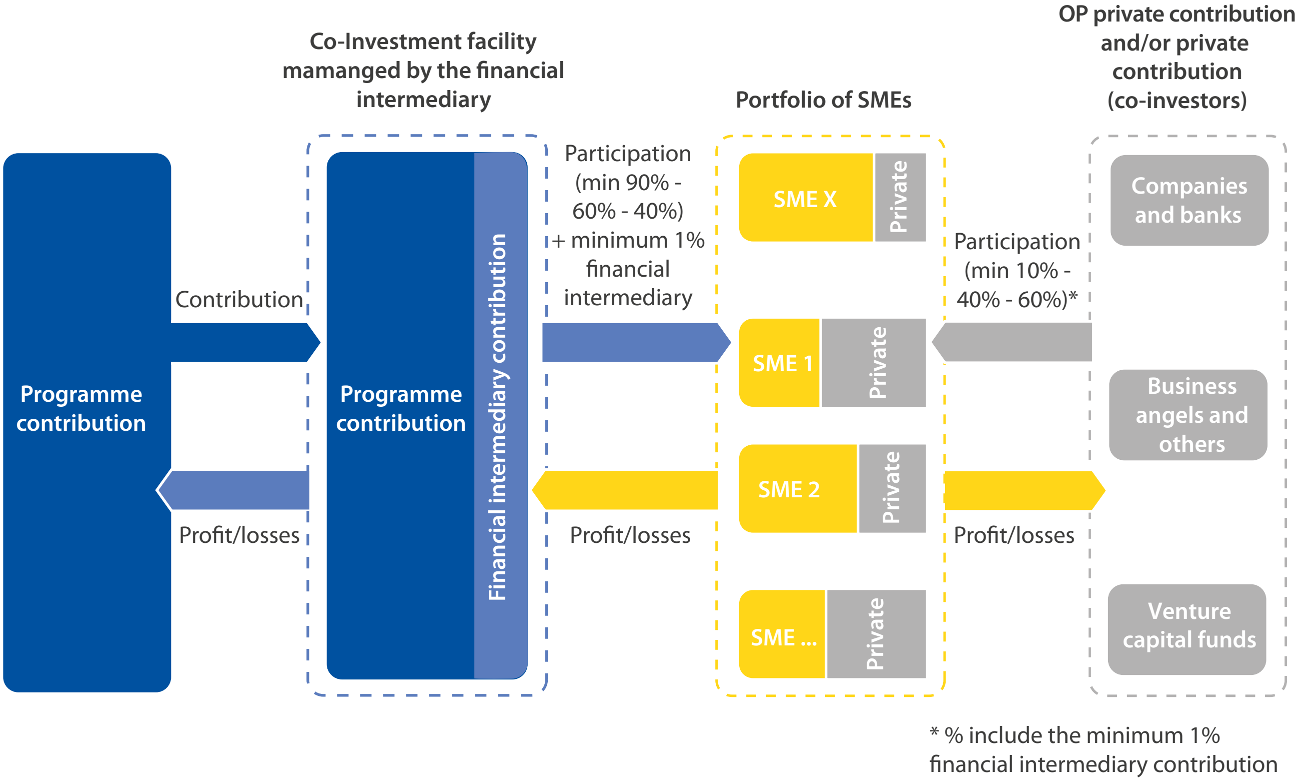
For more information read the fi-compass case study, Equity financing for SMEs in Greece – EquiFund.

Equally, care is needed to avoid crowding out potential private sector capital. ERDF financial instruments should ensure that the public resources are used to the extent necessary to stimulate the market and attract investors, fund managers and other professionals to the region. ERDF equity investments should seek to promote a diverse market with multiple funds in operation. In particular ERDF backed financial instruments should not grow to the extent that they crowd out other market actors, thereby destroying value both of the equity ecosystem and of enterprises. This can happen, for example where a public equity fund creates a large portfolio of companies acting as sole financier without providing added value through business support.

5.4 The 'off the shelf' Co-investment Fund model

The off the shelf model co-investment facility published by the European Commission in 2016[24] has proved to be a successful framework for ERDF equity funds in the 2014-2020 programming period.

Figure 10: Schematic representation of the co-investment facility



The financial instrument is designed to support SMEs at the different stages of the life-cycle depending on the financing needs in the region as identified in the ex-ante assessment. ERDF resources are committed to the financial intermediary who manages it (together with its own financial commitment) with a view to investing in a portfolio of SMEs.

The Co-investment model relies on the ERDF resources to crowd in other investors to invest alongside the financial instrument in growing businesses, either through the fund manager or through direct investment in the company (as part of a fundraising round, for example).

24 Commission Implementing Regulation (EU) 2016/1157 of 11 July 2016 amending Implementing Regulation (EU) No 964/2014 as regards standard terms and conditions for financial instruments for a co-investment facility and for an urban development fund

One of the features of the off the shelf model is the alignment of co-investment ratios with the requirements of Art 21 of the General Block Exemption Regulation[25] (GBER) (Risk Financing). Minimum private sector participation varies depending on the stage of the life cycle of the target company as follows:

- Companies at the seed and start-up phases, defined in Art 21 GBER eligible undertakings prior to their first commercial sale on any market must have a minimum private sector participation of 10%;
- Investments in early stage and expansion companies, defined in Art 21 GBER eligible undertakings operating in any market for less than 7 years following their first commercial sale have a minimum private participation of 40%; and
- For mature companies, defined in Art 21 GBER as eligible undertakings requiring an initial risk finance investment which, based on a business plan prepared in view of entering a new product or geographic market, is higher than 50 % of their average annual turnover in the preceding 5 years, or for follow-on investments in eligible undertakings after the 7-year period of the first commercial sale investments by the co-investment facility require a 60 % private sector participation in the fundraising.

This Investment Strategy is tailored to the requirements of GBER, enabling the financial instrument to take advantage of the State aid flexibilities within the Block Exemption. Similar models can be developed based on the market-conform model where the ERDF financed investments are made on pari-passu terms with market investors. In such a scenario, other investment ratios may be applied, depending on the specific needs of the market sector being targeted by the financial instrument.

25 Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty

EquiFund, Greece – success stories

The EquiFund financial instruments in Greece have already demonstrated the potential of ESIF backed equity funds to support high growth companies and deliver financial returns for reinvestment. Successful trade sales have been announced that have enabled EquiFund financial intermediaries to exit their investments, generating financial returns that can be reinvested to support the growth and expansion of additional companies. Notable early exits include:

Think Silicon is a company based in Patras Greece that specialises in high-performance, ultra-low-power graphic processing units (GPUs) and display controller technology for wearables, Internet of Things, home appliances and industrial automation displays. An EquiFund financial intermediary was lead investor in a fundraising that took place in 2019. The company used the investment to strengthen its team, accelerate product development and strengthen its sales and business activities. Within 12 months of the investment, the company was acquired by Applied Materials, a NASDAQ listed company and one of Fortune's 'World's Most Admired Companies'. Following the acquisition, Think Silicon's executive team and staff will continue to be based in Greece, further developing their products and serving their growing international client base.

Instashop is an on-demand grocery hub. Headquartered in Dubai, the company is the leading online marketplace for supermarkets, pharmacies, pet shops & other businesses in the Middle East. It is an easy way to shop daily needs in just a few clicks straight from the mobile. The order is delivered from a trusted local shop to home or office in about 60 minutes depending on location.

In August 2020, the company announced its acquisition by the global leader Delivery Hero. The financial intermediary VentureFriends supported the company's growth during successive funding rounds, enabling the company, which has its tech hub in Greece, to scale-up to become a market leader in the region. The acquisition for USD 360 million is a record exit for a Greek start-up, returning significant funds to VentureFriends who will now be able to use the resources to re-invest in Greek SMEs in the future.

Those two stories are showing the power of ESIF equity investments, and how ERDF resources can help nurture future successful companies. A patient approach when investing capital demonstrates that a managing authority can provide long term support to its SMEs to address market gaps for financing high growth businesses, which then create long term value for the benefit of the local economy.

For more information read the fi-compass case study, Equity financing for SMEs in Greece – EquiFund and the Blog article EquiFund, Greece: the power of equity financial instruments.

6. Further information

Set out below is a list of fi-compass resources that can be found on our fi-compass website (www.fi-compass.eu) and provide additional information on equity financial instruments established with EU shared management funds.

Factsheets, brochures and studies

Gap analysis for small and medium-sized enterprises financing in the European Union
Quasi-equity finance for SMEs - A fi-compass model financial instrument
Financial instrument products
Factsheet (The Cohesion Fund (CF))
Factsheet (The European Regional Development Fund (ERDF))

Case studies

La Financière Région Réunion - Financial instruments to support SMEs, France
Equity financing for SMEs in Greece – EquiFund
FMFIB: Fund Manager of Financial Instruments in Bulgaria – a multi-sector fund of funds
Case study (Ex-ante assessment for financial instruments, Sweden)
Case study (CAP Troisième Révolution Industrielle Nord-Pas de Calais, France)
Case study (ERDF Languedoc-Roussillon)
FOSTER TPE-PME-AGRI a new generation multi-sector fund of funds, Occitanie, France
Case study (Innovation Fund, East Netherlands)
Case study (Ex-ante assessment for financial instruments in Scotland)
Case study (JEREMIE Acceleration and Seed instrument in Bulgaria)

Videos

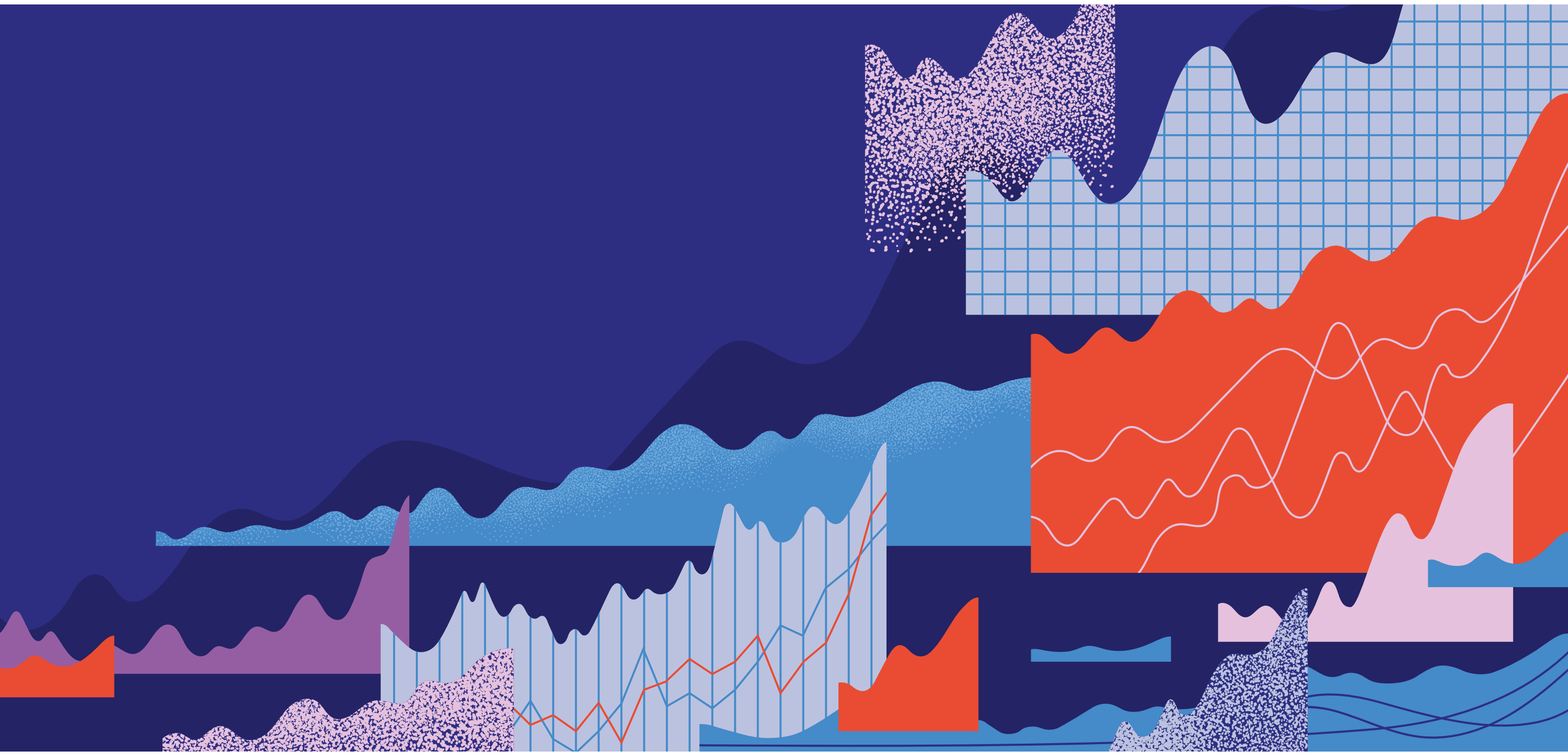
Supporting innovative start-ups – ERDF co-financed Venture Capital (VC) investments in Berlin
ERDF financial instruments in action: sustainable food from insects
Equity financing for SMEs in Greece
Financial instruments in action: renewable energy transition – The Hague
ESIF financial instruments in Italy - MIUR
The ESIF Fund of funds, FOSTER TPE-PME, Occitanie
ESIF equity financial instruments in Northern Ireland
Financial instruments products

Blog

A tech start-up heading for the Big League - Roboze
Nasekomo: sustainable food from insects
EquiFund, Greece: the power of equity financial instruments
Zotcar: the leading private car rental in La Réunion
Matooma: a European success story backed by an ERDF financial instrument
Energy transition in The Hague

Podcast

Episode 5: Equity financial instruments help technology-based SMEs grow and thrive



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