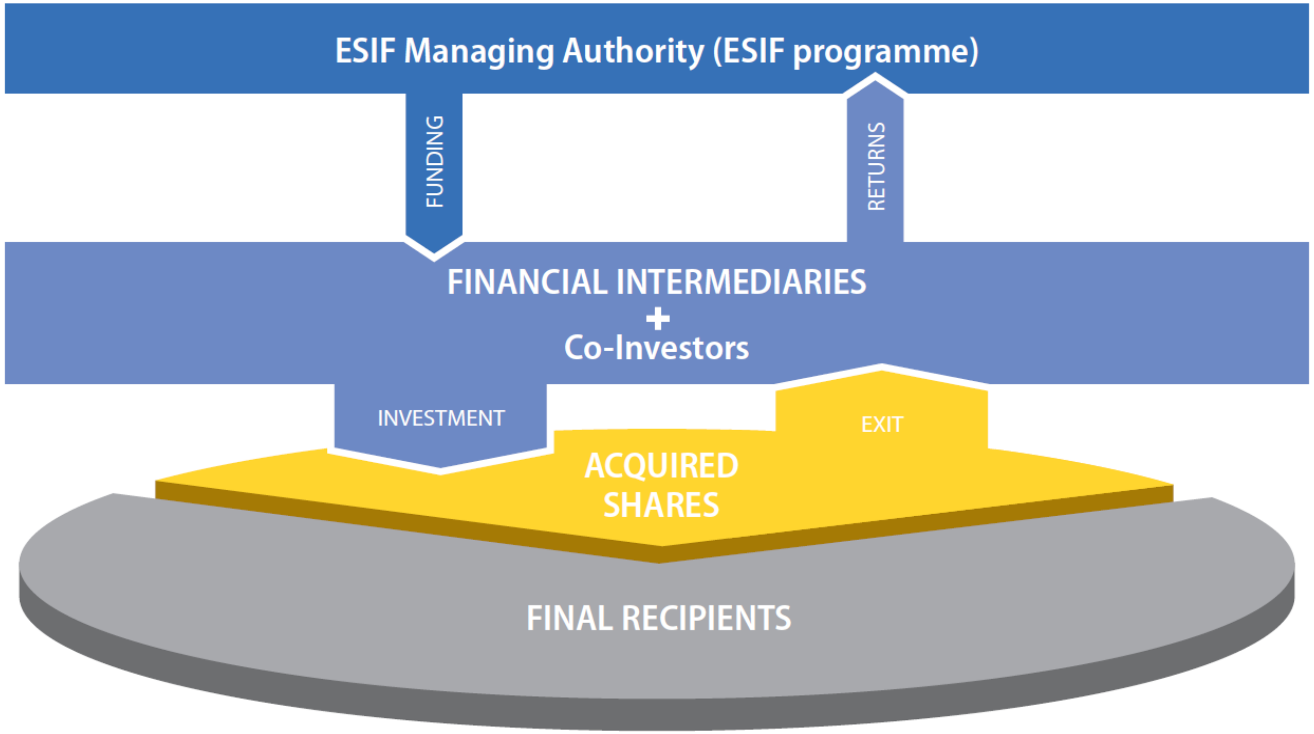
How does an equity scheme work?

Miglena Dobreva, EIB, Financial Instruments Advisor

#ficompass

How does it work?



#ficompass

Possible scope and relation to the CPR Thematic Objectives for ESIF

Equity can support undertakings to cover expenses from preliminary activities such as product research and development (R&D) until a product or service can start generating revenues under **Thematic Objective 1.**

Enhancing access to and the use and quality of ICT, as under **Thematic Objective 2**, can benefit from establishing public-private partnerships for local broadband networks.

Equity financing suits the development requirements of many SMEs, from innovative to traditional, in all their phases under **Thematic Objective 3.**

New and growing green economy enterprises in energy efficiency, renewable energy, environmental protection and the promotion of sustainable urban development under **Thematic Objective 4** are likely to require equity financing.

Public contribution in the form of equity financing in revenue generating transport infrastructure projects can stimulate private equity investors and lead to a better alignment of interest between public and private sides in the area of **Thematic Objective 7**.

Under **Thematic Objective 9**, seed equity can support social enterprises, helping to deliver high quality services of general interest.

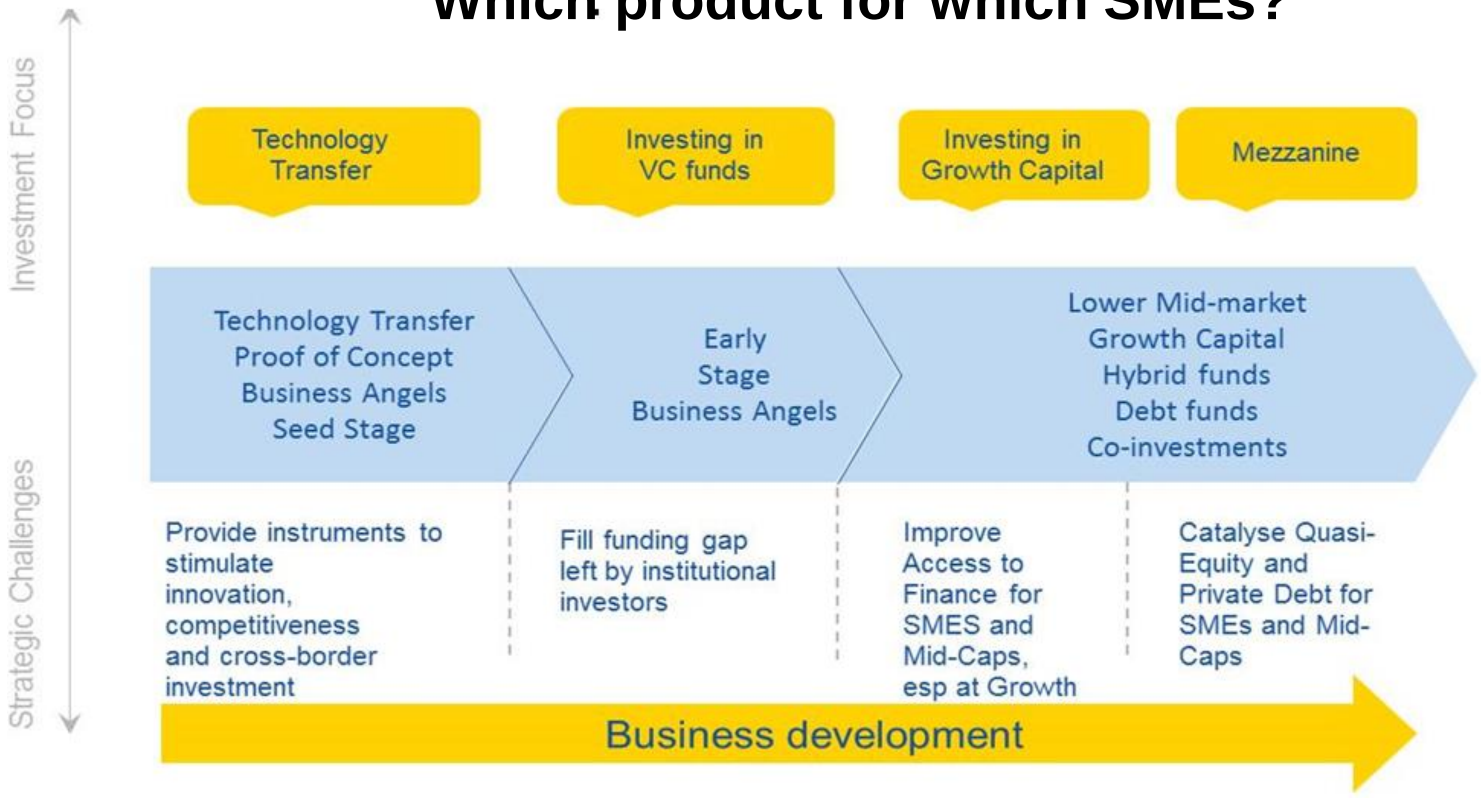
Equity

Main features:

- **Types** of **equity** investment normally depend on the **development stage** of a company;
- The most appropriate financial products to address the market gaps will be identified in the **ex-ante assessment** (incl. leverage effect and reinvestment):
    - ✓ For equity, leverage is measured by the co-investment from public and private resources in the financial vehicle.
- Equity is a longer term investment, normally with minimal dividends in the early life of a company:
    - ✓ Funds can revolve once the investment has been sold, which implies this will occur later in the life of the fund than for loans or guarantees;
- Any pay-off from an '**exit**' is very difficult to determine at the time of investment and estimates will be volatile during the life of the fund;
- There is full **insolvency risk** for the invested capital in the target companies;

Private Equity products

Which product for which SMEs?



Equity – pros and cons

PROS

For F.Ints and other co-investors

- Active role in project management and access to shareholder information
- Managers/owners are motivated

For Final Recipients

- No collateral to be provided
- Provision of management expertise to FRs
- Can access a wider network through involvement of venture capital investor

CONS

For F.Ints and other co-investors

- Full insolvency risk when co-investing
- Establishing the price for the investment can be challenging

For Final Recipients

- FRs can be less attracted by equity due to the obligation to transfer/yield control
- Strong financial discipline required
- Sharing the profits

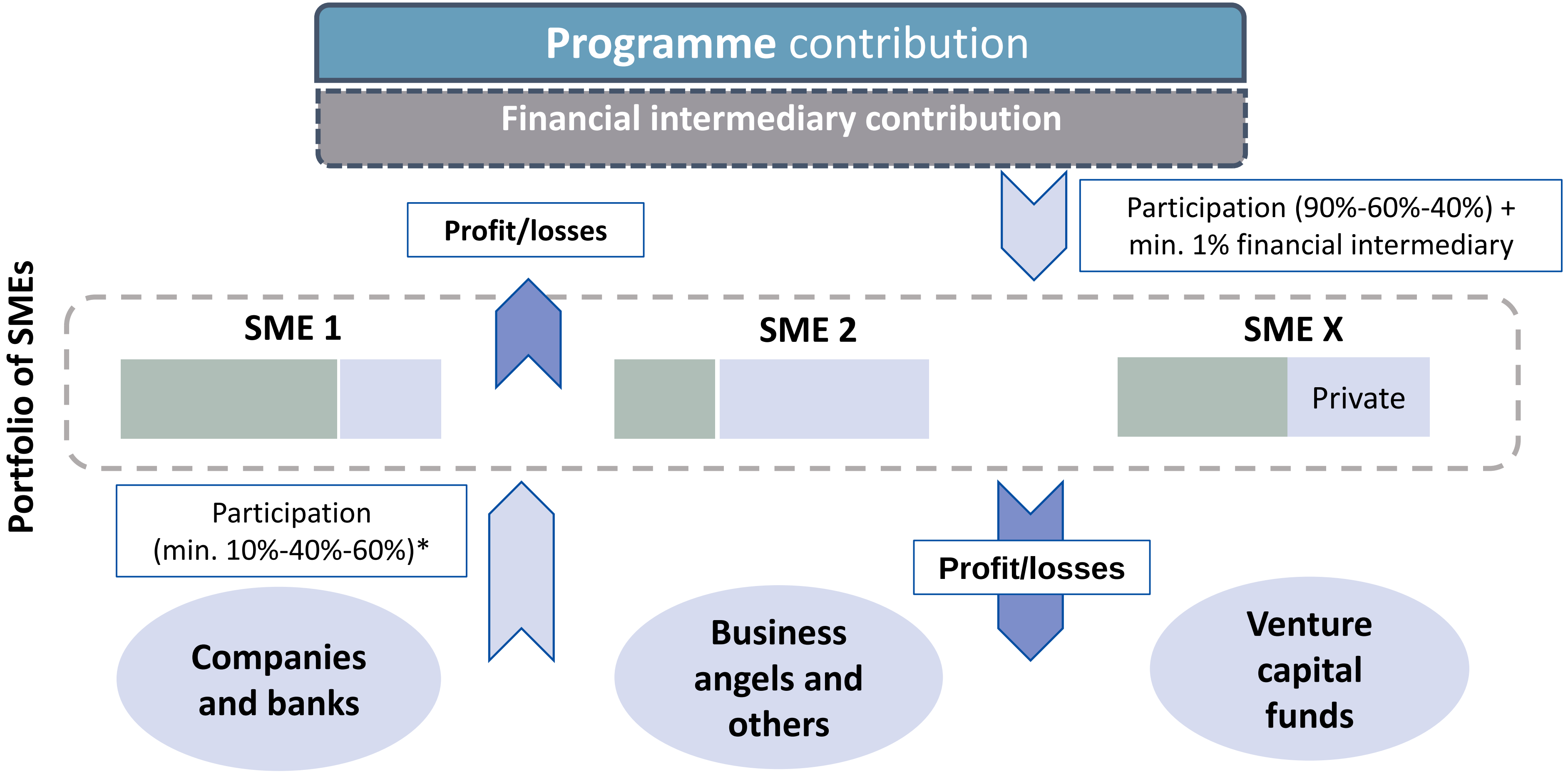
Co-investment facility

The Co-investment facility is a pooled facility managed by a F.Int, economically and legally independent from the MA (or FoF), whereby ESIF funds are invested in equity in SMEs in combination, and pari passu, with third party independent private investors on a deal by deal basis.

Goals:

- Providing equity financing to targeted SMEs, for which the market gap is generally substantial.
- Leveraging the ESIFs to support financing for SMEs.
- Catalysing private investment in the selected geography.

How does a co-investment scheme work?

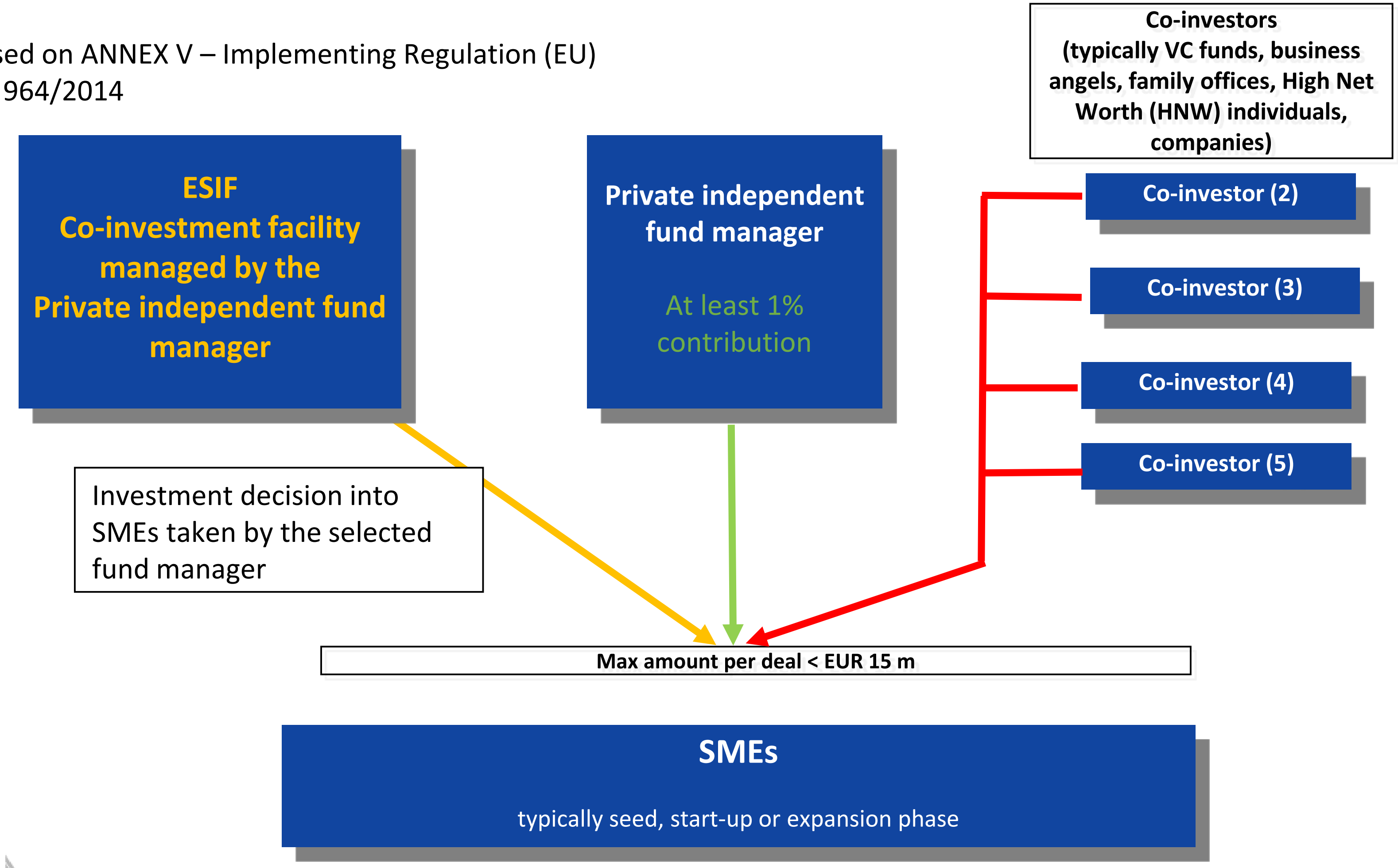


** % include the minimum 1% financial intermediary contribution*

#ficompass

Co-investment facility

Based on ANNEX V – Implementing Regulation (EU) No 964/2014



#ficompass

Co-investment facility

- **Financial Intermediaries:**
  - are duly authorised bodies, owned by private or public entities, investing their own resources and at their own risk;
  - are selected by the MA to **operate on a commercial basis**: they select the target SME, screen it, attract and screens co-investors, make a due diligence, enter into the investment agreement, monitor the investment, and manage the exit;
  - take all investment/divestment decision in a **profit-driven** manner: they are economically viable and operate on the basis of a viable business plan, establishing ex ante all investment criteria and exit strategies.

- **Co-investors:**
  - are any investors which the FI identifies as operating under the "**market economy investor principle in a free market economy"**;
  - are selected by the FI on a deal-by-deal basis, based on a commercial evaluation (no calls).

- **Both are independent from SMEs (except in case of subsequent investments, so called 'follow-on').**

Co-investment facility

- Minimum aggregate co-investment*:
  - For SMEs prior to first commercial sales (seed) ➔ **10% private**
  - For SMEs within 7 years from first commercial sale (start-up) ➔ **40% private**
  - For SMEs requiring an investment higher than 50% of the overage turnover of previous 5 years / or follow-on after 7 years from first commercial sale ➔ **60% private**
  - Where ‘co-investment’ is any funding coming from ‘market economy investors’, other than ESIF funding – e.g. FInt. money is included.

- Target SMEs: only unlisted SMEs falling in the four categories above.

- Remuneration:
  - Management fee funded by ESIF in line with Regulations, typically around 2% p.a. (of the programme contribution commited)➔ FInt. running costs;
  - Carried interest funded by reflows, typically 20% of any reflows after all investors have received their funded commitment plus a hurdle (6-8% p.a.) ➔ profit
- Duration: 10 years extendable. Investment period typically 5 years, after which only follow-on investment and exits.

** ANNEX V – Implementing Regulation (EU) No 964/2014*

Co-investment facility

- Alignment of interest:
  - With FInt.:
    - **Carried interest** (performance fee) – key to carefully balance it with management fees;
    - ‘***Skin in the game***’ – FI co-invests at least 1% on each deal. Cherry picking to be avoided;
    - **Exclusivity**: FI is barred from raising a new fund similar to the facility until 75% of the resources have been ‘invested’, and remaining 25% are earmarked.
  - With Co-investors:
    - Co-investment to be **pari passu** on identical terms, except if the ex ante estimates that an asymmetric profit sharing is needed in light of a substantial market gap.
  - In any case procedures to deal with conflicts must be set in investment agreement; typically an “advisory board” is established within the facility.

- Type of investment: equity and quasi-equity, for any purposes except replacement capital.

fi compass
ESIF

financial instruments revolving capacity building
added value ERDF funding agreement ESF EU guidance
governance ex-ante assessment
technical support seminars leverage financial intermediaries microfinance
co-financing case studies
investments ESIF fi-compass final recipients
business plan Thank you thematic objectives
advisory services guarantees banks loans EaSI equity
EAFRD private investors life cycle combination of support
conferences factsheets
fund of funds EMFF investment strategy CF
managing authorities manuals

#ficompass

European Commission

European Investment Bank The EU bank