6. Integrating SME financing for business succession, in particular employee share ownership into the EU's Long Term Investment strategy

Most recently the issue of long-term financing of the European economy has been raised to a prominent place on the agenda of both the European Commission and the Parliament. In the sixth year after the beginning of the financial crisis capital markets are still reluctant to lend and governments continue to consolidate their budgets. Consequently there is a shortage of financing for SME's, which are the backbone of the EU economy, and essential infrastructure projects. Such financing is, by definition, Long-term Investment. The focus of this proposal is twofold:

- First, to provide long-term financing for SME's in the form of Employee Share Ownership (ESO) schemes and especially Employee Stock Ownership Plans (ESOPs). Here the question of financing business succession as well as growth is of primary importance.
- Second, to provide long-term financing for utilities and infrastructure projects in the form of Consumer Stock Ownership Plans (CSOPs) which enables citizens to own shares in society's stock of capital.

ESO schemes can help to boost growth, create jobs and secure existing employment by providing long-term financing to SMEs which are primarily affected by the lack of financing on the EU financial markets. Furthermore, ESO schemes in the form of a full or partial buy-out deal with the SME succession issue in a constructive way and improve corporate governance. Therefore, any ESO schemes used in financing SMEs at various stages of their development should be recognized as an eligible long-term investment asset in the EU's strategy to promote long-term investment. The types of SMEs most suitable for ESOP-financing are enterprises with long-term time horizons.

CSOP schemes, like ESO schemes also help to increase growth and create new jobs by financing new infrastructure projects, which by definition is long-term investment. Important secondary effects are that CSOP's decentralise ownership and they channel purchasing power into the pockets of citizens as beneficiaries, which promote long-term sustainability.

The following describes how financing ESOP schemes as well as CSOP schemes can be integrated into the Commission proposal for a Regulation on European Long-term Investment Funds.

1. Proposal by the Commission for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on European Long-term Investment Funds (COM(2013) 462 final)

In the summer 2013 the Commission proposed a Regulation of the Parliament and the Council on European Long-term Investment Funds (ELTIF).[1] The ECON committee drafted the Parliament's amendments concerning this proposal in November 2013[2] and the first plenary reading is scheduled for the 15/04/2014. The proposed Regulation would establish a legal framework for cross-border investment funds that would be exclusively involved in investing in long-term asset classes. Long-term assets would be defined as all assets that are not traded on a regulated market. Such assets could be unlisted firms (i.e., in practice mainly SMEs), infrastructure projects or real estate.

2. Securing the inclusion of ESO and CSOP schemes into the class of eligible assets for ELTIFs

As ESO and CSOP schemes fall within the definition of a long-term asset, as set forth in the proposed Regulation, ELTIFs should be encouraged to invest in them. Article 9 of the proposed Regulation states that eligible investment assets include (among others) equity and quasi-equity instruments issued by a qualifying portfolio undertaking (Art. 9 (b)) as well as loans granted by the ELTIF to a qualifying portfolio undertaking (Art. 9 (c)). However, it should be expressly mentioned that these qualifying portfolio undertakings also include ESO and CSOP schemes to avoid any doubt about their eligibility:

- by commenting on Article 9 in the recital "Whereas (5) Long-term classes …" adding the sentence "**Both include assets involving employees of SMEs as well as citizen-consumers of public utilities through share ownership plans, such as employee stock ownership plans (ESOPs) and consumer stock**

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[1] European Commission: Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on European Long-term Investment Funds (COM(2013) 462 final), Brussels, 26.6.2013.

[2] European Parliament: DRAFT REPORT on the proposal for a regulation of the European Parliament and of the Council on European Long-term Investment Funds (COM(2013)0462 – C7 0209/2013 – 2013/0214(COD)).

ownership plans (CSOPs).“ to clarify that qualifying portfolio undertakings also include ESO and CSOP schemes.

3. Introducing specific sub-classes of ELTIFs into the Regulation

Furthermore, it should be considered to amend Article 9 of the proposed Regulation by adding a paragraph along the following lines: “The Commission encourages the introduction of sub-classes of ELTIFs in order to stimulate a focused development of competence in the management of a variety of specific ELTIFs.” As for example the competence required for successful SME mezzanine investment on the one hand and equity investment in real estate on the other is very different, and ELTIFs may want to choose a narrow commitment to specific asset classes in order to develop and allocate their management expertise most efficiently. Such a focus on specific sub-classes of assets will ensure the successful implementation of the ELTIF-Scheme in the EU. Without encouragement of such a focus, ELTIFs may feel compelled to gain scale at all costs, and become all-rounders by sheer size. Excessive size in turn introduces its own cost of complexity and additional risks from becoming “too big to fail”.

4. Financing growth of SMEs through ELTIFs

The ELTIF may also invest in SMEs providing growth capital in the form of an ESOP. In this case, instead of taking out a bank loan directly the financing is channelled through an ESOP trust since ESOPs may also be used to enhance working capital for any legitimate corporate purpose. This involves the issuance of new shares or the sale of existing stock held in the company treasury. Besides creating employee shareholding, the employer company, under certain circumstances, by selling shares at a fair valuation to the trust, receives an equity injection. This is the case when tax advantages are available for paying off leveraged principal with tax-deductible plan contributions. It also occurs when the company acquires cash from the employees directly. However, even without these conditions, the company, through its contributions, fully funds the “equity”.

Usually the dilution of the current stockholders is more than offset by the growth realised and partly offset by any available tax advantages. It can further be compensated for by increased productivity and profitability of the company as a result of higher employee motivation, which in the process raises the value of its stock.

5. Financing business succession of SMEs through ELTIFs

An ELTIF focussing on SME equity and mezzanine investments could invest in financing business succession of SMEs, an already pressing – and still growing – problem across the EU.

- ELTIFs could directly buy out current owners with a mixture of bank-debt, ELTIF-mezzanine instruments and ELTIF equity. The ELTIF would in essence step in as long-term patient capital, which is crucial for the continued viability of many SMEs and the benefits they bring to their communities in the form of jobs and taxes.
- A combination of ELTIF engagement and an ESO-scheme would be desirable in many cases; a whole spectrum of transactions could be developed.

At one end of the spectrum the ELTIF could provide only the mezzanine financing for a 100% ESOP. The employees would be the buyers of 100% of the SME equity and the ELTIF would provide the missing slice of the capital structure between the senior bank loans and the equity slice. Normally an acceptable capital structure would assume 50% senior bank loan and about 20% equity. (The equity could come from a vendor-loan or from a one-time employee-contribution). That leaves 30% for mezzanine and subordinated direct-lending instruments coming from the ELTIF.

- If the necessary equity-slice for a 100% ESOP cannot be procured via vendor-loan or employee-contribution, the ELTIF could step in as a co-investor next to the ESOP scheme in basically any proportion desired and make up the missing equity-part in exchange for a corresponding equity stake, while also providing the mezzanine instruments for the overall transaction.
- In addition to making urgently needed mezzanine and equity capital available for SMEs, especially for ESOPs of SMEs in succession cases, the presence of a professional ELTIF with its own transaction analysis should also have positive effects on the availability and terms of the necessary bank financing.

6. Financing capital ownership of consumers in utilities and infrastructure projects through ELTIFs

An ELTIF focussing on infrastructure may invest for example in an Energy-CSOP, which facilitates broad equity participation of people without assets or savings in a regulated public energy utility. Such entities have the advantage that (a) their regulated status assures that they make profits (thereby reducing the risk of credit financing for their acquisition) and (b) their customer base defines a clearly identifiable group of individuals with an economic relationship to the entity.

Under a CSOP the public utility sets up a fiduciary trust, which is managed by independent trustees authorized to borrow funds for the acquisition of shares in the utility on behalf of the energy consumers. The shares acquired by the trust are allocated among the CSOP consumer-beneficiaries in proportion to their respective energy purchases from the utility. All of the utility income in excess of depreciation associated with the CSOP shares must be distributed to the CSOP. These revenues are used to repay the acquisition loan assumed by the CSOP. Once this debt is amortized the revenue to the CSOP is distributed as income to the consumer-beneficiaries.

CSOP financing is most suitable for smaller energy producers in particular for new investments in the renewable energy sector. The advantage of public utility funding through a CSOP is that the regulatory authority can provide the guarantee against risk to the financing lenders by agreeing to set rates for the regulated utility at levels sufficient to assure amortization of the acquisition loan.

7. Increasing attractiveness of ELTIFs for retail investors

Referring to the critique of the EP that notes in the ECON Own-Initiative Draft Report on Long-term Financing[3] (p. 4) that the characteristics of ELTIFs as described in the European Commission's proposal "will mean that they serve mainly institutional investors" it should be stressed that a sub-class of ELTIFs focusing on SMEs and ESO-schemes would offer an excellent opportunity to attract retail-investors and would at the same time benefit employee-investors in SMEs. In fact such a special sub-class of ELTIFs which focuses on SMEs and ESOPs could be exclusively marketed to retail-investors and, if so desired by the EU Parliament even be given a certain extra incentive in the form of lower tax-burden (similar to the state and local tax exemption provided for municipal bonds in the U.S.).

A dedicated class of ELTIFs (for SMEs in general and SME-ESOPs in particular) which could be available to retail investors only, would create a virtuous circle with retail-investors supporting employees, who are retail-investors themselves. Also, the investment focus on SMEs and ESOPs might make such ELTIFs more appealing to retail-investors, who can more readily relate to SMEs than to abstract huge corporations. If ELTIFs invest in ESOPs then it is ensured that the benefit of the access to capital goes to citizen-investors (i.e. retail-investors) directly, even if in this case they are the investors in the ESOP rather than the ELTIF. Hence even an ELTIF financed entirely by institutional capital would still be benefiting retail-investors.

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[3] DRAFT REPORT on long-term financing of the European economy (2013/2175(INI)), Committee on Economic and Monetary Affairs, 5.11.2013 (Committee vote on 22.1.2014, first reading in the Parliament foreseen for 14.2.2014).

ANNEX: Overview of the Proposed Regulation with focus on ESO, esp. ESOPs

(1) European long-term investment funds (ELTIFs) **provide finance to** various infrastructure projects or **unlisted companies of lasting duration that issue equity or debt instruments for which there is no readily identifiable buyer.**

...

(3) **Financing for projects, regarding** transport infrastructure, sustainable energy generation or distribution, social infrastructure (housing or hospitals), roll-out of new technologies and systems that reduce use of resources and energy or **the further growth of SMEs, can be scarce.** As the financial crisis has shown, **complementing bank financing with a wider variety of financing sources that better mobilise capital markets could help tackle financing gaps**.

…

(5) Long-term asset classes within the meaning of this Regulation **should comprise nonlisted undertakings that issue equity or debt instruments for which there is no readily identifiable buyer**. This Regulation should also cover **real assets that require significant up-front capital expenditure.**

...

(19) **Quasi-equity instruments** must be understood to comprise a type of financing instrument, which is a combination of equity and debt, where the return on the instrument is linked to the profit or loss of the qualifying portfolio undertaking, and where the repayment of the instrument in the event of default is not fully secured. Such instruments include a variety of financing instruments such as subordinated loans, silent participations, participating loans, profit participating rights, convertible bonds and bonds with warrants.

…

(20) To reflect existing business practices, an ELTIF should be allowed **to buy existing shares of a qualifying portfolio undertaking from existing shareholders** of that undertaking.

...

(24) Unlisted undertakings can face difficulties accessing capital markets and financing further growth and expansion. Private financing through equity stakes or loans are typical ways of raising financing. Because such instruments are by their nature longterm investments they require patient capital that ELTIFs can provide.

…

Overview Composition of the of the ELTIF vehicle

(Limitations for certain types of assets / issuers in % of total value of the ELTIF)

min.70% of its capital invested in eligible investment assets and invest no more than: (a) 10% of its capital in assets issued by any single qualifying portfolio undertaking*; (b) 10% of its capital in an individual real asset*; (c) 10% of its capital in units or shares of any single ELTIF, EuVECA or EuSEF; (d) 5% of its capital in assets referred to in Article 8(1)(b) where those assets have been issued by any single body.	*max. 30% of its capital in liquid securities (liquidity buffer) allows:* (1) to manage the cash flow that arises while the long-term portfolio is being constituted and (2) to place surplus cash that is achieved 'between investments' – that is when a long-term asset is sold in order to be replaced by another.
max. 20% aggregate value of units or shares of ELTIFs, EuvECAs and EuSEFs in an ELTIF portfolio shall not exceed; *max. 5% aggregate risk exposure to a counterparty of the ELTIF stemming from over the counter (OTC) derivative transactions or reverse repurchase agreements*	max.30% *borrowing of cash provided:* • it serves the purpose of acquiring a participation in eligible investment assets; • it is *contracted* in the same currency as the assets to be acquired with the borrowed cash; • it does not hinder the realisation of any asset held in the portfolio of the ELTIF; • it does not encumber the assets held in the portfolio of the ELTIF.

* By way of derogation from paragraph (a) and (b), the ELTIF may raise the 10% limit referred to therein to 20%, provided that the aggregate value of the assets held by the ELTIF in qualifying portfolio undertakings and in individual real assets in which it invests more than 10% of its capital does not exceed 40% of the value of ist capital.