**MEMO**

# **Proposal for a cooperation initiative by NPBIs to support small- and mid-cap companies (IESMID) as part of the recovery plan for Europe as it emerges from the Covid-19 crisis**

The unprecedented economic crisis caused by the Covid-19 pandemic is starting to have a devastating impact on the financial structures of small- and mid-cap firms in the European Union (EU). This memorandum proposes a pan-European initiative by long-term public investors (national promotional banks and institutions – NPBIs) aimed at strengthening the equity positions of these firms, all of which play a major role in the economy, with a priority on long-term value creation and the potential for rapid implementation. It is expected that this initiative would be developed in close coordination with the main European institutions (Council, Commission, Parliament).

1. **Background**

Small and medium-sized enterprises (SMEs) are the backbone of the European economy. They create the majority of jobs and are the greatest contributor to the economy’s development potential. Within this sector, companies listed on regulated markets are the most visible segment (small- and mid-cap equities). To a certain extent, these firms are the ones most exposed to fluctuations in share prices (high volatility, lack of appeal for investors due to their low liquidity), which have recently become even more erratic, with larger-than-usual swings across this market compartment, given the deep financial and economic crisis taking shape in the wake of the pandemic. This unparalleled and violent upheaval, with no clear end in sight as yet, will have lasting effects, some of which are already apparent and will hit SMEs particularly hard, wherever they are located in the EU, as they tend to be the most fragile companies in any economy. This observation reflects changes on two fronts:

* **A slump in demand, often as a result of limited business diversification,** especially for firms operating in single-product segments shut down for more than two months.
* **The weakening of financial structures across the segment due to the lockdown’s economic impact**, which might undermine recovery potential for these companies, in the absence of appropriate forms of long-term assistance.

These financial and economic repercussions could be all the more devastating for these companies, given that they were encouraged by national authorities at the outset of the crisis to use debt massively to lessen the blow, thus endangering their financial health for some time to come. Furthermore, in terms of unemployment, the consequences may be even more serious, as these firms account for the largest proportional share of total employment.

**This challenging situation urgently calls for a strong European support initiative over the long term on behalf of this segment of the economy, from which our continent’s future blue-chip companies will emerge.** The approach could take the form of a project to create a European platform aimed at strengthening the equity positions of small- and mid-cap companies by targeting in particular those operating in key strategic sectors for the European economy. Led by the EU, this project would involve the vital participation of the main NPBIs brought together under the banner of the European Association of Long-Term Investors (ELTI) as well as the European Investment Bank (EIB), hopefully with the financial support of the European Commission. Other long-term public or private investors might also be invited to take part.

This structural initiative to be put in place over the long term must not be considered merely as a facet of the ambitious recovery plan for Europe. Beyond this, it aims to:

* **Contribute to current reflections on the EU’s strategic priorities,** particularly in the context of the new SME Strategy announced by Thierry Breton, the EU internal market commissioner, on 10 March 2020, with the establishment of a public-private fund to support IPOs as part of the InvestEU programme. It is also in keeping with the spirit of economic stimulus measures made necessary by the crisis that are in the process of being finalised by the European institutions. In its approach, it is an adaptation for the SME sector of the Marguerite Fund launched at the time of the previous crisis in 2008 for infrastructure investment.
* **Reinvigorate the Capital Markets Union (CMU)** by facilitating the linkage at European level of national markets for the financing of small- and mid-cap companies, whose specific features sometimes make it more difficult to take advantage of the Single Market’s economies of scale.
* **Establish a solid economic continuum between the actions carried out by each national government and those conducted at European level.**

1. **Project specifications for the European platform to support small- and mid-cap companies**

This project must meet **three criteria for long-term value creation**:

* **Fulfil a proven economic need,** which is the case because the response by government authorities to the first phase of the crisis was to encourage the accumulation of massive debt by companies in the European Union. This has significantly weakened the capital structure of these companies to a lasting extent, making it essential that they be provided with a proportional equity injection to finance their further growth.
* **Galvanise and unify a key segment of the European capital market,** that of small- and mid-cap companies, to further the adoption of shared standards and practices giving rise to an improved management culture (governance, benchmarking, etc.).
* **Support two strategic drivers of change**, both essential to promote competitiveness and growth across the European Union (ESG and technology).

1. Investment principles

The fund’s investment strategy would be focused on early stage listed companies in key sectors for future growth in Europe with strong potential for value creation at both the microeconomic and macroeconomic levels.

* **Targets**

Given that most small- and mid-cap companies have taken on high levels of debt during the current crisis, they now have a structural need to bolster their equity in order to continue their growth. The aim therefore is to invest in EU companies listed on regulated markets having the following main features:

* *Size*

The fund’s priority investment targets would be small- and mid-cap companies, in principle with a market capitalisation up to €5 billion, depending on the specific characteristics of national markets in the participating EU member states.

* *Business activities*

In support of the EU’s strategy for green growth and technological competitiveness, the preferred investment targets would be tech companies and companies having integrated ESG criteria into their business strategy and operations.

* **Procedures**
* The platform would take a selective approach to investment, in particular through participation in IPOs and capital increases. It might also make ancillary investments on an ad hoc basis in existing funding rounds to stabilise the ownership structure of companies operating in a key strategic sector for the European economy.

1. IESMID project structure

The IESMID project could be organised in two phases to be examined by the initiative’s promoters: creating a European platform initially and a single European fund in a second stage.

* **First phase: creation of a European platform**

This first option would seem to be the most productive in the short term as it could very likely be put in place rapidly from an operational standpoint. It has the advantage of combining a bottom-up approach, favouring investment decisions as close to the ground as possible, with a top-down perspective involving overall coordination at European level. It would also have a **knock-on effect** that would be easily identifiable across the system, while encouraging the accountability of all participants.

This two-track programme would be organised as follows:

* + ***National funds (NFs)***

Under the proposed approach, which draws on the experience of CDC Croissance , a Caisse des Dépôts subsidiary, the long-term national investor (NPBI) in each participating EU member state would create a dedicated fund (an individual fund or an umbrella fund with two sub-funds, one in technology, the other in ESG) that would invest mainly in domestic small- and mid-cap companies. This system has the advantage of bringing the investment decision-making process to a more immediate level (ensuring the **cultural and physical closeness** essential to a good understanding of the environment in which domestic companies operate). It also favours the **principle of subsidiarity** by directly highlighting investments within the national economy. As a result, it would be possible to measure the benefits of this system at the level of the participating member state, which would be afforded a certain flexibility in terms of the procedures for creating and managing this vehicle within a common framework.

From the financial standpoint, the resources would be provided at the outset by the public investor of the NPBI in question, eventually rounded out, to a certain extent, through commitments by other public or private investors. Each national fund could be managed directly by the NPBI concerned or its management could be delegated to a private operator under terms to be agreed locally.

* + ***A European platform***

To guarantee the initiative’s overall coherence as well as its successful adaptation for all participating member states, a common framework would be put in place at European level, in the form of a central platform that would invest in these national funds. The European Investment Fund (EIF) and the European Commission would play a key role in the initial financing and coordination of this platform. This structure would have the following main features:

* Coordination

The platform’s governance bodies would ensure unity of action among the national funds operating in a decentralised manner, while also evaluating their performance. The overall guidance and supervision of the system would be carried out by investor representatives (if third-party investors are invited to take part in the financing) under the aegis of the EIF. Oversight of operational matters could be conducted via a strategy committee bringing together all investment managers and covering the following functions:

* **Asset allocation decisions and monitoring** – i.e. decisions to invest or divest made by national funds – taking into account performance assessments, analyses of potential opportunities by local investment managers (designated by the sponsor NPBIs of the national funds) and varying management fees from one country to the next.
* Determination of procedures for the creation of national funds (direct or delegated management), performance criteria and reporting requirements to track shared indicators.
* Development and awarding of **unified European quality labels** in the areas of ESG (as a decisive step to promote sustainable finance) and technology, to give clearer shape to a European capital market segment, in line with the Green Deal adopted by the new European Commission after taking office in December 2019
* Governance

The EIF would play a central role in setting up the platform, by virtue of its expertise and the fact that the initial (and likely predominant) financial contribution is expected to be provided by European institutions (European Investment Bank and European Commission). The platform’s governance would be built on a management structure with a status to be determined (technical support, management company or SICAV likely domiciled in Luxembourg) and to be formed by the project promoters, which would imply a distinction between two functional levels (see diagram):

* Supervisory functions for the overall system and the holding structure function of the platform would be the remit of a **Supervisory Board**, under the aegis of the EIF, the latter providing the infrastructure necessary for its operations.
* Guidance and coordination of the entire investment process (see Coordination section above) would be handled by a **Strategy Committee**, bringing together the representatives of the national management structures to promote the emergence of a shared investment culture for this key segment of the European capital market. The governance approach would need to be nimble and flexible, optimally combining the oversight of investors with decentralised management. Given that it would be providing financial resources, the Commission could be represented on these bodies.
* Economy of means

The platform would be founded on the **principle of economy of means** by delegating the management processes to the system’s participants to the greatest extent possible. This approach would have the advantage of encouraging accountability among the participants and keeping costs under control. The aim would be to make use of existing human resources as much as possible, with strict limits on new permanent hires. For example, the EIF could provide the infrastructure at European level via a management structure with annual expenses capped at 0.1% of commitments, for example.

The formation and management of the national funds would be the responsibility of each member state and/or the competent NPBI.

The European tier could therefore bring together European resources (Commission, EIF, etc.), national resources and possibly private institutional investors convinced of the merit of such a platform, the economy of its means at the domestic and supervisory levels, and especially the relevance of its model and its reallocation decisions.

* Amount

In this regard, it is also necessary to distinguish between the national and European tiers.

* At national level, the appropriate budget will depend on the extent of local needs. Experience in France suggests that a starting amount of about €100 million would be appropriate for each of the two themed funds (technology and ESG), in line with the economic potential of each of the corresponding segments. Each NPBI will need to assess its domestic level of need when defining the features of its fund. The consolidation of national needs will result in an overall assessment of the system’s total financing requirement.
* At European level, the platform could start with an initial allocation of at least €100 million, with a ticket size capped at 20% of this total for each national fund, which would be adapted over time depending on fund performance and opportunities emerging on the ground. The total amount could also be adjusted as local needs take shape. A certain number of questions would need to be explored further: the creation of two distinct sub-funds (ESG and technology), the flexibility afforded to national promoters to structure their fund (size, investment criteria, opening up to private third-party investors and the country where the fund would be domiciled and based).

All in all, this system would have the advantage of adaptability in the sense that it would have a decentralised structure favouring the national level, the one closest to local economies. Over the long term, it should give rise to a shared investment culture for small- and mid-cap financing, which would be a good way to demonstrate the usefulness of NPBIs in the context of this crisis.

* **Second phase: creation of a single European fund**

For this phase, the structuring approach could draw on the precedent set by the Marguerite Fund. The fund would have its own management team that would invest directly in European listed small- and mid-cap companies in targeted sectors. Its governance would also use a two-tiered approach: overall supervision by a body bringing together representatives of the investors (Commission, EIF, NPBIs) and a strategy committee comprised of national managers to guide and support the team of investment managers.

The management team could also invest in the national funds or directly in small- and mid-cap companies based in member states.

The other technical specifications to be discussed would be the same as those for the first option: targeted segments (ESG/technology), approaches to participation (IPOs, capital increases, taking part in existing funding rounds, etc.), amount (€500 million at a minimum) and possible sub-fund structure.

The question of the platform’s domiciliation (Luxembourg or other) and the location of the base of operations for the team of investment managers would need to be addressed, as would the possibility of opening up to other public or private investors.

In principle, this second phase would be the logical outcome of the emergence of a shared investment culture as part of the platform. **A preliminary step might be to reflect, once the platform has been created, on the possibility of setting up an allocation for co-investment, which would allow for direct investments in small- and mid-cap companies alongside national managers (see diagram).**

1. Project implementation

**The first priority is to quickly set the process in motion so that it will be twinned with the recovery plan for Europe and above all to put in place the operational system best suited to meeting the financing requirements of the companies concerned.**

This is why it is suggested that the main NPBI partners and the EIB be consulted rapidly to evaluate their interest in becoming involved in such a system. It is worth noting that the timetable for bringing this initiative into being will imperatively need to take into account the countries due to take over the six-month rotating presidency in the near future in order to ensure the necessary institutional momentum. **In this regard, the upcoming German presidency would seem to be decisive for the launch of the project.**

It is recommended that discussions be held as soon as possible in the coming weeks with the main NPBIs to evaluate their interest in the project and seek their support to bring the initiative forward in preparation for the German presidency. The same would be true for the subsequent presidencies (Portugal, Slovenia, France), which should in principle be interested in backing the project.

The initiative’s promoters/sponsors – NPBIs and European contributors (Commission, EIB) – could join together in a formal consortium tasked with steering the operational preparations for the project.

Subject to these prerequisites, the provisional launch timetable presented below (which is open to discussion) could be implemented in the second half of 2020 and the following two years.

* **June–July 2020**

- Sending of an introductory memo describing the broad outlines of IESMID to senior executives of the main NPBIs in order to ascertain their eventual level of interest and gather their feedback

- Notification sent to the European Commission (DFIN/FISMA), the EIB and the EIF presenting the principles behind the initiative

* **September–November 2020**

- Formal description of the initiative at a meeting bringing together the CEOs of establishments / institutions / promoters as a Consortium and presentation to the ELTI

- Lobbying with the aim of including the project for the platform in the conclusions of a European Council meeting, ideally during the German presidency

- Creation of a task force with the mandate of drawing up a master plan for the project (methodology, schedule, deliverable, etc.) by end-November 2020

* **December 2020**
* Validation of the master plan for the project selected by the Consortium of promoter investors
* Articulation of a political rationale for IESMID via the conclusions adopted by a European Council meeting
* **January–June 2021**
* Establishment of the project team by the Consortium with the aim of proposing a detailed six-month operational programme
* **June–December 2021**

* Decision to create the operational platform
* Creation of the legal and technical infrastructure (European platform, national funds)
* **First half 2022**
* Operational launch of the platform and initial investments

**All of the guidelines provided above are intended as a basis for discussion with NPBIs in the context of a meeting to be held in the near future.**