European Commission Expands Eligibility for SME Support and Increases Incentives for Private Recapitalization

BY MALLORY DREYER AND KALEB NYGAARD

Original post here.

On June 29, the European Commission (EC) announced it will extend support to SMEs that were previously ineligible for state aid and amended recapitalization measures to incentivize private investor participation.

This is the EC's third amendment to the Temporary Framework for state aid. The EC adopted the Temporary Framework on March 19 with the first amendment approved on April 3 and the second amendment on May 8. Through the Temporary Framework, the EC defines how Member States can provide aid to companies in response to the COVID-19 pandemic while preventing competition distortion across companies in the EU.

Support for SMEs, specifically startups

The amendment permits Member States to provide aid to SMEs that were already financially troubled on December 31, 2019 provided they are neither insolvent nor have outstanding, non-COVID-19 related rescue aid. The Temporary Framework previously prohibited Member States from providing aid to companies whose capital had shrunk by half or more prior to the pandemic due to accumulated losses. This was because governments did not want to use COVID-19 rescue funding to help firms that were already "in difficulty" and would have been likely to go out of business in the short or medium term absent government intervention.

This amendment allows Member States to introduce support programs for small, young companies, like startups, that traditionally run losses in the first few years as they grow their businesses. It will also allow Member States like Germany and France to expand startup support programs.

Several technology trade groups had urged the EC to be more flexible in its approach to state aid. Many companies in the tech industry are classified as being "in difficulty" under the rules as they operate at a loss in order to achieve fast growth or have taken on significant debt as a result of private equity investments. These companies were unable to benefit from state aid under the rules that the EC put in place for traditional SMEs in March.

Recapitalization Aid Measures

In its May 8 amendment to the Temporary Framework, the EC defined the procedures and requirements for the recapitalization of nonfinancial companies through equity, hybrid equity, and subordinated debt at favorable terms. The June 29 amendment modifies the conditions to encourage private investor participation.

The May 8 amendment established restrictions on share buybacks and management compensation for companies that are recapitalized through State aid. It banned share buybacks and dividends as long as 75% of the State's recapitalization aid was outstanding. However, if the recapitalization measures meet the new criteria under the June 29 amendment, the acquisition ban and cap on management compensation will be limited to three years. Recapitalization measures must meet the following criteria to be eligible for the three-year limit:

1) private investors contribute at least 30% of the new equity injected by the State

2) the State injects new equity under the same conditions as private investors

3) the new equity is pro rata or below to existing shareholdings.

The EC also lifted the dividend ban for the holders of new shares. The dividend ban is lifted for owners of existing shares as long as the existing shares are diluted to less than 10% of ownership. If the existing shares are not diluted to below 10%, the dividend ban applies for three years. However, any remuneration due to the State for hybrid capital and subordinated debt instruments is to be paid before any dividends are paid to shareholders.

The amendment also allows companies with existing public shareholders to raise capital from shareholders like private companies. If the State is an existing shareholder before the granting of COVID-19 recapitalization aid and the participation of private investors meets the three new criteria, the EC will not impose specific conditions on the State's exit.

The EC expects that the amendments related to recapitalization measures will incentivize firms to seek market and State contributions for capital needs.

Relocation

In the June 29 amendment, the EC also clarified that States cannot provide aid to a firm on the precondition that it relocate to the State's territory.

Table 1. Summary of Temporary Framework and Amendments

Date	Included Measures
March 19	- Direct grants, selective tax advantages and advance payments up to EUR 800,000 - State guarantees for loans taken by companies from banks - Subsidized public loans with favorable interest rates to companies - Safeguards for banks that channel State aid to the real economy - Short-time export credit insurance
April 3	- Support for COVID-19 related research and development - Support for the construction and upscaling of testing facilities - Support for the production of products relevant to the COVID-19 outbreak - Targeted support in the form of deferral of tax payments or social security contributions

	- Targeted support in the form of wage subsidies for employees - Expansion of the provisions in the initial temporary framework, allowing companies to receive up to EUR 800,000 in aid through zero-interest loans, 100% guarantees
[May 8]()	- Recapitalization of nonfinancial companies through equity and hybrid equity instruments - Support to companies through subordinated debt at favorable terms
[June 29]()	- Support for SMEs "in difficulty" under specific circumstances - Recapitalization measures amended to encourage private investor participation - States prohibited from conditioning aid to firms on relocation to their territory