BUSINESSEUROPE

COMMENTS

24 April 2018

MAKING THE EU SME DEFINITION FIT FOR SMEs IN NEED OF VENTURE CAPITAL AND OTHER SOURCES OF GROWTH FINANCE

KEY MESSAGES

1 Regarding the overall design of the EU SME definition, BusinessEurope holds the very broad consensus view that:

- the current EU SME definition (dated 2003) is pragmatic and workable for addressing a large number of issues which interest SMEs;
- the basic structure of this definition should not be fundamentally modified, except for increasing financial parameters to account for inflation since 2003.

2 However, technical provisions in the SME definition artificially deprive some companies from the SME status. BusinessEurope's members are unanimous in stressing that this calls for amending the EU SME definition.

For example, an SME will typically lose its SME status when it gets financed by a venture capital fund taking a majority participation in it. As a consequence, this SME can not apply anymore for attractive national or EU financial instruments making reference to the EU SME definition. This can affect the SME growth prospects. The same problem can occur when a private equity investment fund takes a majority participation in an SME.

3 The SME definition contains a calculation methodology for officially granting the SME status to companies. The way this methodology is applied when a venture capital fund or a private equity investment fund takes a majority participation in an SME should be changed.

With regard to these cases, Article 3 of the EU SME definition should be amended to ensure that SMEs do not lose their SME status based on the wrong argument that they are part of a large group and integrated in a common group strategy.

This argument reflects a simplistic view of the SME economy and goes completely against the EU strategy to promote start-ups, scale-ups and innovation.

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A. Background

The EU SME Definition is embedded in the Commission's Recommendation 2003/361/EC of 6 May 2003.
In a nutshell, it makes reference to the following key economic parameters:

Company category	Employees	Turnover … **OR**	…Balance sheet total
Medium-sized	< 250	≤ 50 million Euro	≤ 43 million Euro
Small	<50	≤ 10 million Euro	≤ 10 million Euro
Micro	<10	≤ 2 million Euro	≤ 2 million Euro

In order to clarify whether a particular enterprise is an "SME", the 2003 EU SME definition asks to take into account the economic relationships that this enterprise has with other companies. To this end, the EU SME definition establishes the following 3 categories of companies (presented in very summarised terms below):

a) **autonomous**: if the enterprise is either completely independent or has one or more minority partnerships (each less than 25 %) with other enterprises;
b) **partner**: if holdings with other enterprises rise to at least 25 % but no more than 50 %, the relationship is deemed to be between partner enterprises;
c) **linked enterprise**: if holdings with other enterprises exceed the 50 % threshold, these are considered linked enterprises.

For checking if a company **A** is an SME, the EU SME definition requires (in simplified terms) to sum up the following data:

i. the data of company **A** (number of employees, turnover, balance sheet total);
ii. a proportion of the data of the *partner* companies (equal to the level of participation in the partner companies);
iii. 100% of the data of the *linked* companies.

B. Treatment of SMEs financed with venture capital under the current SME definition

When a Venture Capital (VC) fund has a majority holding in a company A, the EU SME definition requires to sum up the following data:

i. the data of company **A**;
ii. the data of the VC fund;
iii. 0% of the data of the companies in which the VC fund has participations comprised between 25 and 50%;
iv. 100% of the data of the companies in which the VC fund has participations higher than 50%.

Although these provisions (embodied in article 3 of the 2003 EU SME definition) go in the right direction, they still fail to address in a satisfactory way the issues faced by some innovative SMEs, as explained below.

C. Problems remaining for innovative SMEs in need of VC and/or other SME-geared sources of finance

a) Description of the issue

With article 3, a small company A (a start-up or a scale-up for example) loses its SME status once a VC fund of a certain size takes a majority stake in it. That company A is then not eligible anymore to EU or national public support schemes for improving SME access to debt or equity finance, if these schemes refer to the EU SME definition. In other words, going through VC funding closes some attractive and flexible options for later stage financing. When they realize this drawback of VC funding, some SMEs decide not to opt for VC funding, and to rely on traditional bank financing, which usually introduces strong limitations for developing dynamic innovation strategies.

This has been highlighted in particular in the 2012 report produced by CSES (the Center for Strategy and Evaluation Services) for the European Commission on the implementation of the EU SME definition.

Innovative start-ups or scale-ups are sometimes growing very fast, which creates substantial financial needs, possibly leading to a majority participation by a VC fund. A majority participation by a VC fund, combined with or followed by use of EU or national SME-geared financial instruments is sometimes the only path that can get an innovative SME out of the “Valley of death” and put it on a sustained high growth trajectory.

The 2003 definition requests to consider a company funded by VC as part of a larger group. But this is a very theoretical view. In reality, enterprises in which majority is acquired by a VC fund continue to operate with little or no reference to the other enterprises owned by the fund. A VC manager - or any private equity manager - does not have a common strategy for all the SMEs in its portfolio and does not run them, either individually or collectively. The ultimate goal of the manager is indeed to grow these companies separately during a limited period (typically 5-6 years) with the objective of selling them once they have demonstrated their value in order to bring returns to the funds’ investors. Similarly, there is also a strict accounting separation between all companies ran by VC managers.

b) The way forward

Against that background, the EU SME definition should be amended in such a way that company A is also deemed to be autonomous when a VC fund holds 50% or more of the capital or voting rights.

Given that private equity investment funds have exactly the same structure as VC funds, this exemption should also apply to any type of private equity fund ownership, including "growth funds" which typically make investments into scale-ups and are as important as VC funds for the development of a strong European innovative ecosystem.

Charts at Annex I show how to make calculations for granting the SME status to a company, under the current EU SME definition and under the amended definition proposed.

D. Conclusions[1]

The current EU SME definition can cause some SMEs losing their SME status once they are financed by venture capital funds or by private equity investment funds taking a majority participation in them.

Article 3 of the EU SME definition should be amended in a way that SMEs financed by such funds do not lose their SME status based on the wrong argument that they are part of a larger group and integrated in a common group strategy.

This argument reflects a simplistic view of the SME economy and goes completely against the EU strategy to promote start-ups, scale-ups and innovation.

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[1] Note: additional technical recommendations for revising the EU SME definition were presented in a detailed BusinessEurope position dated 7 November 2017, accessible through:

https://www.businesseurope.eu/sites/buseur/files/media/position_papers/smes/2017-11-07_revision_of_the_eu_sme_definition.pdf

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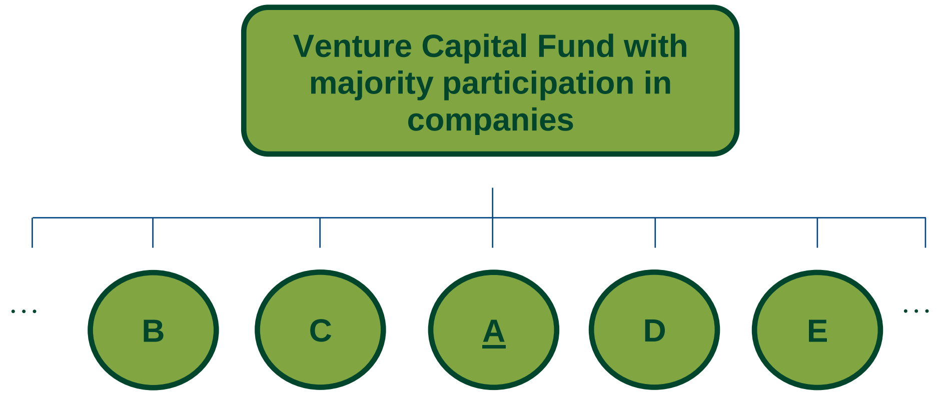
Annex I

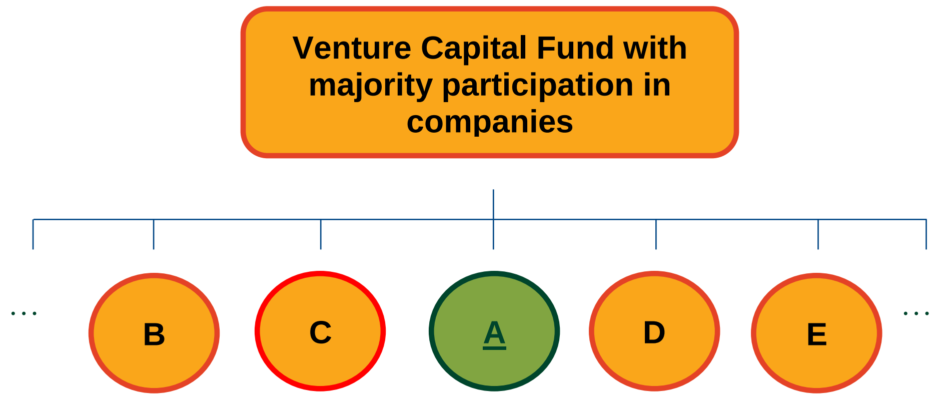
DATA TO USE TO GRANT THE ”SME STATUS„ TO A COMPANY ”A„ UNDER CURRENT EU SME DEFINITION



GREEN: include data in calculations

Annex II

DATA TO USE TO GRANT THE ”SME STATUS„ TO A COMPANY ”A„ UNDER RECOMMENDED REVISED EU SME DEFINITION



GREEN: include data in calculations; **ORANGE**: don’t include data in calculations