MINISTERUL FONDURILOR EUROPENE

Romania

Ex-ante assessment for financial instruments for SMEs in the 2014-2020 programming period

2015

EXECUTIVE SUMMARY

The purpose of the SME ex-ante assessment for Romania is to provide **reliable inputs for the decision of using financial instruments as implementing tool for ESIF funds**, by establishing an *"evidence of market failures or suboptimal investment situations, and the estimated level and scope of public investments needs, including types of financial instruments to be supported*", as required by article 37 (2) of the Common Provisions Regulations ("CPR")[1].

A preliminary analysis of the mismatch between demand and supply on financial instruments for micro, small and medium-sized enterprises (SMEs) across Romania was initially performed for the period 2010-2012 within the document *SME Access to Finance Preliminary Study for Romania* (2013 SME Study), enclosed as Annex 1*. T*he present ex-ante assessment goes further with the analysis based on more recent data (including 2013/2014, whenever it was possible). The ex-ante evaluation is further based on two others documents, developed especially for the purpose of this assessment, which update on the specific sections focused on: microfinance (2014 microfinance study enclosed as Annex 3) and RDI (based on the third-party study contracted separately by the Intermediate Body for Research).

As indicated in the SME ex-ante methodology, this analysis process provides **a snapshot of market conditions at the time of the ex-ante assessment and does not cover projections on future changes to market conditions throughout the programming period, nor the effect of the revolving funds in future cycles**.

The ex-ante assessment requirements established by Article 37 (2) of the CPR are covered in the report[2]:

	Article 37 (2) requirements
Building Block 1: MARKET ASESSMENT	a) Analysis of market failures
	b) Value added of the financial instruments
	c) Additional public and private resources
	d) Lessons learnt

[1] Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006.

[2] The structure of the report complies with the items listed in Art. 37 (2) of the CPR; to be noted that the chapters are presented in the logical sequence of introducing firstly the proposed investment strategy in Chapter D and then, only for the specific instruments proposed, presenting the value added and other detailed features.

Building Block 2: DELIVERY AND MANAGEMENT	e) Investment strategy and implementation arrangements
	f) Expected results
	g) Provisions allowing the ex-ante assessment to be reviewed

The following financing gaps were evidenced through the assessment exercise undertaken herein:

Type of instrument	Financing gap (mEUR) up to 2020
Bank financing (guarantees, risk sharing loans)	Up to 1,893[3]
Microfinance	Up to 940[4]
Equity investments	Up to 544[5]
Total	**Up to 3,377**

In order to **identify the financial instruments** the most appropriate for each Operational Programme, the following steps were performed:

- **Identification of market failures or suboptimal investment situations and the specific market issues** related to each thematic objective.
- **Analyses of the possible financial products taking into account their characteristics** for better filling the market gap.
- **Consultation** with the main stakeholders.

An analysis of **the specific market issues** related to each thematic objective was performed and led to the identification of the most appropriate financial instruments, as follows:

➢ ***For the lack or limited collaterals to gain access to debt finance*** it was identified as the best suited the **guarantee** instrument, which has as **main advantages**:

- Addresses specific risk capacity constraints for SMEs.

[3] Debt financing gap estimate for NACE sectors B-N (excluding notably Agriculture) for year 2020. For detailed methodology, see Chapter B.3.3.
[4] Figure represents the Sum of microcredit gaps for the years 2013-2020. For detailed methodology, see Chapter B.3.3. and the 2014 microfinance study in Annex 3.
[5] For detailed methodology see Chapter B.3.3.

- Disbursement takes place only in case of default.
- Cost reduction for SMEs, in case the guarantee is provided at reduced fees.
- Significant leverage on resources allocated, in the case of the portfolio guarantee.

➢ ***For outdated or lack of physical infrastructure and insufficient or unpredictable cash flow*** there were identified two financial instruments: **loan or equity**.

The loan instrument addresses specific liquidity and risk capacity constraints in a given market segment which provide a company with liquidity but which have some disadvantages: increases the company's risk level, has to be re-paid and assets may be taken as collateral.

Equity investments provide capital to a company, invested directly or indirectly in return for partial ownership of that firms equity investors may assume some management control of the firm and share the firm's profits. The main advantages are: capital injections in SMEs which normally are not considered eligible for bank financing and do not have to be repaid, the risks and liabilities of company ownership are shared with the new investors and there is a know-how-transfer from the professional fund manager.

The instrument is appropriate for SMEs without necessary collateral to secure the level of financing required to start their businesses and for the companies in advanced stage of development, attaining a low debt-to-equity ratio.

➢ ***For low employment rate, underdeveloped entrepreneurial culture and limited access to finance***, the main instruments taken into account were **guarantees and microcredits.**

The analysis concerning the relation between **business stage of development** and **the most appropriate financial instruments** was also performed. Below are presented the results of analysis, specifying how these are reflected in the Operational Programmes which will use financial instruments as implementation tools:

➢ **For seed and start-up phase:**

- Equity Funds for start-ups and early stage: accelerators & seed funds SMEs will be financed through Competitiveness OP.
- Microcredits and guarantees for seed and start-up enterprises financed through Human Capital OP

➢ **emerging and growth stage**

- Portfolio Risk Sharing Loan (PRSL) funded through OP Competitiveness and Regional OP .
- Uncapped Guarantee for SMEs in emerging and growth stage through the SME Initiative.
- Equity Fund for SMEs in emerging and growth stage funded through Regional OP.

The matrix of the proposed financial instruments to be used in the programming period 2014-2020 is presented below.

The leverage is calculated as the amount of financing catalysed divided by the OP contribution (EU funds + national budget), without considering the revolving features and the impact of management costs, which will be assessed at a later stage.

Proposed ESIF Financial Instruments 2014-2020 in Romania

Financial Instrument	Rationale for instrument	Proposed allocation EURm (EU contribution) (1)	Proposed allocation EURm (EU funds + national contribution) (up to) (2)	SME financing supported EURm (estimate) (3)	Leverage effect (estimate) (4)= (3)/(2)
COMPETITIVENESS OPERATIONAL PROGRAMME					
Thematic Objective 1 "Strengthening research, technological development and innovation"					
Equity Funds for start-ups and early stage (Accelerators & seed funds)	Investments in start-up and early stage innovative SMEs	34.0	40.3	44.3	1.1x
Portfolio Risk Sharing Loan for Innovative SMEs	Provide 50% cost reduction and partial risk coverage to innovative SMEs	16.0	19.0	38.0	2x
Total Competitiveness Operational Programme		**50.0**	**59.3**	**82.3**	**1.38x**
Regional Operational Programme					

Financial Instrument	Rationale for instrument	Proposed allocation EURm (EU contribution) (1)	Proposed allocation EURm (EU funds + national contribution) (up to) (2)	SME financing supported EURm (estimate) (3)	Leverage effect (estimate) (4)= (3)/(2)
Thematic Objective 3 "Enhancing the competitiveness of SMEs"					
SME Portfolio Risk Sharing Loan	Provide 50% cost reduction and partial risk coverage	100	117.65	235.3	2x
SME risk capital fund	Risk capital Investments in SMEs	50	58.82	100.0	1.7x
Total Regional Operational Programme		**150**	**176.47**	**335.3**	**1.9x**
Human Capital Operational Programme *Thematic Objective 8 "Promoting employment and labor mobility"* *Thematic Objective 9 "Promoting social inclusion and combating poverty"*					
Portfolio Risk Sharing Loan for SMEs/entrepreneurship	Provide 80% cost reduction and partial risk coverage for entrepreneurship and for job creation	47.3	56	70	1.25x
Microfinance Guarantee	Covering up to 80% of risk of loans for entrepreneurship and for job creation	47.3	56	280	5x
Portfolio Risk Sharing Loan for social enterprises	Provide 80% cost reduction and partial	18.6	22	27.5	1.25x

Financial Instrument	Rationale for instrument	Proposed allocation EURm (EU contribution) (1)	Proposed allocation EURm (EU funds + national contribution) (up to) (2)	SME financing supported EURm (estimate) (3)	Leverage effect (estimate) (4)= (3)/(2)
	risk coverage for social enterprises				
Social Guarantee	Covering up to 80% of risk of loans for social enterprises	18.6	22	110	5x
Total Human Capital Operational Programme		**131.8**	**156**	**487.5**	**2.62x**
TOTAL AND LEVERAGE		**331.8**	**391.77**	**905.1**	**2.31**

The allocation for participation of Romania in SME Initiative for the joint uncapped guarantee instrument is presented below:

EU SME Initiative Operational Programme ***Thematic Objective 3 "Enhancing the competitiveness of SMEs"***				
Joint Guarantee Instrument (option 1 of the SME Initiative)	Covering up to 80% of the risk of loans to SMEs	100	400	4x
Total EU SME Initiative Operational Programme		100	400	4x

The proposed instruments ensure a complementarity between equity and debt instruments, corresponding to the market gaps identified and the segments targeted under the relevant thematic objectives and operational programmes.

With regards to **implementation options**, it is recommended to utilise one or more of the options stipulated by the Common provisions regulation ("CPR"), articles 38 (1) and 38 (4):

1. **Financial Instrument set up at EU level, managed directly or indirectly by the EC, according to CPR article 38 (1)** According to the CPR, Member States may use the ERDF and EAFRD to provide a financial contribution to financial instruments managed indirectly by the Commission with implementation tasks entrusted to the EIB in respect of the following activities: uncapped guarantees and securitisation.

   Romania decided to participate in SME Initiative **with contribution from ERDF for the joint uncapped guarantee instrument (option 1),** which presents numerous advantages:

   - **Improved access to finance** for SMEs through capital relief, loss protection and potentially liquidity for the financial intermediaries;
   - Increased **leverage on public budget** through participation of EIB/EIF, COSME and/or Horizon funds, and private sector;
   - The SMEI **does not require co-financing** with national funds;
   - The SMEI relies on an **ex-ante analysis which has already been performed** by the EC and the EIB Group
   - There is available a **ready-made template for the Funding Agreement** to be negotiated between Member States and the EIF;
   - The treatment of **State Aid has already been cleared** by the European Commission.

2. **Entrustment of implementation tasks to EIB/EIF according to CPR article 38 (4) (b) (i)**

The choice to appoint EIB Group, more specifically EIF, to act as fund-of-funds in implementing SME financial instruments presents several advantages, notably the EIF's relevant experience in implementing the JEREMIE financial instruments in the 2007-2013 programming period.

It is proposed to entrust the implementation to EIF, as Fund of Funds, for the financial instruments financed by Competitiveness OP and Regional OP, and possibly for Portfolio Risk Sharing Loan instrument and also for instruments financed from the Human Capital OP.

3. **Entrustment of implementation tasks to a body governed by public or private law according to CPR article 38 (4) (b) (iii)**

According to the article 38 (4) (b) (iii) of CPR, the implementation of financial instruments could be entrusted to an international financial institutions in which a Member State is a shareholder, or a financial institution established in a Member State aiming at the achievement of public interest under the control of a public authority.

In order to clarify the requirements of the above-mentioned article, the European Commission has developed the Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, a document in draft version at the time of the ex-ante assessment, according to which the award of public contracts by or on behalf of Member States' authorities has to comply with the principles of the TFEU, and in particular the free movement of goods, freedom of establishment and freedom to provide services, as well as other related fundamental principles such as equal treatment, non-discrimination, mutual recognition, proportionality and transparency. Furthermore, public contracts must comply with the public procurement directives (either Directive 2004/18/CE or Directive 2014/24/UE). The only exceptions are related to the designation as bodies implementing financial instruments of EIB/ EIF or an in-house entity. Such institution must also comply with the requirements laid out in articles 7(1) și (2) of Delegated Regulation 480/2014.

Considering that none of the managing authorities owns an in-house entity, the use of a national institution would require a public procurement process. The main disadvantages of this option are the lengthy period needed to begin implementation (depending on the public procurement process) and the lack of expertise in the field.

One of the most important benefits of using Financial instruments in implementation of ESI Funds is their **value added**. At a general level, the **qualitative** value added includes:

- **More responsible approach, better performance and financial discipline**
- **Simplicity of obtaining financing**
- **Creation of a new generation of entrepreneurs**
- E**ncouraging entrepreneurship** among less advantaged social categories;
- I**ntroduction of new instruments** including not only the early stage equity funds but also potentially the microcredit instruments;
- Supporting the buildup and modernisation of the financial system, including also the **non-banking financial institutions**.
- Creating c**ompetition among banks**;
- The **mathematical leverage effect is supplemented** by the stimulation of interest of private investors in a country or sector they would not have considered otherwise, potentially leading to further investments undertaken by them in the future.
- **Flexibility and adaptability**
- **More cost effective management**
- **Quick disbursement of funds**, absorption and less distortion of competition
- **Supporting competitiveness, innovation and entrepreneurship and creating employment**

Also, the financial instruments will provide **quantitative value added** through leverage/multiplier effect, i.e. the financing made available to SMEs divided by the OP contribution to the instrument, as it is presented in the table above. At instrument level, this ranges from a leverage of 1.1x in the case of seed funds and accelerators, where the qualitative dimension prevails by the risk taken in early stage projects, to around 5x for portfolio guarantee instruments. Thus, the proposed portfolios of instruments would lead to a leverage of 2.3 for the financial instruments managed at the national level and of 2.65 including SME Initiative (before considering the revolving features and the impact of management costs).

One of the expected benefits of FIs is **to attract private investments and other public funding**. To this end, international financial institutions should be considered an important source of funding, to the extent that their involvement takes place on market terms.

The sources of private funding, depending on the nature of the instruments, are:

- In the **case of equity funds**, firstly the fund managers invest normally around 1% of the fund capital, for alignment of interest purposes, and in parallel they market the fund to private investors. It is important to note the potential participation here of institutions such as European Bank for Reconstruction and Development (EBRD) or European Investment Bank (EIB). Other private investors may include **institutional investors located in Romania**, such as banks, asset managers and private pension funds.
- In the case of **risk sharing loans**, the banks themselves make available normally 50% (for instruments financed from ESIF) respectively 20% (for ESF) of the funding at SME level from their own sources or from loans either from mother banks or from institutions such as EIB.
- In the case of **guarantees**, the banks make available their own or borrowed funds for the loans extended to SMEs.

The proposed strategy for implementation of the FI with ESIF resources in the period 2014-2020 is based on the market situation as of 2013/2014 and on the lessons learned during the previous programming period. In case of major changes will occur should be necessary to revise the ex-ante assessment. The types of major changes that may require a revision of the ex-ante assessment could be:

- **A significant change in the financial and economic environment** – such as an economic crisis.
- **Changes in the fiscal and financing conditions of the economy.**
- **Changes in liquidity** would lead to an inability to effectively implement some of the proposed financial instruments.

- In case of a change in the legal and institutional framework that lead to **changes in the investment environment.**
- **Inadequate volume** of the support scheme compared to observed demand. For example, a situation where the volume is too low to meet observed demand may undermine the ability of the FI to achieve envisaged objectives.

At this point it is premature to provide a timing for potential revisions of the ex-ante assessment, however it is considered important to point out that more informal updates can be easily obtained by interviews and panel discussions with financing providers (e.g. banks, equity fund managers etc.) and SME representatives, which can be undertaken much faster than formal assessment revisions and may provide critical input for the revision of the investment strategy. Such market testing exercises take place prior to the launch of any new instrument in order to ensure its effective implementation.