EXPERT COMMENTARY

Private equity has benefitted from strong public financial support in the country but the conditions for fund management growth remain insufficient, writes POELLATH's Andreas Rodin

Germany takes steps to shore up the PE market

There has been much coverage of the impact of the coronavirus pandemic on private equity, most notably the drop in investments, as well as its broader effect on the economy and individual industry segments. Over the last year, the German government has introduced measures to bolster the venture capital and private equity industry, including an April 2020 programme to support VC investments in start-ups; a long-term financial initiative to boost private equity investments over the next decade, which was approved in November 2020 and is fully funded through the federal budget; and new legislation submitted to parliament in January that aims to improve the country's competitiveness as a financial services location.

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Corona Matching Facility

In April 2020, the government introduced a fully funded €1.2 billion programme, known as the Corona Matching Facility, to provide co-funding for direct investments through financing rounds for start-ups during the pandemic. The programme's term was initially limited to 31 December 2020, but this was extended to 30 June 2021. CMF is managed and implemented by KfW Capital, the private equity division of the German state-owned development bank Kreditanstalt für Wiederaufbau, and the European Investment Fund.

Co-funding is provided by KfW Capital and EIF indirectly by matching the direct investments of VC funds in start-ups. For this purpose, KfW Capital and EIF enter into a co-investment and trust framework agreement with private equity firms managing funds focused on investing in start-ups. While the rules governing the CMF do not contain specific requirements that have to be fulfilled by private equity

Matchmaker: the CMF forms part of the German government's support for start-ups in need of funding during the pandemic

CMF and state aid

As the Corona Matching Facility is funded out of the federal budget, the support programme had to be structured so as to avoid being qualified as illegal state aid.

For this reason, each co-investment and trust framework agreement includes the following limitations and restrictions.

In relation to KfW Capital and EIF on the one hand and the investing scheme on the other, the matching ratio cannot exceed 70 percent. It will be adjusted downwards on a case-by-case basis so that in any single financing round (i) the total amount of public money invested shall not exceed 70 percent of the total size of the financing round, and (ii) the total amount drawn down from the CMF shall not exceed 50 percent of the total size of the financing round.

If new investors participate in a financing round, the aggregate amount to be invested by new market-oriented investors within the meaning of the European Commission's State Aid Guidelines for Risk Capital must represent at least 30 percent of the total size of the financing round.

firms as a condition of entering into a CTFA – regarding residency, for example – KfW Capital and EIF conduct a commercial, legal and integrity review of the private equity firm prior to committing to co-funding. In order to provide co-funding as quickly as possible, a fast-track approval process was agreed for private equity firms managing funds in which KfW Capital and EIF are already investors.

"There has been demand among the private equity community for support, and the CMF offers a pragmatic and efficient solution"

A fund is eligible for the matching scheme if it fulfils the following requirements: (i) it has to be structured "state aid free" and the aggregate capital commitments of market-oriented investors within the meaning of the European Commission's State Aid Guidelines for Risk Capital must represent more than 50 percent of the total capital commitments to the fund; (ii) the manager complies with anti-money laundering laws and conducts know-your-customer checks; (iii) no strategic or financial investor holds together with its affiliates the majority of the interests in the fund; (iv) the fund must not be incorporated in a so-called "non-compliant jurisdiction"; and (v) the fund is only eligible for matching either by KfW Capital or EIF, but not by both.

When entering into the CTFA, the private equity firm will specify the fund(s) for which the investments shall

be matched and the matching ratio. The private equity manager can elect whether only follow-on investments in existing portfolio companies will be matched or follow-on investments as well as new investments. Matching of new investments only is not available through the programme.

The term during which fund investments will be matched expires on 30 June 2021. In order to avoid "negative selection" by the PE firm, during this period all investments by the funds specified in the CTFA will be matched at the agreed matching ratio. Investments by the funds in financing rounds structured after 30 June 2021 are no longer eligible for matching. However, KfW Capital and EIF will be offered the opportunity to co-invest with the funds up to the amount necessary to provide anti-dilution protection for KfW Capital and EIF in respect of their CMF-funded co-investments made up until 30 June 2021.

While the CTFA is a private law contract, because the CMF is a support programme, each CTFA provides for standardised and uniform terms and conditions. The most important feature characterising each CTFA is the undertaking by the private equity firm to strictly adhere to the so-called *pari passu* principle, ie, all decisions as to the structure, consummation, increase, management, decrease and termination of the funds' investments and the CMF-funded co-investments shall be taken by the PE firm under identical terms and conditions. The authority to make investment decisions rests exclusively with the PE firm and these are binding for KfW Capital, EIF and the fund managed by the PE firm. KfW Capital and EIF do not participate in the PE firm's decision-making process.

Following the government's announcement of the support programme in April, all internal processes have been implemented, and the fast-track approval process of private equity firms and the entire contractual documentation were completed in just two months. By July, KfW Capital and EIF had started entering into CTFAs and private equity firms began to draw down monies from the CMF for investment in financing rounds structured from 2 April 2020. To date, approximately 25 CTFAs have been entered into with private equity firms regarding the matching of investments of around 35 investment funds. The amount committed by KfW Capital and EIF for co-investments funded out of the CMF totals approximately €750 million. These figures indicate that there has been demand among the private equity community for support, and the CMF offers a pragmatic and efficient solution to this.

> *"The lack of growth-stage capital for companies emerging from the European ecosystem continues to be a challenge"*

German Future Fund

With financial support through programmes funded by the EU (via EIF) and the German government, Europe's and, in particular, Germany's venture capital markets have grown. Following the burst of the internet "bubble" at the beginning of the century, European VC funds struggled to reach a reasonable target fund size. With public financial support over the last 15 years, German VC fund managers with a solid track record over a series of fund generations have successfully managed to raise funds at growing volumes.

However, the lack of growth-stage capital for companies emerging from the European ecosystem continues to be a challenge. While Europe has significantly reduced the gap when it comes to the creation of leading technology companies, the structural shortcomings surrounding access to risk capital for European companies persists. This is also the case in Germany.

In order to develop a German and pan-European growth and later-stage financing ecosystem, Europe and Germany need a sufficient number of large-scale venture capital firms that are able to back, as lead investors, EU companies that are on their way to becoming global category players. Taking into consideration the positive impact of public financial support on the growth of Europe's earlier-stage market, in November 2020, the German government announced a fully funded €10 billion programme for the late-stage financing of German technology companies by German and European venture capital firms.

The initiative is referred to as the German Future Fund and consists of several pillars. This includes two growth capital facilities, one to be managed by KfW Capital and one to be managed by EIF, which will commit to funds focused on growth capital investments. It also includes a facility for separate managed accounts, a facility for venture tech growth financing, increased investment volumes for the two state-owned investment schemes (Coparion and High-Tech Gründerfonds) and a public capital commitment to a new fund of funds for investments in target funds focusing on growth capital financing. In order to attract commitments by private investors, the new fund of funds will include a waterfall distribution model where distributions on the public capital commitment rank junior to the distributions on capital commitments from private investors.

The two growth capital facilities for commitments by KfW Capital and EIF replicate the support programme established in 2004 under the ERP-EIF

facility by Germany and EIF to facilitate the growth of Europe's early-stage venture capital market. This initiative has been a great success and has helped Europe to significantly reduce the gap with the US early-stage market over the last 15 years. In line with this, it can be assumed that the long-term GFF initiative for the growth capital market will also be successful.

A more competitive environment

Although Germany has continuously provided strong financial support to foster the venture capital market in relevant segments, it has failed to create a competitive environment for fund managers to conduct business in Germany. At the same time, German technology companies face significant challenges when it comes to attracting qualified staff. The reasons for these defects, which mainly relate to tax issues, are well known and are challenges that POELLATH has addressed in previous commentaries for *Private Equity International*'s *Legal Special.*

In January, the government submitted new legislation to parliament to improve Germany's competitiveness as a location for the fund management industry and to introduce new rules for the taxation of equity participation issued by start-ups to their staff as part of their compensation packages.

The main obstacle for fund managers looking to establish funds in Germany and manage them locally is the government's position on the application of the EU exemption of the management of private equity and venture capital funds from VAT. This issue has been discussed with government over the last 14 years – with no success. The new legislation now provides for a VAT exemption for the management of "venture capital funds". However, such a term has not been legally defined and there is no indication yet of the features required by the ministry to be eligible for the VAT exemption.

In a statement on the new legislation, the German Private Equity and Venture Capital Association included a demand to define the scope of the application of the VAT exemption in accordance with its interpretation by the European Court of Justice and to extend it to fund management by managers subject to regulation by the Alternative Investment Fund Managers Directive or the European Venture Capital Fund Regulation. Although this request has been supported by Germany's second chamber, there is still no certainty whether it will be awarded.

New tax rules

The proposed new rules on the taxation of equity participations can be summarised as follows. While they are taxable at the time when issued, tax will become due and payable on the earlier of (i) disposition of the equity participation by the recipient, (ii) the 10th anniversary of the date of issuance and (iii) termination of the employment contract with the company that issued the equity participation. The new rules apply to equity participation in companies that are small and medium-sized enterprises within the meaning of the European Commission's definition at the time when the equity participation is issued or in the preceding year and if not more than 10 years have passed since the date of its incorporation.

"The government submitted new legislation to parliament to improve Germany's competitiveness as a location for the fund management industry"

In its statement, the German Private Equity and Venture Capital Association outlined three requests: to remove the provision that the tax becomes due and payable upon termination of the employment agreement; to provide that the tax becomes due and payable on the 15th anniversary of the date of issuance; and with respect to the issuing company, that as of the date of issuance not more than 15 years have passed since the date of its incorporation and not more than five years since the date when it lost its status as an SME.

Despite these issues, the new legislation is a welcome and necessary step for improving Germany's competitiveness. However, the new legislation is not enough to achieve the intended objectives. There is another major obstacle that must be removed. Germany lacks legal certainty as to the question of whether a private equity investment strategy constitutes a trade or business according to the German business activity test.

A December 2003 administrative pronouncement on the taxation of private equity funds and their investors provided legal certainty for several years because the set of facts described therein covered more than 90 percent of the investment strategies implemented at that time, and the administrative pronouncement had been applied uniformly and consistently by the tax authorities. However, that has changed over the last few years and there is no longer legal certainty as to the non-business requirements and their application by the local tax authorities. The administrative pronouncement needs to be updated taking into consideration the political objectives outlined above. Otherwise, political and financial efforts to create a more competitive environment will fail. ■

Based in Frankfurt, Andreas Rodin is a partner at POELLATH