# ESCALAR Programme

## Information document

*Important Disclaimer*

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# The scale-up challenge in Europe

Europe is home to a strong and diverse universe of start-ups, covering many sectors and industries.

As these start-ups succeed in the early stages of their development, they reach a point where, to achieve their full potential, they require significant additional capital to finance their growth.

A company has several options when facing such financing requirements. If growth plans can be financed organically, or through loans, they may not need external capital. Typically, this solution is a compromise, resulting in slower growth. Disposals of assets, subsidiaries or intellectual property can provide one-off capital inflows, but are typically insufficient to finance the growth phase of a successful start-up. External, at-risk financing provides the largest potential source of growth capital.

A fund may find it difficult to keep supporting an SME once it has reached its growth stage as they could lack the capacity (remaining funds for follow-on investments, or portfolio diversification limitations) or expertise (stage-specific funds focusing on seed and series A/B financing) to do so. Being unable to turn to their current venture capital investors, a company may seek to grow by pursuing an acquisition by a third party, it could seek additional capital from debt instruments or it could prepare and execute for a public listing to raise funds in an IPO.

In many cases, raising private finance is the most attractive source of funding for continued growth. It provides founders and management with continued autonomy, retains the value of future growth for existing shareholders, and allows the business to continue without any major restructuring.

There is broad consensus among scholars, policy makers and market participants that the European PE/VC ecosystem lacks the risk capital to scale-up promising companies. This is referred to as the **scale-up gap**[1]. This is in part because of a lack of equity funds with strategies or sufficient volume that can adequately support scale-ups, i.e. insufficient financial capacity to provide sizeable follow-on investments to the most successful portfolio companies. The consequence of this scale-up gap is that companies either fail, or find their growth prospects constrained by a lack of funding. In many cases, the result is a departure of the company from Europe as they seek financing in geographies with deeper and more consolidated equity markets and higher levels of demand for the products or services they are developing.

The creation of growth equity funds is considered a key element in a strategy to help Europe catch up to the US in terms of scale-up funding[2]. For this reason, the EIF has developed the **European Scale-up Action for Risk Capital**, or "**ESCALAR**" mechanism. Through ESCALAR, the EIF invests in funds whose strategies support scale-ups. The fund managers supported either identify successful later-stage companies, or finance companies they have invested in through prior fund vintages and whose potential they know well.

# What is the purpose of the ESCALAR mechanism?

ESCALAR aims to increase access to finance for **scale-ups** based in the EU and in the territory of Other Participating Countries[3] through two related effects.

First, the EIF will finance successful ESCALAR applicants by investing in a specific share class with a different risk/return profile (the "ESCALAR share class"). This provides additional capital that can be invested in promising companies in their growth phase.

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[1] "The European Small Business Finance Outlook 2021", Kraemer-Eis, Botarsi, Gvetadze, Lang & Torfs. EIF Working Paper 2021/75.

[2] Duruflé, Hellmann and Wilson, 2017

[3] Please refer to Annex II for full list of Other Participating Countries

Second, the creation of the ESCALAR share class makes it possible for other investors with a risk appetite that is not ordinarily suited to private equity or venture capital, to consider investing in this specific share class, given its adjusted risk and reward characteristics.

The EIF's objective is therefore to support scale-ups by investing its own resources in funds that support scale-ups, and to attract new investors to the private equity and venture capital asset class by creating a product with a risk-reward profile more aligned to their needs, thus drawing in new sources of private finance to help bridge the scale-up gap.

# What is the ESCALAR mechanism?

ESCALAR comprises a structured investment in the form of equity that, compared to a "traditional" fund investment, benefits from reduced downside risk, and as a consequence has a reduced upside return. This share class is not exclusive to the EIF and can be invested in by other parties interested in the risk/reward profile.

Where a fund performs, the non-ESCALAR limited partners (LPs), including the Fund manager, receive a larger share of the returns and are paid some of their return earlier than ESCALAR LPs, resulting in improved investment performance.

Where a fund underperforms, the ESCALAR shareholders have their capital repaid first, and once this has been fully reimbursed, the typical payment structure, including increased share of returns, is paid to the non-ESCALAR LPs.

In every situation where the fund performs, non-ESCALAR LPs will secure improved returns when compared to a situation where there were no ESCALAR LPs.

On the other side, should the fund perform poorly, the ESCALAR LPs will have priority over the reimbursement of the amounts they have paid into the fund. This reduces the risk to which they are exposed. This alternate payment process is brought into play when a **trigger event** is in effect.

A *trigger event*, defined in more detail below, occurs when there is a significant risk that the fund will be unable to generate sufficient reflows to reimburse all the LPs fully.

# How does the ESCALAR mechanism work?

When fund reflows materialise, they are distributed through an adjusted payment waterfall. This process determines the order in which different classes of limited partners get paid out of available funds. The waterfall structure varies upon materialization of the "trigger event", so as to provide, based on the fund performance, additional upside to non-ESCALAR LPs, and reduced downside to the ESCALAR LPs.

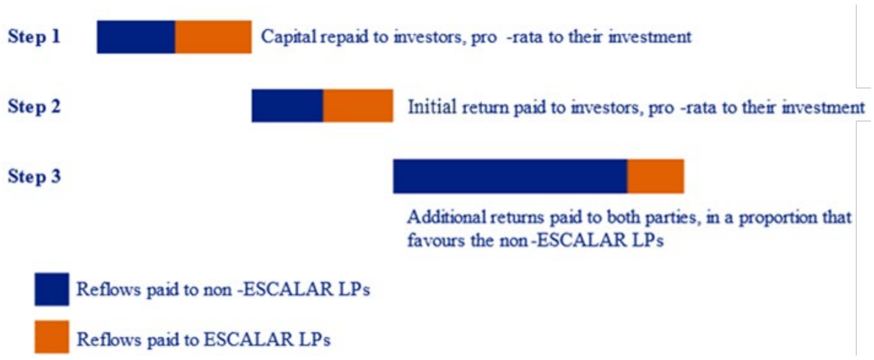
Under the ESCALAR mechanism, a trigger event is deemed to have occurred when the net asset value of the fund has dropped below 1.5 times the net paid-in amounts of the ESCALAR LPs.

In absence of a "trigger event" reflows are first shared pro-rata among all fund investors until the net paid in for all is zero. Any reflows in excess of this are shared according to a waterfall which favours the non-ESCALAR LPs.

In the event of a "trigger event" the waterfall is adjusted to reduce the risk to which ESCALAR LPs are exposed e.g. ESCALAR LPs receive reflows in priority to non-ESCALAR LPs.

## The payment waterfall without a trigger event

In the absence of a trigger event, the reflows will be paid in accordance with the following waterfall:




Where the fund performs well, there is potential to significantly increase the returns of non-ESCALAR LPs.

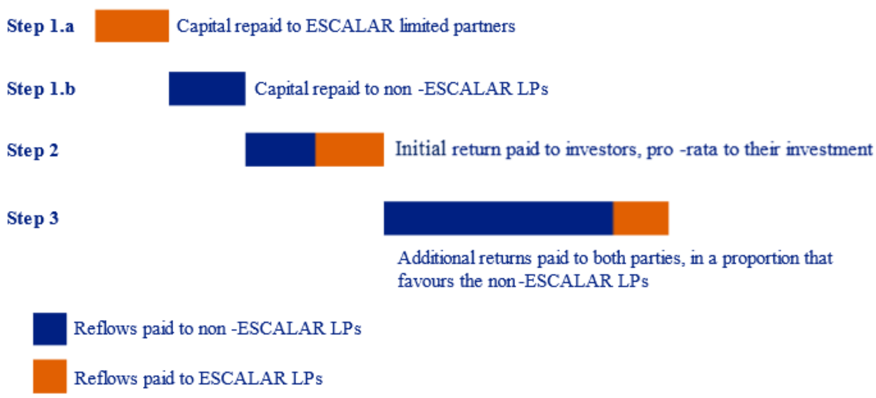
## Payment waterfall during a trigger event

When a trigger event has occurred, only the first step of the payment waterfall is affected.

For the period during which a trigger event is in effect, the first step of the waterfall is divided into two. The ESCALAR LPs will first receive all reflows until the net amounts they have paid into the fund have been reimbursed. Once these amounts have been completely refunded, the non-ESCALAR LPs receive all reflows until their capital has been repaid.

A trigger event is not one-way; if a trigger event is remedied through an increase in the net asset value of the fund, or the ESCALAR receive sufficient reflows for the net asset value of the fund to be more than 1.5 times the net amount of ESCALAR paid-in amounts, the payments priority is also stopped.

The remainder of the waterfall will proceed as in the case where the trigger event does not occur.




# ESCALAR investment parameters and their effect

Non-ESCALAR LPs can expect improved returns in funds that perform well. More importantly, in any fund that does not underperform, the non-ESCALAR LPs will always have an improved return compared to the situation where ESCALAR mechanism is not in place.

The overall effect on other limited partners in the fund will depend on a number of factors, in particular the Initial Return percentage, (floored at 3%).

In addition, the relative proportion of ESCALAR investment to total fund size will have a significant effect, as this determines the leverage with which the ESCALAR terms and conditions act on the returns for other LPs.

Should the fund fail to return its invested capital, the ESCALAR limited partners would benefit from a priority on any reflows that do occur, until their original investment is returned to them. This limits the ESCALAR limited partner downside at the expense of other limited partners in the fund.

In addition, the ESCALAR LPs do not pay management fees to the general manager. For this reason, it is necessary for the fund to have sufficient other LPs, and sufficient assets under management, such that the management fees from other parties are covering fund operating costs. In any event, the EIF ESCALAR Investment cannot exceed 50% of the fund size.

In order to facilitate an ex-ante assessment of the effect of the ESCALAR mechanism on fund dynamics and returns, a financial model may be made available to applicants by the EIF to facilitate simulation of the effect of different parameters.

## ESCALAR investment structures

Funds receiving investments under ESCALAR will need to create an alternative class of shares through which the ESCALAR LPs participate, and these shares will have terms and conditions different to those held by other limited partners.

Two possible structures are envisaged for funds receiving an ESCALAR investment.

***Option 1:***

The ESCALAR LPs invest in the main fund through a separate class of shares. Distributions occur directly from the main fund to the different limited partners in accordance with a payment waterfall described in thei fund rules.

***Option 2:***

A side fund is created in parallel to the main fund. The side fund is used to invest in ESCALAR eligible beneficiaries. Investors of the side fund will be ESCALAR and the main fund.. The main fund invests in the side fund and non-ESCALAR limited partners receive their returns through distributions made from the side fund to the main fund.

This second option is particularly suitable to funds who wish to create a follow-on or ‘opportunities’ fund, dedicated to follow-on investments in the most promising portfolio companies of their main fund, helping these to achieve scale.

In both options, there is scope to bring in additional investors, within or outside the ESCALAR share class, to add financial capital to the fund.

# Applying for an Investment under ESCALAR

The EIF accepts applications for ESCALAR under a **closed call for expressions of interest**. The call will accept applications until 31st January 2024. Once the application period has ended, the EIF will select from the applicants a number of candidates for due diligence.

ESCALAR is financed from the InvestEU mandate, and **applications to ESCALAR will therefore also be applications for financing under InvestEU**, and subject to the terms and conditions of the InvestEU products. ESCALAR candidate funds must therefore have strategies that align with the thematic objectives of InvestEU.

Funds will be considered if their investment strategies can cover one or more of the following target areas:

- **Enabling Sectors**: Space, Semiconductor Technologies, Semiconductor Chips, Defence, Industrial Technologies and Life Sciences.
- **Climate and Environmental Solutions**: Mobility & transport, energy & built environment, Industrial decarbonisation and environmental sustainability, agriculture & natural resources, blue economy.
- **Digital and Cultural & Creative Sectors**: Artificial intelligence, quantum computing, blockchain and distributed ledger technologies, education tech, cultural and creative sectors and other digital technologies
- **Capital Markets Union**: Growth and expansion funds, debt funds and hybrid debt-equity funds.

Full details eligibility, investment and reporting requirements are available on the EIF's dedicated InvestEU webpage[4].

[4] http://www.eif.org/investeu