European Investment Fund

EIF CORPORATE OPERATIONAL PLAN

2003 – 2005

January 2003

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1. EXECUTIVE SUMMARY

The EIF has built up a strong reputation in its two specialised core areas of supporting European SMEs by way of venture capital investing and/or guarantee financings. 2002 has seen a significant slowdown in venture capital activity as a result of market conditions, whilst guarantee activity was maintained. Over the period covered by this COP the EIF intends to pursue its two core product activities, within the constraints set by available resources.

The EIF is aware of the expectations and opportunities created by the Enlargement Process. From now it is establishing the operational tools and contact networks that will allow it to make a useful contribution to Community Objectives whilst **taking full advantage of new opportunities created by the Enlargement Process** to begin officially on 1 May 2004 notably in the extension of the MAP to new Member States.

The EIF will continue to dedicate significant resources to **the active management and monitoring of all its venture capital and guarantee operations**, and to **extend portfolio and risk management** to all its activities with appropriate IT tools. The EIF builds its involvement in venture capital and guarantee operations on the basis that the signing date signals the beginning not the end of a long-term close involvement with its investments.

The EIF aims to permanently assess its activity so as to respond with flexibility to current and forthcoming market needs. In this area a key current development is the establishment of fee generating advisory activity as well as the prospect of a number of fund structures better equipped for current market conditions and allowing for a reduction in costs.

In keeping with EIF's policy drivers, the activities that could emerge over the next two years will be broader than the EIF as presently known. Thus it can be envisaged that the EIF could become a multipurpose vehicle able to rapidly and flexibly fulfil new missions required by the pursuit of **Community Objectives**. Such missions on behalf of key stakeholders or on its own account will only be undertaken if they generate appropriate returns as per EIF's Statutes.

Making full use of the 2000 Statutes in order to better respond to the Fund's mandates can and should result in the development of new tools and innovative financial instruments. Improving the Fund's reactivity to market needs could **expand some of EIF's activity beyond small SMEs and indirect participations**. This will optimise the role of the Fund as a unique institutional and financial link between the EIB and the Commission, without detracting it from its core activities.

In the pursuit of its activities, the EIF will maintain quality corporate governance and adhere to best practices in key areas such as audit, operational and portfolio risk management, etc. as well as transparency.

2. SHAREHOLDERS

The two key partners of the EIF are naturally the **EIB** and the **Commission.** The Fund is keen to further its position as a unique institutional and operational link between both institutions. It can usefully act as facilitator for operating partnerships between both institutions as well as other shareholders in implementing common policy objectives.

i) Increased cooperation with the **EIB** has materialised since 2000, primarily through the transfer and further implementation of the Risk Capital Mandate as part of the "Innovation 2000 Initiative". It is envisaged that increased operational synergies and coordination should further develop in future, based on the complementary role played by the EIF as a specialised subsidiary within the EIB Group. ii) There is also scope to further extend the already active cooperation with the **European Commission.** The ongoing mandates signed in December 2001 in the framework of the "Multi-annual Programme for Enterprise (MAP)" covering the period 2001/2005[1] currently constitute the most concrete basis of this cooperation. Working parties have furthermore been set up with DG Research (in the framework of the Memorandum signed in June 2001 between the latter and the EIB Group) and more recently with DG REGIO, adding new perspectives (possibly to include operational mandates) to the operational cooperation prevailing until now only with DG ECFIN and DG Enterprise within the MAP. This constructive relationship is likely to continue in future including other DGs, with the aim to develop the scope of Community Objectives served by the EIF.

iii) Relations with the third group of shareholders, represented by the **banks and financial institutions**, have gained visibility in the recent past. Information sessions are now organised regularly (the last one hosted by DEXIA-Crediop in Rome in December 2002). Recent progress points that there is additional scope for future strengthening of the relationship with this category of shareholders, **in particular with a core group willing to engage in active cooperation.**

[1] The MAP foresees Venture Capital instruments through "ETF Start-up" and the "Seed Capital Action", and foresees guarantees of SME portfolios of banks and financial institutions through the "SME Guarantee Facility", which now encompasses four windows: micro-credit, ICT investments, equity participations and guarantees of high-growth SMEs.

3. OPERATIONAL PLAN: 2003 – 2005

3.1 The EU underlying policy drivers

The EIF acts as a specialised vehicle working within the framework of the EIB Group (especially within the present Innovation 2000 Initiative running until mid 2003), in close partnership with the Commission. The Fund continues to develop its activity in support of EIB Group strategy and Community Objectives. Since the June 2000 Reform support for SMEs and entrepreneurship, the support of European technologies and Regional Development have formed the core of EIF's policy objectives.

The conclusions of the **Lisbon European Council** (March 2000) highlighted the necessity to bridge the knowledge-based gap between Europe and the USA, and thus increase the EU potential for growth and employment. This guideline, focused primarily on venture capital, was again highlighted in Nice and **Stockholm**, the latter conclusions insisting on the necessary support to "frontier technologies", especially biotechnology. The recent **Barcelona** Summit (March 2002) stressed once more the need to establish a single European Venture Capital market and to foster technology transfer across Europe. However, beyond advanced technologies the Fund is keen to also offer support for the more traditional SME sector and entrepreneurship in general, which remains a permanent preoccupation of the European Council. For instance, the **Barcelona** conclusions recently asked the Commission to report on "the consequences of the Basel deliberations (…) with particular attention to SMEs". The Risk Capital Action Plan Communication which was adopted by the ECOFIN Council on 5 November 2002 specifically recognises EIF's role in support of European Venture Capital under difficult market conditions.

3.2 Venture Capital

Venture Capital market conditions

Latest data available from EVCA (European Venture Capital Association) covering all of Europe, corroborated by findings from other data providers such as Ernst & Young's Venture Capital Advisory Group, Initiative Europe and Tornado Insider, all provide confirmation that the trend which prevailed at the end of 2001 has continued and possibly worsened during the first six months of 2002. At the time of writing, all indicators show activity (investments by VC funds, particularly when excluding follow on investments, and new VC funds raised) is continuing to slow across the region, with little sign of an upturn. Most analysts point to the extreme uncertainty of public markets and related doubts about medium-term economic prospects as main reasons for such low levels of activity in what is typically a busy time of the year. Estimates of Q2 private equity activity at EUR 5.2bn, well below 2001 activity levels for the same period (EUR 22.9bn). Early stage activity comprising the core of EIF activity also suffered, with deals amounting to EUR 600m during Q2 (total 2001 activity on a comparable basis amounted to EUR 1bn). At EUR 2.4bn, venture investment (which includes, but is not limited to, early stage investing) was 46% lower than in the second half of 2001.

During the second quarter 2002, fundraising presented some upturn against the first quarter, with private equity and VC funds raised of EUR 13bn against EUR 3bn during the first quarter, although lower than the EUR 15.5bn during the second quarter 2001.

In sectoral terms it is worth noting that biotechnology and health-related activity continues to be alone in escaping the prevailing gloom and reached a record one third of total activity during first half 2002.

The current year 2002

The December 2001 Business Plan forecasts new commitments for the year 2002 falling in the range of EUR 600m to EUR 800m. It is currently expected that **some EUR 450m of new commitments,** subject to a number of operations reaching certain target levels in their fund raising, and the timely closure of legal documentation satisfactory to the EIF will be signed in 2002. **This would bring the total VC portfolio committed to EUR 2,450m at end 2002, of which about 45% would actually be disbursed.**

This lower than expected outturn results from the very cautious attitude of potential co-investors in the early stage high technology venture capital arena which forms the core of EIF's VC activity. In practice, in many instances where the EIF is willing to make a significant commitment to a fund (in general 20%, while providing incentives to other investors), other partners are still left to be identified in order to raise the remaining portion.

Forecast medium term activity

	2001	2002	2003	2004	2005
Yearly Signatures	800.1	450.0	420.0	440.0	220.8
Cumulative Signatures by Year	1,998.0	2,448.0	2,868.0	3,308.0	3,528.8
Investment Capacity	2,393.7	2,704.3	3,038.7	3,465.4	3,682.3
Utilisation	83%	91%	94%	95%	96%

Future signature figures in the above table are **to a large extent driven by current estimates of resources available for investment under third-party mandates,** rather than only on an appreciation of the amount of possible investments the EIF could in fact achieve on the basis of identified or potential market demand.

3.3 Guarantees

SME Guarantee activity is complementary to EIF's Venture Capital activity, providing a very efficient means of financing large numbers of SMEs by way of the significant leverage effect achieved therefore optimising the deployment of EC Budgetary resources. Guarantee mechanisms considerably improve the ability of SMEs throughout Europe to access credit finance.

Current guarantee commitments

As of 30 September 2002, total cumulative guarantee commitments stood at (EUR m):

Own risk	1,407
Trust activity	2,607
Total	**4,014**

Forecast activity for 2002

The following table shows the expected results for 2002 including original forecasts of the Business Plan as put to the Board in December 2001, as well as the projections through to 2005.

For 2002, a total signatures figure of EUR 1,042 m is foreseen, in line with the December 2001 Business Plan (+9% over 2001). This is the result of the development of both Own Risk (EUR 434m, + 7.5% over 2001) and Trust activity (EUR 608m, +9.6%). Note that budgetary resources under the Growth, Employment & Environment Initiative were committed by May 2002. Cumulative signatures would reach about EUR 4,400m by year-end.

This confirms the overall good balance of revenue streams between own risk operations and trust activity, which is to be maintained in the coming years.

Business Plan 2002 – 2005 (EUR m)

Year	2000	2001	2002	2002e	2003	2004	2005
Guarantee Products	Final	Final	Original (*)	Current (*)			
Credit Enhancement	8	209	*340*	298	385	385	385
Credit Insurance	44	69	*185*	98	25	25	25
Structured investment funds	13	40	*30*	38	30	30	30
Subtotal 'Own resources'	***65***	***318***	***555***	***434***	***440***	***440***	***440***
Growth & Environment	156	86					
Subtotal 'Own risk'	***221***	***404***	***555***	***434***	***440***	***440***	***440***
SME GF 1998-2002	249	555		444			
MAP 2001-2005				164	800	600	600
Subtotal 'Trust'	***249***	***555***	***500***	***608***	***800***	***600***	***600***
Grand Total	***470***	***959***	***1,055***	**1,042**	**1,240**	**1,040**	**1,040**
Change over previous year							
Own risk		*+83%*		*+7%*	*+1%*	*-*	*-*
Trust		*+123%*		*+9%*	*+32%*	*-25%*	*-*
Overall		***+104%***		***+9%***	***+19%***	***-16%***	***-***

(*) Original: December 2001. Current: December 2002

Within the own risk products, the already foreseen shift from credit insurance to credit enhancement is confirmed (new Credit Insurance commitments in 2002 are expected to total EUR 98m, compared to a total of EUR 298m new Credit Enhancement deals). The expected outturn of EUR 1,042m should come out very close to last year's Business Plan forecast, nearly 9% higher than 2001.

Medium-Term Projections 2003-2005

Relatively higher volumes are expected under the trust activity (MAP) by extending the Facility with well-performing intermediaries and by entering into new agreements particularly with regard to the new special windows and the Accession Countries.

For 2003, based on the expected deal pipeline with regard to both own risk and trust activities under the MAP, the total guarantee volume is estimated at EUR 1,240 m, or 19% higher than in 2002, mainly due to the expected increase in the trust activity (+32%). Trust activity (EUR 800 m) is expected to account for approximately 2/3 of the total guarantee volumes.

For 2004-2005 no major changes are foreseen in the guarantee activity, targeting full commitments of the budgetary resources under the MAP at the latest by the end of 2005, while maintaining the own risk activity at its 2003 levels (having reached its "cruising speed"). On this basis, the guarantee activity would platform at a level just over EUR 1,000m per year. The business plan development is based on the amount of EIF capital available and to be allocated in support of the Own Risk deals shown above, and also assume continued good cooperation with the EIB in relevant markets.

4. DEVELOPMENT ISSUES/NEW BUSINESS

4.1 Priorities for 2003: improved framework, additional mandates

EIB Risk Capital mandate (RCM)

It is widely acknowledged that the EIB Group has become a major source of finance for the early stage technology oriented venture capital industry, arguably a long term undertaking for professional investors. The Risk Capital Mandate funded by the EIB is the EIF's most significant financial resource in the field of Venture Capital.

Advisory services

i) To continue to meet its policy objectives whilst expanding its field of action, the EIF is currently ascertaining the market and financial viability for the provision of financial advisory services. This results from a **clearly identified "know how gap" in the area of financial engineering** whereby a significant number of EU-funding recipients including national and regional entities, academic/research institutions etc. sometimes do not have sufficient in house expertise to make fully optimal utilisation of such funding. These are areas where EIF can provide quality advice in view of its expertise as a guarantor or investor. This had been included at the suggestion of, and is conducted in close cooperation with **DG REGIO**.

There are a number of advantages to be derived from opening a new, **fee earning** line of business, foremost of which the strategic advantages and revenue diversification it would entail whilst not requiring additional capital resources.

ii) Ongoing contacts have reinforced the significance of adhering to best market practice in the field of advisory services, chiefly by establishing **a strict separation between advisory and investing activities, and establishing appropriate internal procedures to deal with potential conflicts of interest**. Whilst continuously seeking to maximise the complementarity of its various business lines, the EIF in the conduct of its Advisory activity will contractually establish with its clients that an advisory involvement in no way represents an implicit or explicit investment commitment.

In practice the main avenue currently pursued is the **EU regions** who are recipients of structural funds (financial engineering credits for Objective 1 and 2 regions), with a view to improving the utilisation of EU funding. In this context an exchange of letters has recently been finalised with **DG REGIO**. Other potential counterparts could arise within the scope of **DG RESEARCH**, with the PHARE programme for the Candidate Countries. The provision of such services to authorities located in areas other than the EU and the Candidate Countries could also be envisaged at a later stage.

4.2 Other anticipated developments

[2] April 2002.

Forthcoming Enlargement

The Enlargement Process clearly calls for renewed efforts in the two key areas of Venture Capital and SME Guarantees: while the EIF has been active for some years in the

former, new business has slowed down in 2002 (no new Venture Capital fund has been closed in Accession Countries because of insufficient appetite by co-investors). In the SME Guarantee area, notably on MAP resources, contacts with relevant local financial institutions have been activated/reactivated.

The Enlargement Process is also seen as a key institutional development with consequences being felt from now at various levels in EIF's mission and activities. Thus prior to **1 May 2004,** the **Enlargement** to 10 new member States will give the opportunity to the Fund to **broaden and strengthen its shareholding** structure. The EIF is already exploring ways to attract public or private financial institutions from the Candidate Countries, which should be not only shareholders but also key partners in the Fund's activity in the Candidate Countries.

Commission: targeted increase of the MAP budget line

Amounts currently available under MAP will hardly allow to satisfy the demand identified in the 13 Candidate Countries. Therefore a possible budget increase **up to 2005** needs to be closely followed-up with the Commission.

Additionally, during 2004 the EIF in close contact with the Commission will prepare **the renewal/replacement of the MAP instruments beyond 2005**. A significant increase of the SME Guarantee Facility can be expected as a key means for the Commission's involvement in the support of SMEs and entrepreneurship. Within this context it should be noted that the Industry Council of 5 December 2001 asked the Commission and the EIF to **reflect on new guarantee instruments**.