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Strengthening firms' capitalization in Italy: public support for equity and quasi-equity instruments

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Economic issues and policy responses

- The economic impact of the pandemic and the policy responses led to a **rise in indebtedness** of non-financial firms (NFCs).
  - on average **2 p.p.** increase in leverage with substantial **sectoral heterogeneity**;
  - net leverage has not increased;

- Support provided in the early phase of the pandemic came to an end in some cases; **selective measures** targeting firms' solvency have been adopted over the course of 2020-21.

- Fully-fledged package of **-six-** measures to strengthen NFCs capital structure has been adopted (regulatory framework in *Relaunch decree*, Law Decree 34/2020):
  - providing incentives for **voluntary equity injections**;
  - established a new architecture of **publicly sponsored funds** providing equity and equity-like funding.

Support to NFCs capitalization: overview

Eligibility criteria:

Size and **financial condition** are used to distinguish beneficiaries for different measures.

Policy approach:

- Smaller firms: **wide and decentralized support** based on:

  i) outright cash transfers;

  ii) tax incentives for voluntary equity increases.

- Larger firms: **selective and centralized support** based on:

  i) State-participation in NFCs capital structure.

Mapping the programs

Financial condition and firms' size

Financial condition	SMEs	Large
Distressed	1 - Cash transfers 5* - Employment and business cont. Fund	4* - Relaunch Fund 5 - Employment and business cont. Fund
Sound	1 - Cash transfers 2 - Tax credit equity injections 3 - SMEs equity Fund	4 - Relaunch Fund
	6 - Allowance for corporate equity	

Size class

Note: (*) limited applicability to the cathegory.

1 - Outright cash transfers to SMEs, law decree 34/200, Art. 25; 2 - Tax credit for equity increases to Mid-Caps, law decree 34/2020, Art. 26; 3 - SMEs' Equity Fund, law decree 34/2020, Art. 26 comma 12; 4 - Relaunch Fund, law decree 34/2020, Art. 27; 5 - Employment Protection and Business Continuity Fund, law decree 34/2020, Art. 43; 6 - Allowance for Corporate Equity, law decree 201/2011, Art. 19.

Mapping the programs

Source of funding and firms’ size

Source of equity funding	SMEs	Large
Fully gov. funded	1 - Cash transfers	
Gov. sponsored	5* - Employment and business cont. Fund	4 - Relaunch Fund 5 - Employment and business cont. Fund
Voluntary inject.	2 - Tax credit equity injections 3 - SMEs equity Fund 6 - Allowance for corp. equity	6 - Allowance for corp. equity
	Size class	

Note: 1 - Outright cash transfers to SMEs, law decree 34/200, Art. 25; 2 - Tax credit for equity increases to Mid-Caps, law decree 34/2020, Art. 26; 3 - SMEs’ Equity Fund, law decree 34/2020, Art. 26 comma 12; 4 - Relaunch Fund, law decree 34/2020, Art. 27; 5 - Employment Protection and Business Continuity Fund, law decree 34/2020, Art. 43; 6 - Allowance for Corporate Equity, law decree 201/2011, Art. 19.

Programs targeting micro, small and medium firms

1 - Outright cash transfers:

SMEs (<5 mln revenues) **hit by the pandemic** (33 per cent loss in revenues April 2020 - April 2019) are eligible for cash transfers.

- Size of the contribution: increasing in the amount of **revenue losses** and decreasing in **firms' size** (revenues buckets);
- The measure: 6.2 billion plus new resources made available.

Pros and cons:

- Mitigates liquidity shortfalls and **avoids excessive** use of **financial debt**. Similar proposal Gobbi, Palazzo, Segura (2020); in the EU context a cash-against-tax surcharge scheme discussed in Boot et al (2020).

- Estimates indicated a **budget allocation** aligned with the potential beneficiaries.

- Updates to the perimeter of beneficiaries (self-employed, firms operating in certain sectors or geographic area) have made some companies eligible for two or more type of cash transfers which are computed differently.

Programs targeting micro, small and medium firms

2 - Tax credit for equity increases to Mid-Caps:

Mid-Caps (5>revenues<50 mln) that **increase their equity** are eligible for tax credits to: 1) shareholders; 2) the company when losses in 2020 exceed 10 per cent of its equity.

- Size of credit: 1) 20 per cent of the capital increase (0.4 mln max). The measure ended in December '20; 2) 50 per cent of the loss up to 30 per cent of the capital increase (0.8 mln max). The measure ended in June 2021.
- Viability: **not in financial difficulty** (according to the EU regulation) prior to the pandemic.

Pros and cons:

- **Significant financial incentive** to equity injections. Preliminary analysis confirm that firms' equity increases were substantial in '20 and increasing with respect to '19;

- A **corporate tax credit** for equity increases could complement this measure;

- **Technical caveats**: while parent or subsidiaries are excluded from the tax credit based on anti-elusive arguments. Anti-elusive provisions were not defined in the case of credit for income losses.

Programs targeting micro, small and medium firms

3 - SMEs' Equity Fund:

Mid-Caps (5>revenues<50 mln) **hit by the pandemic** (33 per cent loss in revenues) that **increase their equity** by more than 250k can place bonds to the newly established Fund within the Italian Development Agency (Invitalia Spa).

- Size of financing: the lower i) 3x capital increase, or ii) 12.5 per cent revenues (2019). Cost and maturity defined by regulation with lower repayments when the firm: maintain labour force, invest in ecological transition or technology/digitalization.
- Viability: **not in financial difficulty** (according to the EU regulation) prior to the pandemic.
- The measure: 4 billion (1 billion in 2021). The measure ended in June 2021 with 110 operations.

Pros and cons:

- **Non intrusive**: limited rights in the management of the company; clear anti-elusive rules; incentives for the early repayment.
- **Debt increase:** firms' debt increase in the short term; rewards on repayment, non risk-sensitive pricing mechanism could induce substitution of previous (more expensive) debt.

Programs targeting large firms

4 - Relaunch Fund:

Large firms (>50 mln revenues) **hit by the pandemic** (10 per cent loss in revenues) in one of the categories: i) **strategically important** for the country; ii) in case of failure relevant negative **effects on the job market**; or iii) need of **debt restructuring/turnaround**, are eligible for equity and equity-like intervention by the newly established Fund within the National Promotion Bank (Cassa Depositi e Prestiti Spa).

- Type of financing: operations: i) at market terms ii) EC temporary state aids framework..
  - i) **longer-term perspective**, facilitate firms' ecological and digital transition, entail a private investment along with the intervention of the Fund.
  - ii) re-establishing firms' **financial structure** (debt to equity ratio) **prior to the pandemic**, can help less sound firms, whose viability may be considered at risk in the absence of the intervention.
- Viability: **not in financial difficulty** (according to national criteria) prior to the pandemic.
- The measure: 44 bln; its size could be expanded using state-guaranteed bonds issued by the Fund or by private investments. More resources have been allocated for 3 billion. The duration set is 12 years. To date, the Fund has not concluded any operations yet.

Programs targeting large firms

4 - Relaunch Fund:

Pros and cons

- **The governance:** the Fund operates through a wide set of instruments and uses a consolidated institutional architecture (CDP Spa); implementation was slow.

- **Monitoring:** for equity injections the Fund retain rights in the management of the company, the company is due to comply with a number of obligations to maintaining competitive markets (restrictions on compensations, use of the funds, limits on stock repurchase and dividend distribution).

- **Exit**: penalties apply for delayed reimbursement or repurchase (increase in the cost of the intervention through the payment of extraordinary dividends or additional shares to the Fund).

- Estimates indicate potential beneficiaries between 1.250 (only about 50 are eligible to capital increases) and 2.900 for i) and ii) operations respectively out of 3.800 large non-financial firms.

Gobbi, Palazzo, Segura (2020) put forward the idea of a Fund for the restructuring of debt of larger companies through the purchase from banks of Covid-loans with priority for guaranteed loans.

Programs targeting large firms

5 - Employment Protection and Business Continuity Fund:

Firms: i) **registered historical brands**, ii) **large** (>250 employees), iii) **strategically important assets,** in **financial difficulty** that have a **restructuring plan** are eligible for equity and equity-like interventions by the newly established Fund within the Italian Development Agency (Invitalia Spa).

- Type of financing: max investment cannot exceed 10 mln, and 5 years maturity. Private co-investment (25-50 per cent) is also required
- Viability: **the firm is in financial difficulty** (under either the EU or national legislation).
- The measure: about 0.3 bln, refinanced by 0.250 bln in 2021 and 0.1 bln for each year between the 2020 and 2035. To date, the Fund has not concluded any operations yet

Pros and cons:

- **Flexibility**: wide set of instruments available; the acquiring company can start the procedure; public-private partnership in the restructuring process.
- Complexity and de-facto marginalization of SMEs: non unique definition of financial distress; ambiguous perimeter of beneficiaries.

Programs targeting all firms

6 - Allowance for Corporate Equity:

Tax incentives for equity injections or retained earnings through a notional **deduction from the corporate income tax base** or, alternatively a tax credit which can be compensated with other tax liabilities, reimbursed or transferred to third parties.

- Size of credit: the deduction equals to the net increase in the equity base times an annually determined tax rate. **The notional rate has been increased** to 15 per cent for the year 2021 from 1.3 per cent.

Pros and cons:

- The incentive can **activate substantial investments in firms' equity base**, especially in the smaller firms; extremely simplified policy tool **does not require defining (potentially controversial) aspects of the intervention** (amount, feature of the firm).

- **Avoids an immediate** (and very large) **disbursement for the government**.

- Budget constrained SME owners may not participate in this programme, unless willing to allow new equity partners to join the company.

Appendix

Financial difficulty - EU regulation

Under the EU legislation a firm is considered to be in financial difficulty when (see UE n. 651/2014, UE n. 702/2014 and UE n. 1388/2014):

- in the case of limited liabilities companies, the accumulated economic losses exceed 50 per cent of firm's equity;
- in the case of partnerships, the accumulated economic losses exceed 50 per cent of firm's equity;
- formal insolvency procedure has been started or the criteria to start an insolvency procedure are met by the firm.
- in the case of large firms, the ratio debt to equity or ebitda to interest expenses have been greater than 7.5 or lower than 1.0 respectively. Start-up SMEs (less than 3 years since their foundation) are considered in financial difficulty only when iv) conditions apply.

Financial difficulty – Relaunch Fund

Financial distress is identified using accounting ratios computed before the pandemic (31-12-2019), in particular:

- economic losses to equity > 50 per cent;

- financial debt to equity > 7.5 or ebitda to interest expenses < 1, for at least once in the last two years;

- formal insolvency procedure has been started.

In the case of operations at market terms, the definition of financial soundness is **stricter**: it is also required that **accounting losses were not reported** in the last two years and **credit losses were not reported** in the national credit register. Moreover, the underwriting of junior bonds by the Fund requires, additionally, that the firms has obtained a **credit rating**.