

# **High growth companies and how to fund them – a real driver of economic growth?**

**Corporate Acquisitions and Joint Ventures Commission**

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## **National Report of Estonia**

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The working session in Prague is entitled “*High growth companies and how to fund them – a real driver of economic growth?*” In the working session we plan to address funding alternatives for high growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high growth companies. This questionnaire mainly concentrates on these two topics in relation to high growth companies, but will also cover commercial and regulatory opportunities and constraints.

## 1. CORPORATE FINANCE – FUNDING ALTERNATIVES

### 1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

The definition of “high growth company” by OECD covers enterprises whose average annualised growth is greater than 20% per annum (measured by number of employees or by turnover) in a period of three years. Estonia applies the same definition.

The most common form of undertaking of a high-growth enterprise is a private limited liability company - *Osaihing (OÜ)*. Such a company form does not allow for preference shares, therefore the most common type of instrument at investing into a high growth company is an ordinary share. Debt instruments are not used very often, the reasons being not so much legal implications but rather either on the founders’ unwillingness to incur leverage at an early stage, or the push by the investor to acquire equity. It is common that stock option plans for employees (or additional shares for founders) are agreed upon at an early stage.

### 1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above) (Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

Ordinary shares in a private limited liability company are designed for a smaller company form, they give its holder voting rights, including the right to appoint board members and decide on the distribution of profits. While preference shares cannot be issued in a private limited liability company, it is possible to state in the articles principles by which the distribution of profits/liquidation proceeds is not equal to the shareholdings in the company, effectively incorporating aspects of preference shares. By default, the transfer of shares of private limited liability company is by way of a notarised transaction (assumption being that the turnover of shares is not very high), and the shares do not need to be registered in an electronic form (as opposed to shares in a public limited liability company) at the Central Register of Securities. However, often investors prefer to have shares electronically registered, as this removes the requirement for a notarised transaction, and thereby facilitates the transfer of shares at later stages.

Sometimes convertible loans are used by investors at an early stage (though more often after the initial phase), using this is fairly straight forward and does not entail much documentation (even loan agreement does not have to be in a written format, however, the conversion needs to be adequately documented in compliance with the Estonian Commercial Code).

**1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?**

There are no regulatory constraints for using the ordinary shares or convertible loans in Estonia. Restrictions may arise at subsequent public offering of securities, and sometimes even an earlier pooling of funds may trigger registration obligation with the financial supervisory authority.

**1.4 Is crowdfunding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.**

Crowdfunding is quickly gaining momentum, moving from local non-business projects (hooandja.ee) to platforms that are targeting companies who would like to obtain financing for business ventures (Investly). Crowdfunding has proved to be a channel for both marketing the product (testing ground for the product), as well as a financing channel. The problems may derive from possible legal implications if the administrator of a crowdfunding platform goes insolvent, or the vetting of credit worthiness of a crowdfunding initiator. Also issues in relation to confidentiality of business secrets may become a problem. Further, depending on the legal setup, such platforms may qualify as public offer of securities or other types of activities that require licencing from local financial supervisory authority.

<b>2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL</b>
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**2.1 Who are typical investors into a high growth company in your jurisdiction? Sources of funding (i.e founders-family-friends, angel investments, venture capital investments, private equity)**

High growth companies have typically funding from venture capitalists, also recently angel investors and angel investor groups have become rather active in providing funding to high growth companies. Private equity does not provide funding for high growth companies in Estonia.

**2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?**

There is no general size for an investment into a high growth company, typically such an investment is below 500'000 MEUR (early stage high growth companies considerably less). While no reliable statistics exists regarding deal sizes of high growth companies, the statistics of the Estonian Venture Capital and Private Equity Association on 2013 relating to generalised deal value of its members' (primarily venture capital) investments refers to possible high growth company deal values of around EUR 100'000-200'000.

**2.3 Describe the process of documenting the investment** (Which documents are typical? Which terms need to be included in the articles to be enforceable? etc.)

Typical documents include: a) a term sheet; b) an investment/subscription agreement; c) a shareholders' agreement; d) corporate documents (decision to increase capital and the right to waive the existing shareholders' pre-emption right to subscribe for shares must be adopted by qualified majority voting of the existing shareholders, and the capital is increased at its registration at the Estonian commercial registry). With a more established company, the parties may enter into a separate non-disclosure agreement for the due diligence period.

The most extensive document regulating the rights and obligations of the investors, the company and the existing shareholders is the shareholders' agreement. Typically, the quorum requirements and the transfer of shares provisions are reflected in the articles of association as well for putting the public on notice of such clauses which differ from the default clauses set out in the respective laws.

**2.4 Are there incentive schemes for investing into high growth companies** (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)?)

As in other EU countries, there are a number of schemes in Estonia for incentivising investments into high growth companies. For example, the Estonian, Latvian and Lithuanian governments together with the European Investment Fund (EIF) established the Baltic Innovation Fund (BIF). BIF is a fund of funds initiative launched in 2012 to boost equity investments made in Baltic small and medium sized enterprises (SMEs) with high growth potential. The BIF represents a EUR 40 million investment by the EIF with each Baltic government committing EUR 20 million through their respective national agencies.

Also, the Estonian Development Fund, a public institution whose aim is to contribute to the economic development of Estonia, is investing into innovative companies in Estonia.

**2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?**

With private limited liability companies, even the investors have settled for ordinary shares, admittedly sometimes with slight differences as compared to founders' rights. Electronically registered shares may be deemed to be more preferable for investors, as it facilitates the transfer of shares (no need for a notarised transaction) however, since the electronically registered shares are held on securities accounts administered by banks, it may be more complicated for a foreign investor to open a local bank and securities account in Estonia. Similarly to entrepreneur's viewpoint, it is a balancing act in deciding on whether to invest

as a lender where the risk of no return is lower, or whether to take equity which allows for more control and participation in future profit sharing.

### **3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL**

#### **3.1 Which company form is most popular?** (Special company forms for high growth companies? Tiers of management typical for a high growth company? Liability point of view?)

A private limited liability company is a widespread limited liability business form in Estonia, while the other typical form is the Estonian public limited liability company - Aktsiaselts (AS).

A private limited liability company is better suited for smaller businesses or with limited number of shareholders, having smaller share capital requirements (minimum EUR 2,500) and simpler corporate structure, for example formation of a supervisory board (in addition to the executive management in the form of a management board) and election of an auditor is optional.

In case of a public limited liability company, the share capital requirement is higher (minimum EUR 25,000) and the corporate structure is more complex- formation of a supervisory board, auditing of the annual accounts and registering the shares at the Estonian Central Register of Securities is compulsory (the latter is not the listing of the company's shares at the local stock exchange).

Typically, a high growth company has a two-tier management system at the first stage, however, it is quite common that an investor would like to set up either a formal supervisory board for monitoring the investment, or a more informal advisory committee.

#### **3.2 What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?**

A study conducted for the period of 2007-2010 under the auspices of the Statistical Office of the European Communities (Eurostat) showed that majority of high growth companies at that stage were in the manufacturing, trade and transportation sectors. While no more recent studies exist, the economic recession has most likely had its impact on the sectors of high growth companies in Estonia. Currently, it is probable that IT start-ups may play an increased role in the high-growth enterprises area.

#### **3.3 Are there incentive schemes for entrepreneurs incentivising high growth companies** (e.g accelerators/incubators? Other?)

There are a number of accelerators in Estonia, both general and specialised (e.g on mobile games etc). Also, there are a few incubators in major cities in Estonia, mostly backed by local municipalities.

### **3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?**

From the company's point of view, there is not much difference as to whether the shares are registered electronically or not. From the point of view of complying with the statutory net assets' requirements (the net assets may not be at any time less than half of the share capital amount or the statutory minimum share capital amount), which may be problematic with new companies, the equity investment may be more preferable. However, from the point of view of preserving control over the company and retaining future profits, debt financing could at times be more preferable.

## **4. CORPORATE GOVERNANCE – CONTROL ISSUES**

### **4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:**

#### **a. Anti-dilution measures**

Anti dilution measures are not very often found in Estonian transaction documents, however, the practice is changing slowly.

#### **b. Rights of first refusal, pre-emption rights, drag and tag along**

As a rule applicability of pre-emptive rights on transfer of shares is regulated differently for public and private limited companies. This is due to their different nature. In general, private limited companies are meant for a "closed" circle of shareholders, while public limited companies are meant to attract a larger number of shareholders and capital from outside. Regulation on pre-emptive rights in limited liability companies supports this basic distinction.

In the case of private limited companies, the pre-emptive right of other shareholders upon transfer of shares is provided by law. However, it is generally possible to deviate to a certain extent from this requirement in the articles of association.

In Estonia, the pre-emptive right can be removed by the articles of association or substituted with a requirement that transfer of shares is subject to other pre-conditions such as consent of the other shareholders, management board or other bodies. If the pre-emptive right applies it only applies to transfer of shares for cash or other consideration

(ie sale). Therefore, pre-emptive rights generally do not apply in the case of gifts or transfer of shares to the share capital of another company as a non-cash contribution.

In the case of public limited companies, the presumption is reversed. The law does not provide for a pre-emptive right on transfer of shares, but the articles of association may so provide. Thus, it is left to the shareholders to decide whether they wish to control entry to the shareholders circle.

In general, the term for exercising pre-emptive rights varies between one and two months. In Estonia, the pre-emptive right applies only in the case of transfer of shares to third person.

In addition to the statutory right of pre-emption, parties often agree to establish contractual pre-emptive rights, tag-along and drag-along rights. It is common to seek a tag along clause to give the investor an option to exit together with other selling parties (typically in proportion to their shareholdings) or to request a drag along clause to ensure that if a trade sale is conducted the buyer can acquire the entire company.

c. Protective provisions

The protective provisions - veto powers, give the investors a blocking position over certain material company transactions. The list of issues giving rise to veto powers is typically rather extensive in an investment agreement. These days good/bad leaver clauses can be found in the agreements more often than earlier.

d. Information rights

Information rights exceeding the statutory obligatory reports are often included, however, the formality and frequency varies greatly: less formalised 3-month management reports have recently been accepted, however, investors have also asked for monthly management reports in pre-agreed forms as well.

e. Dead-lock resolution

It is common to regulate deadlock provisions for joint ventures to ensure that where the shareholders are unable to agree on certain matters they have ways of resolving the dispute. Given the varying strengths of the parties, the specific types of deadlock clause should be carefully considered together with an advisor to ensure that the most effective measure is adopted. As even with the deadlock provisions in place, disputes are often impossible to avoid, therefore, recently the use of deadlock resolution provisions have been decreasing.

f. Board seats / observer rights

It is typical that an investor would like to have a seat in the supervisory board, sometimes also in the management board, however, as management board membership means daily management of the company, investors typically would not like to take that level of responsibility.

g. Any other terms specific/important in your jurisdiction?

No



## **5. EXIT STRATEGIES AND TIME HORIZON**

### **5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?**

Few companies choose to exit through IPOs due to the small market and transaction size, therefore the most common exit route is either trade sale or sale to venture capital/private equity firms.

Typical transaction length, including a due diligence phase, typically takes 2-4 months.

### **5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 4 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?**

Estonia has a liberal investment policy, which freely allows foreign investments without burdensome restrictions. Typically, at the next round of investment, a new shareholders' agreement is negotiated.

## **6. REGULATORY ISSUES**

### **6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?**

In Estonia, there is no annual corporate tax on income or profits. However, a tax of 21/79 applies to distribution of dividends and other similar payments, as well as certain costs. There are no thin capitalisation rules and no taxes incurred on market level interests, therefore acquisition finance is usually structured to a great extent as debt.

### **6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.**

Persons intending to engage in certain regulated activities, such as activities in the insurance, financial services and energy sectors, should apply for the necessary operating licences. Typically, consent from a supervisory authority must be applied for if the buyer intends to acquire a qualified holding in a company or intends to increase its qualified holding so that the proportion of the share capital or votes in the company exceeds certain legal thresholds.

**7. OTHER**

**7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high growth companies which have not been discussed in responses to earlier questions (if any).**

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