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**Subject: State aid N 521/2007 – Germany (Free State of Bavaria)
Risk Capital Scheme '*Clusterfonds Start-up!'***

Dear Sir!

## 1. PROCEDURE

(1) By letter dated 12 September 2007, registered on the same day, Germany notified the aid measure 'Clusterfonds Start-up!' (Thereinafter "the Fund").

(2) By letter of 8 November 2007, the Commission asked for additional information on the measure's subject matter. The German authorities responded by letter dated 19 December 2007, registered on the same day.

## 2. DESCRIPTION OF THE MEASURE:

### 2.1. Objective

(3) The German authorities discern a shortage in private share capital that affects young, technology focused micro- and small enterprises at the end of their seed stage. With the aid scheme in question, the German authorities intend to pre-empt

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that deficiency. The purpose of the Fund is to invest in eligible target enterprises and thus provide financing.

(4) The Fund will not only provide financing, but will assist the target enterprise's management with technical and commercial mentoring, through a 'coach'. The coach may invest in the target enterprise, too. The coach will be paid by the target enterprise.

(5) The Fund will not act as a 'lead investor' to other investors, e.g. will not be a member of a syndicate of private equity investors holding the largest stake in a target company, in charge of arranging the financing and most actively involved in the overall project.

(6) The Fund is intended to provide an incentive to business angels to invest in eligible seed-phase micro- and small enterprises. In any case, private investment of at least EUR 100,000.00 either by the target enterprise's founders or other seed-capital providers is a precondition for obtaining Fund financing. Germany informed the Commission that the Fund will not intervene in cases where financing by business angels or other venture capital firms is possible.

(7) According to the German authorities, private venture capital providers are very exacting as regards the market maturity of an enterprise in which they consider to invest. Such strict requirements would result from these capital providers' aim, on the one hand, to optimise their portfolios' potential (*Chancenoptimierung*), and, on the other hand, to minimise the underlying risks (*Risikominimierung*). Furthermore, private risk capital providers would seek to limit liaison and support efforts (*Betreuungsaufwand*). This is why not only a 'proof-of-concept' has to be demonstrated in order to obtain private risk capital financing. Rather, a 'proof-of-market' usually is to be supplied, too. Such 'proof-of-market' e.g. includes the presence of first customers, sustainable sales and scalable business plans (*skalierbare Geschäftsmodelle*).

(8) According to the German authorities, the aforementioned requirements can only be met towards the end of the seed phase, and in most of the cases only with additional financing. This is why the Fund is planned to bridge the gap between the end of the seed phase and the first round of investments by private venture capital providers.

(9) Germany hopes that the Fund will be an effective and efficient instrument in order to open up the yet unexplored potential of innovative growth enterprises in their seed- and early stages (*Anlauf- und Aufbauphase*).

(10) The German authorities further substantiated the perceived market failure affecting the provision of risk capital with an independent report by Fleischhauer, Hoyer & Partner, a Munich-based private equity consultancy[1].

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[1] Venture Capital für Unternehmensgründer: Eine empirische Marktanalyse. Fleischhauer, Hoyer & Partner, commissioned by Bayern Kapital, Landshut; Munich, August 2007. The authors declared in writing that the ordering party did not influence the study and that they assume full responsibility for the report's content.

(11) In its empirical market study, said consultancy found that public investors play an important role in financing start-up enterprises, as three investments out of four are made by funds which are State funded. Private investors would only in very rare, exceptional cases invest in very early stages. The study evaluated the reasons for such reticence and found that there are both operative reasons (e.g. business plans, exit scenarios) and strategic reasons (e.g. the small size of transactions compared to high monitoring and support expenses; expected high returns on investment).

(12) The report proposes to expand the supply of seed and post-seed financing. Undertakings having successfully attained that latter stage would still not be mature enough for private venture capital financing. The report points out that, while doing so, the attention should be turned to other groups of investors, notably business angels, whose requirements would be more moderate.

### 2.2. Legal basis

(13) The measure’s legal base is:

– Draft Articles of Association: *Entwurf des Gesellschaftsvertrags der Clusterfonds Start-up! GmbH*;

– Draft Investment Terms and Conditions: *Entwurf der Beteiligungsgrundsätze der Clusterfonds Start-up! GmbH*;

– Draft Statutes of the Fund's Investment Comittee: *Entwurf der Geschäftsordnung für den Beteiligungsausschuss der Clusterfonds Start-up! GmbH.*

### 2.3. Implementing authority

(14) The scheme will be implemented by *LfA Förderbank Bayern* (LfA). LfA is a bank for the support of economic development in the Free State of Bavaria and is a body governed by public law. Pursuant to the Art. 3 of the Act on the establishment of LfA (*Gesetz über die Bayerische Landesanstalt für Aufbaufinanzierung - LfA-Gesetz – LfAG; Bay RS 762-5-F*), this bank's public task is to fund, within the framework of the financial, economic, transport, environment and employment policy, and in accordance with the State aid rules of the European Community, projects of commercial businesses as well as other measures for the betterment and strengthening of the economic, transport and environmental structure of Bavaria. (…) LfA may also fund public authorities and public associations and participate in financing from European Investment Bank or similar European Financing Institution's sources, for projects of common European interest with an impact on Bavaria. (…) The Bank may carry out other banking activities only if these are directly related to the accomplishment of its tasks."

(15) The German authorities informed the Commission that LfA is an integral part of the State administration. The Bavarian State Ministry of Finance is LfA's legal supervisory authority. Said Ministry acts as a shareholding ministry that exercises shareholder rights on behalf of the Free State of Bavaria, who is the sole shareholder.

(16) LfA's Administrative Board determines the guidelines in terms of operations of LfA and supervises its entire management to the extent permitted by applicable law. At the time the Commission assessed the notified measure, that board

consisted of six full members and a guest member, three of which were Bavarian State Ministers respectively State Secretary, and seven deputy members, three of which were heads, respectively deputy heads of department of several Bavarian Ministries. That board gives advice to the board of management and can make recommendations as well as enquiries.[2]

### 2.4. Budget and duration

(17) The Fund's initial capital will be EUR 20 million, provided by LfA and *Bayern Kapital GmbH*, a 100%-affiliate of LfA. The maximum fund capital may amount up to EUR 40 million, after the possible subscription of shares by private investors.

(18) The German authorities committed to put the measure into effect only after approval by the Commission. Once the approval will have been obtained, the Fund is planned to enter into an investment phase of up to five-years. The entire duration of the Fund is planned to be 10 years, in view of the need to pursue successful exit strategies at the level of each investment. That duration may be extended to up to 12 years at best, in order to assure an optimum disinvestment.

### 2.5. The Fund structure

(19) '*Clusterfonds Start-up!'* will have the legal form of a limited partnership with a liability company as a general partner under German law (*Gesellschaft mit beschränkter Haftung und Compagnie Kommanditgesellschaft – GmbH&Co KG*). The Fund's general partner will be *Clusterfonds Bayern Verwaltungsgesellschaft GmbH*. The Fund's limited partners will be LfA and its affiliate *Bayern Kapital GmbH* (BKG). The German authorities declared that the Fund's sole purpose is the administration of the investment monies for the purposes of the notified measure. The Fund will be prohibited to diversify into any other activities.

(20) The Bavarian State Government instructed LfA to establish the Fund in cooperation with BKG. '*Clusterfonds Start-up!' GmbH&Co KG* will implement its own accounting system which is separated from LfA's accounting. The Fund's annual financial statements must be established in accordance with the German rules on financial statements of large capital companies (*Rechnungslegungsvorschriften für grosse Kapitalgesellschaften*). They will be audited annually by a chartered accountant.

(21) With the intention of further increasing the Fund's volume, the German authorities will publish an invitation to capital providers to acquire a stake in the Fund's capital, in the Official Journal of the European Union. That invitation will be published after the Commission has cleared the measure.

(22) The Fund is not revolving, i.e. that its monies can only be invested once. After the settlement of all costs, any capital reflux will paid to the Fund's shareholders.

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[2] Source: LfA's website, http://www.lfa.de/website/en/lfa/leitbild/index.php?style=

### 2.6. Investment instruments

(23) Investments eligible for coverage by default guarantees under the scheme are

- Equity investments,
- Subordinated loans,
- Silent participations (if applicable with a conversion option).

(24) Investments by the Fund will not exceed EUR 0.5 million per micro-/small. According to Germany, the Fund's stake in a target enterprise will be up to 25%, but will most probably be considerably below that ceiling.

(25) The German authorities informed the Commission that, on the one hand, it is in principle possible to provide larger funding to enterprises that are entering their seed stage. On the other hand, higher funding could promote enterprise formations with an even higher capital demand. If such enterprises would later turn out to be not viable, this could entail overall negative effects. Therefore, the German authorities intend to limit funding to the extent that is strictly necessary and financially viable.

(26) The Fund will provide capital preferentially in the form of equity investments combined with subordinated loans. An investment by the target enterprise's founders or a 'side investment' by other seed capital providers of at least EUR 100,000 is a prerequisite for an investment by the Fund. Contributions from the founders' own resources (*Eigenbeiträge*) that have been made at the start of the seed phase can be taken into account, too.

#### *2.6.1. Equity investments:*

(27) The Fund will acquire shares in target companies, through an increase in capital stock, at nominal value. After such increase in capital stock, the Fund will hold a 10%-stake in the target enterprise.

#### *2.6.2. Subordinated loans*

(28) In case of liquidation of the target enterprise, subordinated loans and all related interest will only be treated preferentially over equity substituting shareholder loans (*eigenkapitalersetzende Gesellschafterdarlehen*). In case of insolvency of the target enterprise, subordinated loans will be subordinated to all debts, except loans provided by other shareholders.

(29) The duration of subordinated loans will be 7 years. The interest rate is 10% p.a. After a two-year moratorium (*Stundung*), interests will fall due by the end of the third year. These loans will be unsecured.

(30) Provision will be made for the gradual conversion of subordinated loans, including accumulated interest, into equity will be made, at the time of further rounds of financing. Such conversion will take place at exactly the same terms and conditions (*pari passu*) under which private investors take a stake in the enterprise concerned. Thus, the Fund is expected to avoid the dilution of its

participation and keep its target 10%-floor stake. According to the German authorities, the prospects for high profits at exit can thus be maintained.

#### 2.6.3. *Silent participations (stille Einlagen)*

(31) Silent participations will be subject to a subordination agreement. According to Germany, the terms of silent participations under the measure will be close to the conditions customary in the market (*marktnahe Bedingungen*). This instrument may be combined with a conversion option, and will in such case be subject to the same terms and conditions as apply to subordinated loans.

(32) In case of liquidation of the target enterprise, non-converted silent participations will only be treated preferentially over equity substituting shareholder loans (*eigenkapitalersetzende Gesellschafterdarlehen*). In case of insolvency of the target enterprise, silent participations will be subordinated to all debts, except loans provided by other shareholders.

(33) According to the German authorities, the duration of silent participations will be sufficiently long, as a rule until the end of the Fund's duration. The remuneration for silent participations will consist of a one-off administrative fee (*Beteiligungsentgelt*), a fixed and a performance-based component and a flat-rate final premium (*pauschale Endvergütung*) at the end of the duration. Silent participations will be unsecured.

(34) Conversions will be effected at exactly the same terms and conditions (*pari passu*) that will apply to private equity financiers.

### 2.7. Target enterprises invested-in

(35) According to the German authorities, the Fund will only invest in micro and small enterprises falling within the Community SME-definition[3]. Eligible micro and small enterprises must have the legal form of a joint stock company (*Kapitalgesellschaft*) and must neither be younger than one year, nor be older than two years, as from the start date of commercial operations. Further, target enterprises must be innovative and oriented towards technology and growth. The measure is not sector specific.

(36) The following companies/sectors/activities do not qualify for financing under the scheme:

- Firms in difficulty, as defined in the Community Guidelines on State aid for rescuing and restructuring firms in difficulty[4];
- Firms in the shipbuilding, fishery, fish farming, coal, mining, shipbuilding and steel sectors;
- Export-related activities: The Fund's investments will not be directly linked to the quantities exported, to the establishment and operation of a

3 OJ L 124, 20.05.2003, p.36.

4 OJ C 244, 01.10.2004, p.2.

distribution network or to other current expenditure linked to the export activity, as well as aid contingent upon the use of domestic in preference to imported goods.

### 2.8. Provision of seed-phase capital

(37) The Fund will provide early stage capital, with a focus on the late seed phase capital (*Seedendphase*). Target enterprises are expected to be in a transition from the seed to the start-up phase. The German authorities assume that eligible enterprises, as a rule, will have initiated the seed phase with their own funds or, to a small extent, with capital provided by family members and friends. Based on previous experience, the German authorities argue that such funds do not suffice to end the seed phase successively and to acquire successive financing.

(38) The German authorities provided information as to the seed-phase character of the Fund's planned investments. According to that information eligible enterprises will already have made the 'proof of technics' of the technology they have developed, on the base of a very first test product (*'technischer Erprobungsträger'*). Commercial sales, even of the very first product configurations, must not have started yet. At most, the enterprise concerned may have first contacts with test customers who have frequently been involved in the product development phase. According to Germany, production will in such cases often take place in the development environment or in installations that have been rented additionally. In Germany's view, commercially viable results and a corresponding 'proof of market' can be expected at the end of that phase, thus establishing a basis for the start-up phase. The Fund financing will be used to put into practice innovative business concepts, through the completion of a prototype and the acquisition of first test customers (*Referenzkunden*), up to a successful 'proof of market''.

(39) The German authorities confirmed that the start-up phase will not qualify for financing and informed the Commission of the distinction made between seed- and start-up phases for the purposes of the notified scheme. They pointed out that only in the start-up phase genuine marketing by a comprehensive market introduction will take place. Only then, multi-stage prototype optimisation with a view on a mature prototype or even a first product ready for production and sale, which nevertheless will need diversification in subsequent steps, can be expected. In the start-up phase, the conditions for series production would still have to be set.

(40) In particular, Fund financing may be used for

– The setting-up of the enterprise and its structures;

– Product- and process development and necessary patent applications;

– The initial marketing of a developed product or process;

– Coaching costs.

### 2.9. Participation of private investors

(41) Private investors may provide up to EUR 20 million to the Fund capital, thus doubling the initial EUR 20-million capital provided by LfA and its subsidiary Bayern Kapital. With reference to the capital market failure that the independent report identified, the German authorities explained that private-investor participation in the measure is not certain. Nevertheless, an invitation to capital providers to acquire a stake in the Fund's capital will be published in the Official Journal of the European Union.

(42) The following conditions apply to private-investor share subscription: The subscription phase will end on 31 July 2008. The minimum investment is EUR 2.5 million but there is no upper limit. Thus, private investors may acquire shares up to EUR 20 million, which is the maximum total share in the Fund's that may be held by parties other than LfA and Bayern Kapital.

(43) The German authorities declared that private investors who hold a stake in the Fund will be proportionally represented in the Fund's Investment Committee (*Beteiligungsausschuss*). That body will consist of 4 members. The committee may take majority votes, however only with one negative vote or abstention at most.

(44) For the time being, and until the closure of the subscription phase, 2 members have been proposed by the Bavarian State Ministry of Finance and by LfA. Investors who join later will have a right to propose members of the investment committee which they can exert after the closure of the subscription phase.

(45) The German authorities declared that the 2 members representing future private stakeholders will be external experts directly recruited from the private sector. The criteria for selecting these experts will be an appropriate academic training and own experience in successfully setting-up enterprises (*Gründungs- und Aufbauerfahrung*), respectively a long-standing applied-research activity in a senior position.

(46) Public and private investors in the Fund will share the same terms and conditions. Profits will be distributed *pro rata*, according to the investor's share in the Fund's capital.

(47) As was mentioned further above, private investment alongside the Fund, either by the target enterprise's founders or other seed-capital providers, is a precondition for Fund intervention.

### 2.10. Investment decisions – business plans

(48) Target small- and micro enterprises must submit meaningful business plans, which allows for an appraisal of the project's viability. According to the German authorities, such appraisals will be based on pre-established criteria and will follow a purely commercial logic. The scrutiny of business plans will consist of several steps:

1. Potential deals will be examined by a 'Coach'. As a rule, the Fund will consult a Coach as cooperation partner for each investment. Coaches must provide documentation as to their commercial and technical

expertise, as well as of their solvency (*Bonität*) as is customary in the banking business. The Coach may invest in the Fund.

2. After a positive appraisal by the Coach, the Fund will commence its exhaustive due diligence procedure. In order to evaluate a project's viability and expected satisfactory returns, an external expert's technology and market report will be commissioned for each due diligence procedure.

3. In a final step, the Fund's investment decision will be subject to the vote of the Fund's investment committee.

### 2.11. Investment decisions – exit strategies

(49) Germany declared, firstly, that a clear and realistic exit strategy for each investment will be identified when the Fund decides to invest and, secondly, that exit strategies will be profit-driven. The basic strategies are:

– Silent participations: Repayment of the capital invested, including the agreed remuneration;

– Equity investments: sale at the highest price that can be obtained on the market. The detailed options will be:

  – the sale of the enterprise;

  – trade sale

  – initial public offering (IPO);

  – buy-back by senior shareholders (*Altgesellschafter*).

### 2.12. Management of the risk capital measure, best practice and regulatory supervision

(50) The Fund will be managed by Bayern Kapital GmbH (thereinafter BKG), which is 100% owned by LfA. Germany informed the Commission that BKG had not been selected with an open tender procedure. Instead, in January 2007, the Bavarian State Government has instructed LfA and its affiliate BKG to implement measure in question.

(51) With reference to LfA's 100% ownership of BKG, the German authorities informed the Commission that the selection of BKG is to be considered as a so-called in-house transaction, as regards the commissioning of an affiliate which is by 100% owned by the contracting entity. Hence, according to Germany, public tender rules and provisions would not apply. Germany reasons that Council Directive 92/50/EEC of 18 June 1992[5] and its successor Directive 2004/18/EC of 31 March 2004[6] on the coordination of procedures for the award of public works

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5 OJ L 209, 24.7.1992, p.1.

6 OJ L 134, 30.4.2004, p.114.

contracts, public supply contracts and public service contracts are therefore complied with.

(52) According to information provided by the German authorities, BKG has since 1995 gained broad expertise in managing investments in technology-oriented enterprises and is experienced in conducting due-diligence, selecting target enterprises, negotiating investment contracts, as well as in monitoring and supervising invested enterprises invested-in and in implementing exit strategies.

(53) According to the German authorities, BKG will receive market rates for its services. That remuneration would reflect the relatively small size of the Fund's investment. The management's remuneration will in part be performance-dependent, based on a carried-interest agreement.

(54) Germany asserted that BKG's purpose is not to compete with commercial fund management firms but to assist the Free State of Bavaria in implementing its initiatives and measures.

(55) The German authorities informed the Commission that BKG is audited by a chartered accountant, pursuant to the German legislation applicable to large joint stock companies (*grosse Kapitalgesellschaften*). Apart from that, audits will also span the proper conduct of business and the economic status pursuant to Art. 53 (1), Nr. 1 and 2 of the Act on Budget Principles (*Haushaltsgrundsätzegesetz*).

(56) LfA, which is BKG's mother company, is subject to all regulatory-supervision rules that apply to Banks in Germany.

## 2.13. Assessment of the planned measure's impact

### *2.13.1. Other policy options*

(57) The German authorities informed the Commission on the expected impact of the proposed measure and of other policy options and other supply and demand side issues affecting the targeted micro and small enterprises.

(58) The Bavarian State Government considers the planned measure to have a positive impact as an integrate component of a wider framework. That framework of a deliberately broad design is aimed at fostering young technology-focused enterprises' access to financing. Said framework consists of the following measures:

– Direct grants

– Loans

– Guarantees

– Promotion of business-angel networks

– Business-plan contests

– other platform-activities for the procurement of financing offers and for bringing together company founders and capital providers.

(59) The German authorities have assessed the effectiveness of alternatives to the notified risk capital instrument. They argue that non-selective instruments, in particular tax advantages, would not provide a sufficient stimulus. Target enterprises would not generate profits in the foreseeable future and said tax instrument would thus not generate an incentive to reduce the tax amount on income received. In Germany's view, such non-selective instruments are not adequately targeted. Germany draws attention to the fact that the Free State of Bavaria, who initiated the notified measure, does not have the legislative competency to adopt non-selective tax aid measures.

(60) In view of the limited availability of public funding, the German authorities pointed out the necessity to allocate public monies efficiently. They therefore conclude that quality-based criteria must be applied to select eligible enterprises.

(61) Germany further reasons that aid in the form of loans and direct grants is unsuitable to address the financing gap in the seed phase, which is characterised by high losses and, as a rule, by the lack of collateral. As such aid is to be granted for specific, individual projects it could only serve as a supplement to more flexible financing. Besides, such aid would not be available to the extent actually required by the target enterprises, due to budgetary and regulatory-policy reasons. Furthermore, Germany indicated that direct grants and loans, while entailing payment obligation for the State, would not allow for its participation in the success of the newly founded enterprise.

#### *2.13.2. Impact assessment*

(62) The fund instrument in question is expected to allocate State funds efficiently and well targeted. Based on a report on the German market, by the US-based National Venture Capital Association (NVCA), the German authorities assume that the notified measure could be an important factor in research and development on new products and technologies, since risk capital financed technology enterprises have a much higher potential for escalating innovation than mature enterprises.

(63) For the purposes of an impact assessment, the German authorities have also evaluated data collected by the State owned bank *Kreditanstalt für Wiederaufbau (KfW)* and the German Private Equity and Venture Capital Association (*Bundesverband Deutscher Kapitalbeteiligungsgesellschaften*). The German authorities draw the conclusion that the German venture capital market's structures are not yet sufficiently solid and that parts of it have a considerable potential for development which is in need for State-initiated risk capital supply.

(64) Based on above considerations, the German authorities concluded that the particular circumstances applying to young innovative enterprises necessitate the creation of a specific risk-capital instrument, as other measures would not provide sufficient funding. The German authorities reason that the notified measure is designed to reinforce the structures of the German venture capital market and create significant stimuli for private capital providers.

#### *2.13.3. Current and future measures alongside 'Clusterfonds Start-up!'*

(65) Assuming that risk capital financing has a positive economic effect, Germany implements specific measures at the Federal and *Länder*-levels in order to address

a sustained market failure. According to Germany, other current measures within that context are:

- Co-investment and loan schemes implemented by KfW;
- The 'European Recovery Programme' (ERP) Fund;
- The 'High Tech Starters Fund' (*'High tech Gründerfonds'*).

The German authorities informed the Commission that it is yet too early to provide a conclusive evaluation of these measures.

(66) The Bavarian State Government considers providing further EUR 40 million and EUR 10 million from the ERDF for two additional co-investment measures which are expected to start in 2008. These measures will exclusively provide financing concomitantly with private investors and will focus on young innovative enterprises in their start-up phase. Germany pointed out that these planned measures are designed to continue the approach of the notified Fund. They reason that thus the incentive created by that Fund will be improved and utilised in an optimal manner.

### 2.14. Size of the Fund - advantage of economies of scale

(67) The Fund management is planning to subscribe to an estimated 35 to 40 investments of up to EUR 500,000 each with capital provided by LfA and Bayern Kapital alone (EUR 20 million). The German authorities expect private investment in the Fund to allow for further investments of approximately the same number and order of magnitude. The German authorities asserted that adequate risk diversification will thus in any case be ensured.

(68) Germany further informed the Commission that BKG has long-standing experience, standardised processes and that it is drawing on external services and expertise as the case may be. According to Germany, that structure will allow for the efficient supervision of approximately 70 – 80 target enterprises. BKG's structure will also allow for a minimisation of transaction costs which in any case will be covered by income from investments.

### 2.15. Cumulation with other aid - monitoring of target enterprises

(69) The Fund's investment statutes stipulate that in all cases where the capital provided to a target enterprise is used to finance initial investment or other costs eligible for aid under the block exemption regulations, guidelines, frameworks, or other State aid legislation, the relevant aid ceilings provided in such legislation will be reduced by 50%, respectively 20% in assisted areas, during the first three years of the first risk capital investment and up to the total amount received.

(70) The aforementioned reduction will however not be applied to aid intensities provided for in the Framework for State aid for Research and Development[7] or

[7] OJ C 45, 17.2.1996, p 5.

any other successor framework[8] or block exemption regulation in this field. As the Fund's investment statutes are the inherent purpose of the contract (*Geschäftsgrundlage*) with the Fund management, the latter will bound to observe these cumulation rules.

### 2.16. Monitoring and reporting

(71) Germany committed to maintain detailed records on the risk capital aid for at least 10 years. Such records will contain all information necessary to establish that the provisions of the Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises[9] have been complied with, in particular as regards the size of investment tranches, the size of enterprises invested-in, the stage of financing, the sector of activity (preferentially at the 4-digit NACE-code level), as well as information on Fund management and other criteria set forth in aforesaid Community Guidelines.

(72) The German authorities further committed to publish the full text of the scheme on the internet and to communicate the internet address of the publication to the Commission.

(73) Lastly, Germany committed to provide an annual report on the measure’s implementation, containing:

(a) A summary table with a breakdown of the investments effected under the risk capital measure including a list of all the enterprise beneficiaries of risk capital measures:

(b) Details of potential deals scrutinised and of the transactions actually undertaken;

(c) Performance of the investment vehicles, with aggregate information about the amount of raised capital.

## 3. ASSESSMENT

### 3.1. Compliance with the obligation to notify in Article 88(3) of the EC Treaty

(74) Germany notified the measure in accordance with Article 88(3) of the EC Treaty. Implementation of the scheme will not commence prior to the Commission's approval.

### 3.2. Relevant Community rules

(75) The Fund's investments will be financed by LfA Förderbank Bayern (LfA) and its affiliate Bayern capital GmbH (BKG), which are both State bodies and which

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[8] On 1 January 2007, the successor Framework to the Framework for State aid for Research and Development entered into force: Community Framework for State aid for Research and Development and Innovation; OJ C 323 of 30.12.2006, p. 1.

[9] OJ C 194, 18.8.2006, p. 2.

draw on State resources. Thus, the notified scheme will be financed with State resources.

(76) Private capital providers will be invited to invest in the Fund, once the notified measure has obtained Commission approval. Given the above mentioned participation criteria, only a limited number of risk capital providers may be able to invest in the Fund. It is true that the number of private investors is not directly limited. Nevertheless, since private investors together may not provide more than 50% of the Fund's EUR 40-million maximum capital, possibly not all applications for shares might be considered. The Fund measure is thus selective at the level of private investors.

(77) The Fund will invest in target micro- and small enterprises, as defined by the Fund's investment statutes. It will do so with a limited budget, and only for a definite period in time. Hence, the measure is selective as regards both private investors who may wish to invest in the Fund, and target enterprises.

(78) In addition, the financing under the scheme could improve the overall financial condition and enhances the market position of said parties involved. Furthermore, the measure under scrutiny does not rule out the award of aid to firms engaged in economic sectors where intra-Community trade takes place[10]. Thus, the scheme and its operations could constitute aid within the meaning of Article 87(1) EC.

(79) The assessment of the notified measure could fall within the scope of the Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (thereinafter "the Guidelines")[11]. For the Guidelines to be applicable the following conditions, as laid down in Section 2.1 of the Guidelines, must be met: Firstly, the measure must be a scheme, targeting micro and small enterprises. Secondly, the measure must not be intended to provide capital to an individual enterprise *(ad hoc*-measure). Thirdly, the measure must exclude aid to enterprises in difficulty as defined in the Community Guidelines on State aid for rescuing and restructuring firms in difficulty and in the shipbuilding, coal and steel industry. Lastly, the Guidelines do not apply to aid for export-related activities, namely aid directly linked to the quantities exported, to the establishment and operation of a distribution network or to other current expenditure linked to the export activity, as well as aid contingent upon the use of domestic in preference to imported goods.

(80) The measure in question consists of a scheme targeting investments, in micro- and small enterprises, being in their seed stage. It is not intended to provide aid to an individual enterprise (*ad hoc* measure). Furthermore, funding under the measure will not be provided to enterprises in difficulty and enterprises in the

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10 According to EUROSTAT's *External and intra-European Union trade Monthly statistics — Issue number 9/2007*, the 2006 intra-Community trade figures for goods traded intra-EU for Germany show dispatches of goods worth EUR 555,177 million and arrivals worth EUR 455,987 million (http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-AR-07-009/EN/KS-AR-07-009-EN.PDF).

11 OJ C 194, 18.8.2006, p. 2.

shipbuilding, coal and steel industry. Neither will any funding be directly linked to export-related activities.

(81) Hence, all exclusionary conditions set out in Section 2.1 of the Guidelines are met.

(82) Consequently, the Guidelines apply to the risk capital measure in question. For this reason, the Commission based its assessment of the existence of aid on said Guidelines.

### 3.3. Presence of "State aid" within the meaning of Article 87(1) of the EC and compatibility with the common market

(83) Pursuant to Section 3.2 of the Guidelines, economic operators (investors) as well as target enterprises may be provided benefits through a risk capital scheme. Said provision further postulates to consider whether a fund or other investment vehicle involved and/or its manager may be benefiting from State aid. The presence of State aid at each of said levels will be considered in the following.

#### *3.3.1. State aid at the level of investors*

(84) Pursuant to Section 3.2 of the Guidelines, the Commission will consider investments to be effected *pari passu* between public and private investors, and thus not to constitute State aid, where its terms would be acceptable to a normal economic operator in a market economy in the absence of State intervention. This is assumed to be the case only if both public and private investors share the same upside/downside risks and rewards and level of subordination, and normally if 50% of the funding of the measure will be provided by private investors, who are independent of the target companies.

(85) The German authorities will publish an invitation for private capital providers to invest in the Fund, in the Official Journal of the European Union. Further, an investment by either the founders of the eligible target enterprise or an investment by other seed capital financiers, of at least EUR 100,000.00 is the prerequisite for an investment by the Fund. Hence, there are three types of investors concerned:

1. Private capital providers who respond to the invitation in the OJ and invest in the Fund;

2. The founders of target micro- and small enterprises who provide investments;

3. Private seed- capital financiers ('business angels') who make a 'side-investment', together with the Fund.

(86) *Ad 1 - private capital providers:* The Commission assessed the risk and subordination arrangement that will apply to private investors who directly join the Fund. As regards private investors who subscribe to the Fund's shares, the Commission notes that these will share exactly the same risks and rewards and level of subordination as limited partners in Clusterfonds Start-up GmbH&Co KG, as stipulated in the Fund's Articles of Association and as confirmed by the German authorities.

(87) Consequently, private investors possibly joining the Fund will effect their investment *pari passu* with the public investors. The measure therefore does not constitute State aid in the sense of Article 87(1) EC at the level of investors holding Fund shares.

(88) *Ad 2 – 'founders':* Founders do not qualify as private investors in the sense of Section 3.2, as they are not to be considered as independent from the target enterprise. Therefore, the pari passu condition does not apply and the Commission deems the measure to constitute State aid at the level of this category of investors.

(89) *Ad 3 - 'business angels':* The Fund will draw on various investment instruments, as described further above, namely equity investments, subordinated loans and silent participations. It can not be excluded that business angels chose different instruments to effect the specific side investment which is a precondition for the Fund investment. Hence, business angels could invest under conditions that are more favourable than those applying to the public Fund investment and more favourable than the conditions they would face without the concomitant involvement by the Fund. For instance, a business angel might provide that side-investment in the form of a long-term financing that comprises an element of fixed remuneration and/or to which the public investment is subordinated.

(90) Therefore, it can not be excluded that the measure constitutes State aid in the sense of Article 87(1) EC at the level of private seed- capital financiers ('business angels') who make a side-investment, together with the Fund at conditions that are more favourable than those applying to the public investor.

(91) Provided that the two latter categories of investors, namely *'founders'* and *'business angels'* are engaged in economic activity, the proposed measure falls under Art.87 (1) EC. The notified scheme is funded through State resources. It favours a limited number of investors who will be selected during the implementation of the scheme. Hence, the measure is selective. Due to said advantages, investors could improve their overall financial condition and enhance their market position. As the provision of risk-capital is a sector where intra-Community trade takes place, it must be assumed that said advantages are likely to distort competition and thereby affect trade between Member States. Hence, the Commission has come to the conclusion that the measure constitutes State aid to the investors involved in the scheme, within the meaning of Article 87(1) EC.

### *3.3.2. State aid at the level of the Fund*

(92) According to Section 3.2 of the Guidelines, the Commission generally considers an investment fund to be an intermediary vehicle for the transfer of aid, rather than a beneficiary of aid itself.

(93) According to the information available, the Fund will not diversify into any other activities than those necessary for the implementation of the notified measure. The Commission therefore does not consider the Fund to be a separate aid beneficiary.[12] Further, separate accounting, as stipulated by the Fund's Articles of

[12] This principle is in line with the Commission decisions on the ‘Viridian Growth Fund’ (State Aid C 46/2000), the ‘Coalfields Enterprise Fund’ (State Aid N 722/2000), the ‘Community Development

Association, will prevent any spill-over of the measure's public financing into any possible economic activities of LfA and BKG, who are the public investors within the measure's framework and who are the Fund's limited partners.

### *3.3.3. State aid at the level of the Fund's management*

(94) Pursuant to Section 3.2 of the Guidelines, aid to the fund's managers or the management company will be considered to be present if their remuneration does not fully reflect the current market remuneration in comparable situations. On the other hand, that section provides for the presumption of no aid if the managers or management company are chosen through an open and transparent public tender procedure or if they do not receive any other advantages granted by the State.

(95) The Commission notes the German authorities' assurance that the Fund's managers remuneration will correspond to market rates. However, this statement has not been evidenced. The Commission further notes that BKG has not been chosen through an open and transparent public tender.

(96) The management of funds must be considered as economical activity, as it is usually conducted for profit. Given that, firstly, BKG has not been chosen by an open and transparent public tender procedure and, secondly, the market conformity of its remuneration has not been demonstrated, presence of an advantage to the BKG in the form of a possible overcompensation can not be excluded.

(97) As a result of the choice of BKG, the measure is selective at the level of the Fund's management. The management of capital funds is an activity that is the subject of competition and trade between Member States. Therefore, the scheme may affect competition and trade between Member States. In that context, Germany's argument that BKG does not intend to compete with other fund management firms is not relevant, since State aid must be measured by its effects. Consequently, the Commission considers that it is not excluded that the measure constitutes aid at the level of the Fund's management, in the sense of Article 87(1) EC.

### *3.3.4. State aid at the level of the target micro- and small enterprises*

(98) Section 3.2, last paragraph of the Guidelines provides for factors to be taken into account for the determination of whether or not enterprises invested in must be considered as recipients of State aid. In particular, where aid is present at the level of investors, the Commission will consider that it is at least partly passed on to the target enterprises and thus that aid is also present at their level.

(99) Considering the presence of State aid at the level of the private investors involved, an advantage for the micro and small enterprises invested in must be presumed. However, it is not certain whether any private investors will participate

Venture Fund' (State Aid N 606/2001), the 'SMEVCLF' (State Aid N 620/2002), the 'Wales Early Stage Fund' (State Aid N 572/2003), the 'ERDF risk capital fund Berlin' (State Aid N 212/2004), the 'ERDF risk capital fund Schleswig-Holstein' (State Aid N 213/2004) and the 'ERDF Risk Capital Fund Thüringen' (State Aid N 266/2004). There, the Commission concluded that Funds with the single purpose to transfer funding to eligible target enterprises are no beneficiaries of aid in the sense of Art. 87 (1) EC.

in the measure at all. In the possible event of total absence of private monies in the Fund's capital, investments in target enterprises will exclusively be made with Sate resources.

(100) Apart from the aforesaid reference to State aid to investors, Section 3.2 provides for another criterion, on which the presence of State aid at the level of target enterprises can be based. Accordingly, when an investment is made on terms which would be acceptable to a private investor in a market economy in the absence of any State intervention the enterprises in which the investment is made will not be considered as aid recipients. For this purpose, the Commission will consider whether such investment decisions are exclusively profit-driven and are linked to a reasonable business plan and projections, as well as to a clear and realistic exit strategy. Also important will be the choice and investment mandate of the fund's managers or the management company as well as the percentage and degree of involvement of private investors.

(101) It is true that, according to the German authorities, investments are profit-driven, are linked to reasonable business plans and clear and realistic exit strategies. Nevertheless, the Commission must also consider the above-described choice of the Fund's management, which is a State body that has been given instruction by a State Ministry to manage the Fund. Above all, the Commission considers the uncertain involvement of private investors.

(102) Only a limited number of micro and small enterprises, selected by the Fund managers, will receive financing. Investment transactions will be funded through the scheme's limited resources, for a limited period of time. The measure is therefore selective at the target enterprise level, too. Financing under the measure could improve the target enterprises' overall financial condition and enhance their market position. These enterprises are not prevented from engaging in competition and trade among Member States. Hence, competition and trade could be affected.

(103) In conclusion, the Commission can not exclude the presence of State aid in the sense of Article 87(1) of the EC Treaty at the level of the enterprises invested in.

### 3.4. Assessment of the aid-measure’s compatibility

(104) As was stated above, the measure in question could constitute State aid at the level of, firstly, the private investors, secondly, the Fund's management firm BKG and, thirdly, to the micro and small enterprises invested in. Consequently, the measure's compatibility has to be assessed pursuant to the conditions laid down in the Guidelines. Section 4.3 of the Guidelines provides for specific compatibility conditions. If these conditions are fulfilled, the incentive effect, the necessity and the proportionality of the aid can be considered as present, and the overall balance of the potential negative and positive effects of the aid can be considered positive.

#### *3.4.1. Maximum level of investment tranches*

(105) Section 4.3.1 of the Guidelines stipulates that tranches of finance, whether wholly or partially financed through State aid, must not exceed EUR 1.5 million per target-SME over each period of 12 months.

(106) Financing under the measure, as described above will be provided within said limits, as investments will not exceed EUR 0.5 million per target enterprise. Hence, investment tranches are in line with Section 4.3.1 of the Guidelines.

#### *3.4.2. Restriction to seed-, start-up and expansion financing*

(107) According to Section 4.3.2 of the Guidelines, the measure must be restricted to small enterprises up to their expansion stage, respectively to medium-sized enterprises up to their start-up stage (outside assisted areas). Medium-sized enterprises located in assisted areas may be financed even up to their expansion stage.

(108) As was illustrated further above, financing will only be provided for target enterprises being in their seed stage. Hence, the measure complies with Section 4.3.2 of the Guidelines.

#### *3.4.3. Prevalence of equity and quasi-equity investment instruments*

(109) Section 4.3.3 of the Guidelines requires that at least 70% of the measure’s budget must be provided in the form of equity and quasi-equity investment instruments.

(110) According to information provided by the German authorities, the Fund's investments will consists of a mix of equity and subordinated loans with a conversion option, or of silent participations, with a conversion option. The Commission notes that the information provided by the German authorities is not sufficient to assess the economic substance of silent participations and to decide whether or not they constitute quasi-equity investment instruments. The Commission further notes that the 70%-floor for equity investment instruments is not ensured under the scheme in question.

(111) Therefore, the requirement laid down in section 4.3.3 of the Guidelines is not met.

#### *3.4.4. Participation by private investors*

(112) As stipulated by Section 4.3.4 of the Guidelines, at least 50% of the funding of the investments made under the measure must be provided by private investors.

(113) It is true that private investors will at least be invited to participate in the Fund. It is also true that a EUR 100,000.00 private side-investment is required to trigger a Fund intervention. Nevertheless, it can not be ruled out that private investors subscribe to less than 50% of the Fund's capital, or that even no private investors at all are interested in joining the Fund. Neither can it be ruled out that Fund investments, drawing from Fund resources which consist of less than 50% private investor monies, exceed said EUR 100,000.00 side-investment threshold.

(114) Therefore, Section 4.3.4 of the Guidelines is not complied with, either.

### **3.5. Compatibility with the common market – detailed assessment**

(115) As was demonstrated above, two of the conditions set out in Section 4 of the Guidelines are not complied with. When a measure does not meet all conditions set out in Section 4, the Commission shall apply the detailed assessment pursuant to Section 5 of the Guidelines. Hence, the assessment must be based on a number

of positive and negative elements. No single element is determinant, nor can any set of elements be regarded as sufficient on its own to ensure compatibility. In some cases, their applicability, and the weight attached to them, may depend on the form of the measure.

(116) Section 5.1 of the Guidelines provides for certain risk capital measures that shall be subject to a more detailed assessment given the less obvious evidence of a market failure and the higher potential for crowding out of private investment and/or distortion of competition.

(117) Section 5.1 (e) of the Guidelines refers to measures providing seed capital to small enterprises which may foresee

– less than 50 % (in non-assisted areas) or 30 % (in assisted areas) or no private participation by private investors, and/or

– predominance of debt investment instruments as opposed to equity and quasi-equity.

(118) As the measure in question is exclusively aimed at the provision of seed capital to micro- and small enterprises, as private participation could be considerably lower than aforesaid thresholds, it falls within the detailed assessment as provided for by Section 5 of the Guidelines, based on a number of positive and negative elements.

### *3.5.1. Positive effects of the aid*

#### 3.5.1.1. Existence and evidence of market failure

(119) Section 5.2.1 of the Guidelines sets forth criteria as to the existence and evidence of market failure. It provides for an exhaustive list of risk capital measures to which it applies, namely those envisaging investment tranches into target enterprises beyond the conditions laid down in section 4, in particular those providing for tranches above EUR 1.5 million per target SME over each period of twelve months, follow-on investments or financing of the expansion stage for medium-sized enterprises in non-assisted areas as well as measures specifically involving an investment vehicle.

(120) Since the risk capital measure in question is not included in the list set out in Section 5.2.1, the existence of a market failure does not have to be evidenced in the present case.

(121) With respect to market failures affecting enterprises in their seed stage, Section 5.1 (e) of the Guidelines rather stipulates that such market failures are more pronounced due to the high degree of risk involved by the potential investment and the need to closely mentor the entrepreneur in this crucial phase. This is also reflected by the reluctance and near absence of private investors to provide seed capital, which implies no or very limited risk of crowding-out. According to Section 5.1 (e), this is one of the reasons that may justify a more favourable stance of the Commission towards measures targeting the seed stage, also in light of their potentially crucial importance to generate growth and jobs in the Community.

### 3.5.1.2. Appropriateness of the instrument

(122) Section 5.2.2 of the Guidelines stipulates that an important element in the balancing test is whether and to what extent, State aid in the field of risk capital can be considered as an appropriate instrument to encourage private risk capital investment. In its detailed assessment, the Commission will take particular account of any impact assessment of the proposed measure which the Member State has made. Where the Member State has considered other policy options and the advantages of using a selective instrument such as State aid have been established and submitted to the Commission, the measures concerned are considered to constitute an appropriate instrument. The Commission will also assess evidence of other measures taken or to be taken to address the "equity gap" notably ex post evaluations and both supply and demand side issues affecting the targeted SMEs, to see how they would interact with the proposed risk capital measure.

(123) In view of the measure's appropriateness, the Commission examined the independent empirical study and other information provided by the German authorities. Based on that information, the following can be established:

- The number of manufacturing high-technology enterprise formations is declining on the long term: There are 40% less formations in 2006 than in 1995;

- Only 5% of young high-tech enterprises have received capital from third-party investors. Only 17% out of these 5% have received financing from venture capital funds. This constitutes only 1% of the 18,000 high-technology enterprise formations in 2006 in Germany, being 180 enterprises;

- Enterprises financed through private equity grow faster and employ more personnel than those which do not benefit from such financing. 'Growth capital' is therefore important;

- Venture capital financing is preferentially provided to mature enterprises. The average venture capital target enterprise is rather in its expansion stage than in its seed- or start-up stage;

- Between 2004 and 2007, the number of venture capital providers has declined by 30%, from 132 to 102. Out of these 102, only 60 - 70 are actively operating on the market;

- The increased activity of semi-public or public funds has revived the seed-investment segment, but in view of the current decline in start-up investments the sustainability of that development has to be questioned;

- 76% of the seed-, and 75% of the start-up investments covered by the study were made by public funds, in the 18 months preceding the study, dated 1 August 2007;

- The strategic reasons for the reticence of venture capital providers to intervene in the seed phase are high technology- and market-related risks, high monitoring-, consultancy- and administrative costs compared to small transactions and the objective to maintain an investment for only up to 5 years, given most VC-Funds' 10-year durations, while seed-investments require to be held longer;

– The report provides for a detailed examination of operative reasons for rejecting interesting and actually viable investments. In summary, the lack of experienced management in young enterprises and of scalable business plans, of market potential beyond a EUR 500 million-threshold required by most pan-European venture capital providers, of satisfactory exit perspectives, of prototypes, of test customers (*Referenzkunden*), and the low turnover.

(124) The report concludes that public investors play an essential role in financing recently formed enterprises. In order to provide a broader base for financing young enterprises, both strategic and operative factors have to be taken into account. The report finds that in particular seed- and post-seed financing has to be expanded. While doing so, however, other investor groups, in particular business angels, should be taken into account. This group would usually be less exacting as regards yield potentials and would be ready to invest in enterprises whose business model do not fully correspond to that required by traditional venture capitalists. The report therefore recommends developing existing financing instruments on the one hand, while developing complementary approaches on the other hand.

(125) The Commission notes that the measure pursues three objectives. First and foremost, funding will be provided to seed-phase enterprises. According to the empirical analysis carried out by the study, financing in that stage is needed in order to grow and reach subsequent stages. However, for the reasons explicated further above, such funding is only very reticently offered by private capital providers, even despite a valuable business model exists.

(126) The measure is however not limited to merely invest Fund monies. Rather, the requirement to acquire a private side-investment of at least EUR 100,000.00 aims at involving private seed capital providers, in particular business angels.

(127) Thirdly, the measure obliges target enterprises to be mentored technically and commercially by an expert. The measure's mentoring provisions aim at clearing away the above mentioned obstacles preventing private investment, and thus encourage private funding

(128) The Commission has evaluated information on the German authorities' impact assessment of the proposed measure and whether they had considered other policy options and the advantages of using the selective instrument in question.

(129) Based on that information, the Commission notes that, firstly, the measure is embedded in a wider framework and is needed to optimise the entire framework's effectiveness in addressing the shortage in risk capital financing in Germany. Secondly, Germany has sufficiently demonstrated that non-selective policy options, in particular tax incentives, are not suitable to address the specific requirements of early stage enterprises in need of financing. Thirdly, the German authorities have assessed the impact of the notified measure and informed the Commission of their findings.

(130) As Germany has demonstrated the advantage of the selective instrument in question and has carried out a proper impact assessment of the measure, the Commission considers the Fund in question to constitute an appropriate instrument.

(131) Lastly, the German authorities informed the Commission measures taken or to be taken to address the "equity gap". The Commission notes, however, that these measures can not yet be evaluated. Nevertheless the Commission finds that the notified measure will interact with these other measures, as described further above. Thus, the Fund in question, which only focuses on the seed-end phase of target micro and small enterprises, will be complemented and could thus help addressing the equity gap in the German risk capital market.

(132) Based on information provided by Germany, the Commission concludes that the measure is aimed at encouraging private investments. Hence, it is an appropriate instrument in the meaning of Section 5.2.2 of the Guidelines.

#### 3.5.1.3. Incentive effect and necessity of the aid

(133) Section 5.2.3 of the Guidelines stipulates that the incentive effect of risk capital aid measures plays a crucial role in the compatibility assessment. While the Commission believes that the incentive effect is present for measures meeting all the conditions in Section 4 of the Guidelines, Section 5.2.3 ascertains that, as for the measures covered in Section 5 of the Guidelines, the presence of the incentive effect becomes less obvious. Therefore, Section 5.2.3 obliges the Commission also to take into account the additional criteria laid down in Sections 5.2.3.1 – 5.2.3.4.

– Commercial management:

(134) Pursuant to Section 5.2.3.1 of the Guidelines, in addition to the conditions laid down in Section 4.3.6 the Commission will consider it positively that the risk capital measure or fund is managed by professionals from the private sector or by independent professionals chosen according to a transparent, non-discriminatory procedure, preferably an open tender, with proven experience and a track record in capital market investments ideally in the same sector(s) targeted by the fund, as well as an understanding of the relevant legal and accounting background for the investment.

(135) The Commission notes the German authorities' statement that BKG has a track record and proven experience in funding young technology enterprises. The Commission however also notes that BKG has not been chosen in a transparent, non-discriminatory procedure, and that it is not a private sector enterprise.

(136) However, Section 5.2.3.1 of the Guidelines stipulates that the criteria set forth in this Section have to be considered positively in addition to those laid down in Section 4.3.6 of the Guidelines.

(137) In view of the fund management, Section 4.3.6 (a) requires an agreement between the fund management and the fund’s participant, providing that the management’s remuneration is linked to performance. Said agreement must further set out the objectives of the fund and the proposed timing of investments.

(138) According to information provided by the German authorities, BKG's remuneration will be linked to performance, by means of a carried-interest agreement. Remuneration arrangements, the Fund's objectives and the proposed timing of investments will be set out in the Articles of Association and the Investment Terms and Conditions. The measure is therefore in line with the criteria set out in Section 4.3.6 (a) of the Guidelines.

– Presence of an investment committee

(139) Pursuant to Section 5.2.3.2 of the Guidelines, a further positive element would be the existence of an investment committee, independent of the fund management company and composed of independent experts coming from the private sector with significant experience in the targeted sector, and preferably also of representatives of investors, or independent experts chosen according to a transparent, non-discriminatory procedure, preferably an open tender.

(140) For the time being, and at least until closure of the subscription phase, only the public stakeholders will be represented in the investment committee. However, as was explained further above, (43) et seq, private investors who will subscribe to a stake in the Fund will be proportionally represented in the Fund's decision making.

– Size of the measure/fund

(141) In accordance with Section 5.2.3.3 of the Guidelines, the Commission will consider it positively where a risk capital measure has a budget for investments into target SMEs of a sufficient size to take advantage of economies of scale in administering a fund and the possibility of diversifying risk via a pool of a sufficient number of investments. The size of the fund should be such as to ensure the possibility of absorbing the transaction costs and/or financing the later more profitable financing stages of target companies. Larger funds will be considered positively also taking into account the sector targeted, and provided the risks of crowding-out private investment and distorting competition are minimized.

(142) The Commission notes that the Fund's initial capital will amount to EUR 20 million. Private investors will be invited to augment that capital even further, up to EUR 40 million. The German authorities expect that up to 50 target enterprises will be funded with the measure.

(143) Based on information provided by Germany, described above, 2.14, the Commission finds that the Fund's size is sufficient and that the risk is adequately diversified. There is also no doubt that the Fund's transaction costs can not be absorbed.

– Presence of Business Angels

(144) With respect to measures targeting seed capital, Section 5.2.3.4 stipulates that the Commission will consider positively the direct or indirect involvement of business angels in investments. Even measures that foresee a predominance of debt instruments, including a higher degree of subordination of the State funds and a right of first profit for business angels or higher remuneration for their provision of capital and active involvement in the management of the

measure/fund and/or of the target enterprises can thus be declared compatible with the common market.

(145) Although it is not guaranteed that business angels will be involved in each investment, the measure aims at involving business angels indirectly, through investments alongside the Fund. The Commission notes that one of the Fund's primary objectives is to provide an incentive to business angels to invest in eligible seed-phase micro- and small enterprises (see above, (6)). Furthermore, the involvement of business angels is recommended by the reports on which the German authorities have based the preparation of the Fund (e.g. above, (12)) Hence, the involvement of business angels plays a significant role in the measure's overall framework.

(146) Hence, although business angels might not intervene concomitantly with each Fund investment, the measure's aim to involve this category of venture capitalists is to e considered positively.

3.5.1.4. Proportionality of the aid

(147) Section 5.2.4 of the Guidelines Compatibility stipulates that the aid amount is limited to the minimum necessary. The Commission will consider that a transparent, non-discriminatory open tender for the choice of the management company and a public invitation to investors positively influence the assessment of proportionality as they represent a best-practice approach.

(148) The Commission notes that funding under the measure will be limited to the extent strictly necessary to pursue the measure's objectives. It is true that the Fund's management has not been selected by an open tender procedure. However, its remuneration will be linked to performance.

(149) Further, an invitation to investors will be published at the launch of the measure. Investments by public and private investors in the Fund will be made at exactly the same terms and conditions (*pari passu*). Thus, investors in the Fund will not be overcompensated. The aid can therefore be deemed proportionate.

*3.5.2. Negative effects of the aid*

(150) Section 5.3 of the Guidelines requires that the potential negative effects of risk capital measures in terms of distortion of competition and risk of crowding-out private investment be balanced against their positive effects. These potentially negative effects will have to be analyzed at each of the three levels where aid may be present.

(151) The measure in question grants aid at the levels of the investors, the management and the target enterprises. Section 5.3 refers to several distortions of competition, in sections 5.3.1 and 5.3.2.

3.5.2.1. Crowding out private investment

(152) Pursuant to Section 5.3.1 of the Guidelines, State aid may result in crowding out private investment. That Section is based on the presumption that this risk becomes more relevant, the higher the amount of an investment tranche invested into an enterprise, the larger the size of an enterprise, and the later the business

stage, as private risk capital becomes progressively available in these circumstances.

(153) Section 5.3.1 of the Guidelines requires specific evidence regarding the risk of crowding-out for measures providing for larger investment tranches in target SMEs, for follow-on investments or for financing of the expansion stage in medium-sized enterprises in non-assisted areas or for measures with low participation by private investors or measures involving specifically an investment vehicle. The measure in question foresees a low participation by private investors.

(154) In that context, the Commission notes the German authorities' intention to limit investments to the strict minimum necessary for the achievement of the measure's objectives. The Fund's investment in one target enterprise will amount to EUR 500,000 at most, thus being EUR 1 million less than the EUR 1.5-million safe-harbour limit set out in Section 4.3.1 of the Guidelines.

(155) It is further to be noted that the Fund will exclusively invest in micro- and small enterprises in their seed stage. According to specific evidence provided by the German authorities, private financing was available for only 5% of young technology enterprises, and the majority of those who received such financing were older than the enterprises targeted by the Fund and were provided higher amounts of funding. Also, the Fund will not provide funding in cases where funding from private venture capital firms or business angels is possible.

(156) Based on the aforesaid, the Commission considers the measure not to result in a crowding out of private investors.

(157) In addition, as stipulated by Section 5.3.1 of the Guidelines, Member States will have to provide evidence to show that there is no risk of crowding-out, specifically concerning the targeted segment, sector and/or industry structure.

(158) It is true that the Fund in question does not target any specific sector or industry. However, as it is addressing technology enterprises in their seed stage, the Fund is focusing on a certain segment of the industry, namely on enterprises that are technology-based and innovative.

(159) Based on information provided by the German authorities, the Commission finds that the measure does not entail a risk of crowding out private investors, for the following reasons:

– <u>No Fund-investments in cases where private funding is possible</u>: Prior to each investment, the Fund management will scrutinise whether financing from a private venture capital fund or business angel is possible. In the affirmative, the Fund's statutes prohibit any investment;

– The Fund will not act as a 'lead investor';

– <u>The Fund investments are targeting a demand that private investors are not readily available to meet</u>: The ceiling for each investment is EUR 500,000.00. According to the above cited study report, the average investment made by private VC-Funds in seed-stage enterprises is EUR 1.3 million. 76% of these investments had been made by public funds. Only

2% of seed-stage enterprises that had sought venture capital financing managed to receive funding from a private investor;

– The Fund invests in target enterprises which are younger than those funded by private investors: The Fund's target enterprises must not be older than 2 years. According to the study report provided by the German authorities, 34% of private venture capital investors invested in enterprises between 2 and 3 years of age. Only 9% of these capital providers invested in enterprises that were younger than 1 year and thus, in the German authorities' view, being in their classical seed-stage. According to the report, the average age of an enterprise receiving private venture capital is 2.6 years;

– Section 5.1 e) of the Guidelines provides for the legal assumption that the reluctance and near absence of private investors to provide seed capital, implies no or very limited risk of crowding-out.

#### *3.5.3. Cumulation with other aid*

(160) Section 6 of the Guidelines provides for a reduction of aid intensities granted under the measure in question when used to finance investments or other costs eligible for aid under other block exemption regulations, guidelines, frameworks or other State aid documents. It also provides that no such reduction is applicable to aid intensities provided for in the Community Framework for State aid for Research and Development[13] or any successor framework.

(161) Based on information provided by Germany, the Commission concluded that the scheme complies with the cumulation rules set out in Section 6 of the Guidelines.

#### *3.5.4. Monitoring and reporting*

(162) Section 7.1 of the Guidelines stipulates that Member States shall submit annual reports on a risk capital measure's implementation and further sets forth which information such reports must comprise.

(163) The annual reports Germany committed to provide will comply with the requirements set out in Section 7.1 of the Guidelines.

### 3.6. Conclusion

(164) The Commission concludes that the aid granted under the risk capital scheme '*Clusterfonds Start-up!'* fulfils the conditions as set out in the Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises.

## 4. DECISION

(165) On the basis of the foregoing assessment, the Commission concludes that the risk capital scheme '*Clusterfonds Start-up!'* is compatible with the common market

[13] OJ C 45, 17.2.1996, p 5.

pursuant to Article 87(3) (c) of the EC Treaty. This decision does however not prejudice the position the Commission might take on the compatibility of the above measures with Internal Market rules, especially regarding public procurement and concessions.

(166) The Commission reminds Germany that all plans to modify this aid scheme have to be notified to the Commission.

(167) The Commission further reminds Germany to provide an annual report on the measure's implementation. This report will contain:

(a) A summary table with a breakdown of the investments effected under the risk capital measure including a list of all the enterprise beneficiaries of risk capital measures:

(b) Details of potential deals scrutinised and of the transactions actually undertaken;

(c) Performance of the investment vehicles, with aggregate information about the amount of raised capital.

(168) Said report will be published on the internet site of the Commission.

If this letter contains confidential information, which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter, in the authentic language, on the Internet site

http://ec.europa.eu/community_law/state_aids/index.htm

Your request should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
Directorate for State Aid
State Aid Registry
B-1049 Brussels
Fax No: +32 2 296 12 42

Yours faithfully,

For the Commission

*Neelie KROES*
Member of the Commission