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Subject: State aid n° SA.36428 (2013/N) - United Kingdom
Amendments to the existing aid scheme "Enterprise Capital Funds" (C 17/2004)

Sir,

The Commission wishes to inform you that it has decided to raise no objections to the amendments of the above mentioned measure, for the reasons set out below.

1. PROCEDURE

(1) The Enterprise Capital Funds ("ECFs") scheme (SA.15373) was approved by the Commission on 3 May 2005[1] ("Decision of 2005") under Article 87(3)(c) EC (now Article 107(3)(c) TFEU) and in particular on the basis of the Risk Capital Guidelines of 2001[2], in force at the time, after opening a formal investigation procedure (C17/2004 (ex N566/03)).

(2) On 27 March 2013, the UK authorities pre-notified several amendments to the ECFs scheme, without prejudice to the parallel monitoring of the existing scheme under the procedure SA.15373 (ex. 2011/MX).

[1] OJ L 91/16, 29.3.2006

[2] OJ C 235, 21.8.2001, p. 3.

The Rt Hon William HAGUE
Secretary of State for Foreign Affairs
Foreign and Commonwealth Office
King Charles Street
London SW1A 2AH
UNITED KINGDOM

Commission européenne, B-1049 Bruxelles – Belgique - Europese Commissie, B-1049 Brussel – België
Telephone: 00-32 (0) 2 299 11.11.

(3) A meeting took place on 21 May 2013 between the Commission services and the UK authorities to discuss possible changes to the pre-notified scheme. Following two teleconferences on 1 and 2 July 2013 the UK authorities submitted a modified version of the intended scheme on 4 July 2013.

(4) On 2 August the Commission sent a request for information to the UK authorities asking for clarifications, which was followed by a meeting which took place on 6 August 2013.

(5) On 16 August 2013, the UK authorities submitted the formal notification, including the official forms, and completed it with additional elements on 21 August 2013.

2. DESCRIPTION OF THE EXISTING ECFS SCHEME (DECISION OF 2005 AND NATIONAL LEGAL BASE)

(6) By combining public and private investment into investment funds, the ECFs scheme aimed at improving access to risk capital for SMEs throughout the UK. The Government and private investors were to sign limited partnership agreements setting the conditions for their participation into each fund. The Government and other investors in the fund would be limited partners.

(7) The General Partner[3] of the partnership would appoint a fund manager responsible for managing the activities of the partnership. In order to preserve their limited liability, the limited partners were not to become directly involved in the management of the fund. Further persons could be admitted as investors or limited partners by the fund manager at any time, provided that they accepted the conditions of the limited partnership.

(8) The amounts of public participation, profit share and repayments priorities[4] in each ECF were to be determined through a competitive bidding process between potential fund managers, in order to ensure minimal public support.

(9) In order to qualify as an ECF, a fund had to submit a robust business plan including: i) relevant information on the management team and their relevant experience, ii) the amount of private money and their source, iii) the proposed ECF's investment strategy, including the proportion of funds intended to be invested in early stage and start-up companies, and iv) repayments agreements.

(10) Government participation into each fund was limited to no more than twice the private capital raised by the fund that is to say that at least 33.3% of the fund endowment was to be provided by private investors. The distribution of the profits and losses between public and private investors in the ECFs was based on the logic that, on the downside, the losses were distributed at equal terms, the private investors being fully exposed. On the upside, the distribution of the profits was non *pari passu*, *i.e.* private investors received most of the profits notably above a certain profitability rate. This mechanism enabled ECFs to

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[3] *General Partner* – the owner/owners of a partnership who have unlimited liability. In the case of a limited partnership, only one of the partners will be the general partner and have unlimited liability while the other partners will be limited partners.

[4] The partnership agreement on prioritization of [of?] repayments referred to: (1) interest on the public participation, (2) leverage, (3) private capital, and (4) profit distribution.

attract private participation and ensured that they were commercially oriented[5] while entailing state aid.

(11) According to the rules of the scheme[6], an ECF may invest early and expansion capital in any company:

- that meets the EU definition of an SME;
- where the purpose of the relevant investment, or the application of the proceeds of such investment by the relevant company or undertaking, is predominantly related to or for the benefit of the economy of the UK;
- whose equity or other securities are not, at the time of investment, listed on a recognised stock exchange (such as the London Stock Exchange) or otherwise quoted on a non-recognised exchange, i.e. AIM, Ofex or any other market on which prices are quoted publicly;
- that does not operate in any of the restricted sectors referred to in Article 32 of the EC Treaty or in sensitive sectors for which the Risk Capital Guidelines (see below point 4.3) do not apply; and
- where the trade of such company is a qualifying trade as defined in Paragraph 4, Schedule 28B of the Income and Corporation Taxes Act 1988, or where the company is undertaking research and development with a view to carrying on a qualifying trade[7].

(12) An ECF fund was to invest alone or along with other investors, including other ECFs, in eligible SMEs by means of equity or quasi-equity instruments between £250,000 (€357,000[8]) and £2m (€2.9m) per single investment round. Pure debt investments without

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5 Once one ECF met its expenses and liabilities (including fund management fees) the government receives a prioritised return equivalent to the interest charged on the balance of outstanding loans to the fund (at the time 4.3% per annum, currently 3% but subject to change based on the government's cost of borrowing). Once the government has received its prioritised return, outstanding loans may then be repaid to the government and the private investors under the terms specified in the applicant's bid. All further distributions to investors are to be divided between the government and all other private investors in a fixed profit-sharing ratio.

6 Enterprise Capital Fund – Guidance for applicants http://www.capitalforenterprise.gov.uk/files/Guidance%20for%20Prospective%20ECF%20Managers%20-%20V2.pdf

7 A trade will not qualify if one or more excluded activities together make up a 'substantial part' of that trade. The main excluded activities are: (1) dealing in land, financial instruments, or in goods other than in the course of an ordinary trade of retail or wholesale distribution; (2) financial activities, property development, or providing legal or accountancy services; (3) leasing (including letting assets on hire, except in the case of certain ship-chartering activities); (4) receiving royalties or licence fees, except where these arise from an intangible asset such as a patent or know-how, most or all of which has been created by the company (or one of its subsidiaries); (5) farming, market gardening, or forestry; (6) operating or managing hotels, guest houses, hostels, or nursing or residential care homes; and (7) providing services to another company in certain circumstances where the other company's trade consists to a substantial extent in excluded activities. Source: Enterprise Capital Funds – Guidance for applicants

8 Exchange rate £ to €1.42

equity components were explicitly forbidden under the scheme[9]. Additional investments beyond the limit of £2m were permitted in case the ECF invested on similar terms as the other commercial investors.

(13) Follow-on investments were permitted in the first six months after the first investment, as long as the total equity funding raised by the SMEs from ECFs and other equity investors was no more than the £2m (€2.9m) limit[10].

(14) Follow-on investments in excess of the above limit were permitted, where necessary, only after a period of at least 6 months and to prevent dilution, up to a maximum 10% of each ECF's committed capital.

(15) When exercising the follow-on anti-dilution mechanism, the ECFs had no specific powers beyond those of any shareholder; ECFs were allowed to make such investments when made on the same terms as purely private investors, in order to obtain the best value from an investee company. In addition, ECFs had no right of first refusal when investing through the anti-dilution mechanism.

(16) The ECFs scheme was initially approved for a period of 10 years, until 2 May 2015, and was intended to be self-financing in the medium term. For the first year of its operation, the UK allocated €65m to cover the cash-flow cost of the initial public participation.

3. NOTIFIED AMENDMENTS TO THE SCHEME

(17) The UK authorities have notified the following amendments and stated that apart from the notified amendments, all the other conditions of the existing ECFs scheme (C17/2004) remain unchanged.

3.1. Eligibility conditions

(18) The UK authorities intend to focus the risk finance measures deployed by the ECFs on both early stage SMEs and later stage SMEs, irrespective of their location (*i.e.* assisted or non-assisted areas), provided the latter fulfil several conditions.

(19) The ECFs will invest in undertakings which at the time of the initial risk finance investment are unlisted SMEs and fulfil one of the following conditions:

(a) they have not been operating in any market;

(b) they have been operating in any market for less than 7 years following their first commercial sale;

(c) they require an initial risk finance investment which, based on a business plan prepared in view of entering a new product or geographical market, is higher than 50% of their average annual turnover in the preceding 5 years.

In setting these conditions, the UK authorities have sought to align their scheme to the eligibility conditions under the provisions for risk finance aid provisionally foreseen in

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[9] ECF Partnership agreement, Schedule 1 – Investment policy, Point 3.6: "[ECF] may not acquire Investments in a Portfolio Company..... (d) in loan finance or debt instruments with no associated equity investment."

[10] Funds provided in the form of debt finance, without any equity or quasi-equity components, were excluded from the ceiling.

the draft new General Block Exemption Regulation (GBER), currently under public consultation, and the future Risk Finance Guidelines (RFG).

3.2. Increase of the initial investment tranche from £2m to £5m per undertaking

(20) The UK authorities provided evidence that the equity gap for the initial round of investment into the eligible SMEs now extends up to £5m (€5.8m). Such an amount would not be covered either by traditional institutional lenders or by private investors. The UK authorities seek the approval of the increase of the annual investment tranche from £2m, as set out in the Decision of 2005, to £5m.

(21) The above mentioned cap will include investments made within the scope of the measure, from investors benefitting from the aid, while excluding finance from market oriented investors providing capital to the eligible SMEs independently from the ECFs and outside of the scope of the measure, hence receiving no aid in connection with their investment.

3.3. Introduction of an overall investment cap of €15m per undertaking

(22) Based on the evidence regarding the duration of typical holding periods for early stage venture capital investments and the financing needs of such undertakings, the UK authorities seek the approval of an overall investment cap of €15m per undertaking. This limit would offer ECFs the capability and resources to follow-on the first investment round with subsequent rounds.

(23) This overall cap will include private investments made within the scope of the measure, *i.e.* investors that invest along ECFs and which receive aid, while private investors outside the scope of the measure, *i.e.* independent co-investors which invest in the same SMEs without receiving any advantage, are not to be included in the cap, as they are not recipients of aid.

3.4. Increase of the maximum public contribution into each ECF from £25m (€29m) to £50m (€58m)

(24) The UK authorities claim that there is evidence that the larger the funds, the more likely they are to be successful, particularly when making early stage investments. They could more easily follow-on successful first investments and be more attractive to private investors. In addition, institutional investors seem to be less prone to invest in smaller funds due to their limited diversification. Therefore, setting the limit for Government participation at £50m (€58) per fund might help achieve better efficiency and scale of operations.

3.5. Allowing follow-on anti-dilution investments[11] and increase the limit for such investments from 10% to 15% of an ECF's capital

(25) In the Decision of 2005 follow-on anti-dilution investments were allowed only after 6 months from the first investment round and subject to an upper limit of 10% of each ECF's capital, which the UK authorities envisage to increase to 15%, arguing that the

[11] Follow-on investment is a form of investment whereby an investment fund looks proactively to inject more capital into an investee in exchange for new shares. Follow-on anti-dilution investment is a reactive form of investment whereby ECFs provide more equity into that company, along with a new (existing or new) investor, in order maintain its shareholding position.

figure reflects market practice[12]. In addition, follow-on investments for anti-dilution purposes will be possible up to the overall investment limit of €15m. Any follow-on investment beyond the threshold of €15m will be undertaken on a pari-passu basis and appropriate accountancy methods will ensure that no aid is transferred to private investors in connection with such investments (see point 3.3. above).

3.6. Allowing for private participation ratios tailored according the development stages of the investees

(26) The UK authorities claim that the equity gap for investments up to €15m would be better addressed if the level of participation through State resources were to be tailored according to the development stages of the investees. Therefore, while the UK authorities intend to maintain the public participation at 2 (public) : 1 (private), *i.e.* maximum 66.7% public participation, for funds targeting SMEs prior to their first commercial sale, they seek for the approval of ECFs capital structure of 1.5 (public) : 1 (private), *i.e.* maximum 60% public participation, for funds targeting SMEs up to 7 years following their first commercial sale, or SMEs that intend to launch a new product or to enter a new market, given the less severe market failure the latter would face.

3.7. Allowing ECFs to make secondary purchases in specific and limited situations

(27) The UK authorities claim that there is a market gap with respect to funding replacement capital transactions within the £5m annual investment cap proposed for ECFs. They propose that the capital allocated for such operations shall not exceed 50% of the total invested capital for the transaction at issue, with the remaining committed capital to be invested into fresh equity. Such a design would ensure that the investment will fund genuine growth.

(28) Moreover, the UK authorities asked also for the approval of small capital replacement operations in limited circumstances, *i.e.* allowing the replacement of a manager or a minority shareholder in order for the company to continue with committed shareholders. This kind of operation will be limited at £100,000 per transaction and per company.

3.8. Extend the duration of the ECFs scheme by additional 10 years as of the date of the approval decision

(29) The amended scheme shall be in force for an additional ten years as of the date of the Commission's approval.

3.9. Increase the budget

(30) The estimated budget is £300m and will supersede the existing budget of £200m that covers the period from April 2011 to March 2015. The expected annual expenditure will be at maximum £75m.

[12] The same figure is used by the European Investment Fund when it invests into funds.

4. ASSESSMENT

4.1. Legality

(31) By notifying the modified scheme, the UK authorities have complied with their obligations under Article 108(2) TFEU.

4.2. Existence of aid

(32) The notified modification does not change the Commission's previous assessment with respect to the existence of aid, namely that private investors and the target SMEs are beneficiaries of State aid in the sense of Article 107(1) TFEU[13].

4.3. Assessment

(33) The Risk Capital Guidelines of 2001, on the basis of which the ECFs scheme was approved, stated that specific factors adversely affecting the access of SMEs to capital, such as imperfect or asymmetric information or high transaction costs can cause a market failure that would justify State aid. They further specified that there is no general risk capital market failure in the Community, but rather funding gaps for some types of investments at certain stages of enterprises' lives for which the Commission will require provision of evidence of market failure before being prepared to authorise risk capital measures.

(34) The Risk Capital Guidelines of 2006 (hereafter the RCGs of 2006) reiterate that it is the primary role of the market to provide sufficient risk capital, but that there is an "equity gap" due to a persistent capital market imperfection preventing supply from meeting the demand at a price acceptable to both sides, which negatively affects European SMEs. The existence of the equity gap may justify the granting of State aid in certain limited circumstances.

(35) The Commission may accept the existence of market failure without further provision of evidence in cases where each tranche of finance for an enterprise benefiting from risk capital measures which are wholly or partially financed through State aid respects the conditions set out in chapter 4 of the RCGs of 2006. Should a risk capital measure go beyond the limits set by the above provisions, the Commission will require specific evidence of market failure before authorizing a risk capital measure on the basis of a detailed assessment under chapter 5 of the RCGs of 2006.

(36) The Commission understands that the UK authorities seek the approval of several modifications of the existing scheme, some of which may go beyond the limits set by the RCGs of 2006.

(37) The Commission underlines that the assessment of the modified scheme was performed based on the evidence provided by the UK authorities and under the rules set by the RCGs of 2006, while taking also into consideration the on-going discussion on the modernisation of these rules as reflected in the draft new General Block Exemption Regulation published on 8 May 2013 and currently under public consultation, and the

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13 Decision C17/2004 (SA.15373), recitals (99) to (103).

draft Risk Finance Guidelines, published for public consultation on 24 July 2013 and adopted on 15 January 2014.

4.4. Compatibility of the amendments

4.4.1. Eligibility conditions

(38) As pointed out in section 3.1. above, the UK authorities intend to circumscribe the ECFs investments to early stage SMEs and to SMEs in their later stage, subject to the latter fulfilling certain conditions.

(39) More specifically, the ECFs will be allowed to invest in unquoted SMEs that will have been operating in any market for less than 7 years following their first commercial sale or in SMEs with no commercial sale at the moment of an ECF's first investment. In addition, investments in later stage SMEs will be accepted if the investment will allow the investee to launch a new product or enter a geographical market. In this case the risk finance investment should be higher than 50% of their average annual turnover of the investee in the preceding 5 years (see paragraph (19)).

(40) The Commission recalls that the RCGs of 2006 leave the possibility to Member States to take measures targeting SMEs in later development stages subject to convincing evidence being provided that the envisaged investments will be made only into SMEs affected by a market failure so as to exclude possible crowding-out effects and undue distortions of competition. In this respect, the Commission considers that the studies and surveys the UK authorities brought to its attention provide sufficient evidence demonstrating that the SMEs coming within the above mentioned categories, *i.e.* SMEs between the seed stage and the early growth stage, are affected by a market failure resulting in an equity gap that not traditional funding channel is currently able and/or willing to fill.

(41) In addition, the Commission notes that the amendment proposed by the UK authorities is in line with the envisaged new rules for risk finance aid as set out in the draft new GBER which are now in the process of being adopted and the future Risk Finance Guidelines.

(42) Therefore, the Commission raises no objections with respect to this amendment.

4.4.2. Increase of the initial investment round from £2m (€2.3m) to £5m (€5.8m) per undertaking

(43) The UK authorities claim that the SMEs in the UK face an equity gap that evolved compared to the moment of the approval of the existing scheme in 2005, and state that the equity gap in the UK now amounts to £5m (€5.8m) per annual investment tranche. Raising the investment limit to this level would ensure sufficient focus on early stage SMEs and would limit the disadvantages that ECFs could encounter compared with other similar instruments. In particular, such an increase of the initial investment would allow more flexibility for ECFs and will improve the chances of the ECFs' investment strategy to succeed.

(44) The UK authorities submitted several studies demonstrating the evolution of the annual "equity gap" beyond the authorised initial investment limit of £2m (€2.3m), and claim that the existing cap it is not sufficiently flexible in order to meet the needs of high-growth SMEs, and to successfully follow-on the initial investment into an undertaking.

To support their arguments, the UK authorities provided the following two studies which surveyed various market participants:

a) Rowlands Review (2009), *The Provisions of Growth Capital to UK Small and Medium Sized Enterprises*[14]. The study identifies a gap in growth capital between £2m (€2.3m) and £10m (€11.6m), which private sector venture capital funds and the banks are unlikely to fill in the near future. In addition, it suggests an increase of the market gap up to £5m (€5.8m) for early stage investments, and up to £10m (€11.6m) for growth capital, which means that raising the annual investment tranches up to £5m (€5.8m) would ensure sufficient focus on early stage companies.

b) SQW Consulting report (2009), *The Supply of Equity Finance to SMEs: Revisiting the Equity Gap*[15].The study found that the limits of the equity gap are believed to stretch from £250k to at least £2m, with some participants putting the ceiling at £5m. In the case of sectors requiring complex R&D or large capital expenditure, the gap may extend up to £15m. The study underlines the main difficulties UK companies have compared to their peers form the United States: "*At the early stage UK companies are only raising half of the amount a similar company would in the US. At later stages US funding can be 2.5 times greater than for a similar company in the UK. This suggests that growing UK companies may be seriously under-funded compared with their US peers.*" The findings of the study suggest that high-growth SMEs in the UK may be seriously under-funded compared with their Unites States peers.

c) Two assessments of the equity initiatives of the Department for Business, Innovation and Skills, within the UK Government:

- A survey of 2010 among Enterprise Capital Funds managers and investees companies concluded that higher investment limits were needed for the investment in SMEs, which would necessitate larger funds size; the fund managers claim that the equity gap for the initial investment has now widened to £3-5m (€3.5-5.8m).

- A survey from October 2012 among funds managers confirmed that the equity gap stretches beyond the actual limit of £2m (€2.3m), with £5m (€5.8m) being the most commonly-cited figure for the upper limit.

(45) The above studies indicate an evolution of the equity gap from older research in particular HMT's *Bridging the Finance Gap (2003),* which considered that the equity gap stretched up to £2m (€2.3m). It is to be noted that already the study of 2003 concluded that for technology-intensive industries the equity gap was reaching up to £5m.

(46) The Commission notes also that the proposed increase of the annual investment tranche within which the ECFs will be allowed to operate is mitigated by a more refined definition of the eligible SMEs.

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14 http://www.bis.gov.uk/files/file53698.pdf.

15 http://www.bis.gov.uk/files/file53949.doc

(47) Moreover, while the RCGs of 2006 stipulate in their chapter 4 an annual investment tranche of €2.5m per SME, the Commission has already accepted in a recent UK case[16], following a detailed assessment pursuant to chapter 5 of the RCGs of 2006, that the annual equity gap in the UK is between £250,000 and £5m.

(48) Therefore, the Commission raises no objections with respect to this amendment.

4.4.3. Introduction of an overall investment cap of €15m per undertaking

(49) Based on evidence that the holding period has extended in the last years, and given the increasing capital needs of investees, the UK authorities seek the introduction of an overall investment cap of €15m per SME, which will generally be enough to make a first investment round, as well as subsequent follow-on investment rounds. This limit would offer ECFs the liberty and capability to follow-on a successful initial investment with subsequent rounds and would help the investee to attain a sufficiently stable state as to be able to attract significant private sector funding on its own.

(50) The UK provided evidence that the average holding periods for a fund are now longer than 5 years that is, the exit opportunity will come later into the investment process. In particular, according to a study by NESTA[17], the time to exit has constantly increased since 2001. Thus, the time taken to successfully exit through an initial public offer has reached an average of just over 7 years in 2009 across all countries in the study. For early stage investments with unproven technology, the investment time period until successful exit could be even longer than the average. This increases the likelihood that the investor will spend additional resources as the company will typically need a constant flow of investment.

(51) In addition, a recent survey of fund managers delivering publicly backed funds shows most respondents (72%) reported they currently judge the exit opportunities for their portfolio companies as being poor or very poor. Just 19% of fund managers reported that the current state of the venture capital market for providing opportunities for successful exits is good. This again suggests that investors need to stay longer with their investment in the target company, thus likely requiring additional resources.

(52) Other studies[18] also underline the critical importance of follow-on funding for the commercial expansion of an SME after the initial resources provided by its early stage investors are exhausted. Sectors with high capital requirements and more capital-intensive industries would be more affected.

(53) The RCGs of 2006 provide only for a limit in terms of annual investment tranches and do not establish an upper limit with respect to the overall investment into an undertaking. Therefore during the lifespan of the fund, the latter could invest in an undertaking during several rounds provided the amount invested at each round remains within the annual cap corresponding to the proven equity gap.

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16 SA.33849 (2012/N): United Kingdom Amendments of the Enterprise Investment Scheme (EIS) and the Venture Capital Trusts Scheme (VCT).

17 *Venture Capital: Now and After the Dotcom Crash*, Yannis Pierrakis, Nesta (National Endowment for Science, Technology and the Arts), July 2010

18 Rowlands review, *The Provisions of Growth Capital to UK Small and Medium Sized Enterprises*

(54) Moreover, the new rules on risk finance aid, currently in the process of being finalized, contain provisions allowing schemes that are better aligned with market practices and that respond faster to SMEs' funding needs by fixing a safe-harbour rule capturing an overall investment amount of €15m per undertaking. In addition, the new Guidelines contain specific assessment criteria for measures allowing higher overall investment amounts.

(55) Therefore, for the reasons mentioned above, the Commission will not raise objections with respect to the introduction of an overall investment cap limiting the total amount of finance that an SME could receive from ECFs.

4.4.4. Increase of the maximum public contribution into each ECF from £25m (€29m) to £50m (€58m)

(56) The UK authorities provided evidence that larger funds are more likely to be successful, particularly when making early stage investments and also when they are focused on developing technology. Larger funds have a greater ability to follow on, are more attractive to better qualified fund managers and are more able to support full investment teams. In addition, larger funds could be more attractive to more risk-averse private investors, for example institutional investors who tend to prefer funds that are able to better mitigate the risk at the portfolio level through their size.

(57) The UK authorities also brought evidence that currently it takes longer for new funds to be raised than, for instance, 10 years ago. A study of January 2013[19], carried out in consultation with the UK's Access to Finance Expert Group and Professor Gordon Murray, showed that the desire for liquidity has narrowed the potential investor base for venture capital funds. In addition, the interviews revealed that General Partners are currently taking a longer time to raise new funds. Those General Partners now seeking to raise funds have curtailed their expectations and reduced the total funding sought.

(58) The UK authorities provided evidence that institutional investors who were previously an important source of capital for venture capital funds limit their investment in such instruments due to under-scaled funds which do not manage to have sufficiently diverse portfolios of investments or the ability to follow-on their investments.

(59) This evidence highlights a cyclical problem, which has the potential to become a longer term structural failure. In addition to the alignment to market practices, increasing the size of ECFs does contribute to addressing the long-term structural market failure with respect to the equity gap. The presence of a cyclical problem, which is further compounding the structural issues, provides an additional argument for increasing the fund size as evidence indicates that there are fewer private sector market players able or willing to finance early stage SMEs through to growth and expansion stages where they can access market finance. Therefore, the UK authorities assert that in order to make the resources available to build the momentum, an increase of the size of Government participation to £50m (€58m) per ECF fund would be needed.

(60) The Commission notes that neither the Decision of 2005, nor the RCGs of 2006 set an upper limit for the Government participation into a scheme.

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19 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32263/12-539-sme-access-external-finance.pdf.

(61) The Commission notes therefore that, given the design of the scheme (see point 4.4.6), the increase of the Government participation into ECFs is rather of a technical nature and raises no objections to this amendment as it has no significant impact on competition.

4.4.5. Allowing follow-on anti-dilution investments and increase ECF investment limit into a company from 10% to 15% of ECF's capital[20]

(62) The UK authorities claim that allowing follow-on anti-dilution investments reflects normal commercial practice as such a mechanism would allow any ECF to maintain its shareholding position. The UK authorities intend to modify the upper limit of successive follow-on anti-dilution investments, which would increase from 10% to 15% of each ECF's total capital, as the latter figure would be better aligned with market practices.

(63) This amendment is connected with the amendment presented in point 4.4.3, as the modified scheme will allow ECF to invest through follow-on investments up to the overall cap of €15m.

(64) The Decision of 2005 allowed ECFs to make follow-on investments under the following conditions[21]:

a) Follow-on investments were permitted as long as the total equity funding raised by the beneficiary SME from ECFs and other equity investors did no exceed the £2m (€2.9m) limit.

b) Follow-on investments in excess of the £2m limit were permitted in exceptional cases, after a period of 6 months from the ECF's initial investment in a beneficiary SME, and where necessary to prevent dilution, subject to an upper limit of 10% of each ECF's committed capital.

(65) In addition, the decision of 2005 established that in order to operate this mechanism any ECF could not invest on less advantageous terms than other commercial investors[22].

(66) Firstly, the Commission notes that anti-dilution investments are justified to maintain the shareholding position into the target investee, and that they will be made under market conditions so as to limit to the minimum the aid provided to the private investors investing within the scope of the measure.

(67) Secondly, the Commission understands that the scheme will allow the ECFs to increase the amount invested for anti-dilution purposes as described under paragraph (64) b) from 10% to 15% of each ECF's committed capital. In this connection the Commission notes that the increase of the public participation in each ECF, up to £50m (€58m), and the proposed ratios of public and private participation in each fund will lead to most of the funds reaching a size of less than €100m. Therefore, in this case the overall cap of €15m would not be exceeded. However, should any ECF reach a size larger than €100m, the

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[20] Follow-on investment is a form of investment whereby an investment fund looks proactively to inject more capital into an investee in exchange for new shares. Follow-on anti-dilution investment is a reactive form of investment whereby ECFs provide more equity into that company, along with a new (existing or new) investor, in order maintain its shareholding position.

[21] See recitals 27 and 28 of the Decision of 2005.

[22] See recital 26 of the Decision of 2005.

follow-on anti-dilution mechanism will allow the ECF to invest beyond the limit of €15m.

(68) However, the Commission takes note of the commitment given by the UK authorities to ensure that whenever follow-on anti-dilution investments would exceed the cap of €15m, any amount invested by any ECF in excess of this threshold would be made on a pari-passu basis so as to exclude any aid to private investors participating within the ECFs. An appropriate accountancy system will be set up in order to ensure the effective implementation of this commitment.

(69) For the reasons mentioned above, the Commission concludes that the follow-on anti-dilution mechanism can entail aid only up to the limit of 15% of the ECFs' committed capital and within the overall investment cap which corresponds to the proven market gap. Therefore, the Commission does not raise objections with respect to this amendment.

4.4.6. Allowing for private participation ratios into each ECFs below the minimum limits set in the RCGs and tailored on the basis of the development stage of the investees

(70) The UK authorities envisage modulating the public / private participation ratios into each ECF on the basis of the fund investment profile, reflecting the type of investees and their development stage. The funds targeting SMEs prior to their first commercial sale will be allowed a maximum public participation into each fund of 66.7%, *i.e.* a ratio of 2 (public) : 1 (private). For funds targeting SMEs up to 7 years following their first commercial sale, or SMEs that intend to launch a new product or to enter a new market, given the less severe market failure the latter would face the public participation will be limited to 60%, *i.e.* a ratio of 1.5 (public) : 1 (private). The rationale for such differentiation would be that early stage SMEs face a more severe market failure compared to later development stage SMEs.

(71) Based on the Risk Capital Guidelines of 2001, the Commission authorized in 2005 a maximum participation of public capital twice the level of private capital per ECF, *i.e.* 66.7% public participation on the fund capital. The decision did not make any distinction between the types of funds based on their target SMEs.

(72) The RCGs of 2006 set the minimum private participation at 50%, or 30% for funds investing in SMEs located in assisted areas. However, point 5.1. d) of the RCGs of 2006 states the conditions under which the Commission may authorise measures providing for a participation by private investors below 50 % in non-assisted areas or below 30 % in assisted areas: *"In the Community the level of development of the private risk capital market varies to a significant extent in the various Member States. In some cases, it might be difficult to find private investors, and therefore the Commission is prepared to consider declaring measures with a private participation below the thresholds set out in section 4.3.4 compatible with the common market, if Member States submit the necessary evidence."*

(73) The Commission understands that the UK authorities intend to differentiate between ECFs with respect to their capital structure not on the basis of the location of the investees, *i.e.* located in assisted or non-assisted areas, within the meaning of the RCGs of 2006, but on the basis of development stage of the funds' target investees as stated above.

(74) Although the current scheme seems to rely on private capital leverage ratios below those set by the RCGs, the UK authorities argue that such lower private participation ratios would be justified due to the very limited use of preferential conditions for private investors and by the policy objective of designing the measure as close as possible to market conditions.

(75) To justify their claim with respect to the higher public participation compared to the thresholds set by the RCGs of 2006, the UK authorities highlight the lack of any downside protection to private investors and their first loss position, which is to be balanced by significant returns out of the performed investments. Therefore, since the funds are managed by professional and independent private sector managers and they do not provide any downside protection to private investors, the aid at the level of the investors would be kept to a minimum. They also highlight that the fact that private investors retain a first loss piece in the financial instrument induces the ECFs' managers to target only high-growth SMEs.

(76) The Commission notes that the increase in size of the market failure as demonstrated above at points 4.3.2 and 4.3.3 shows that the UK SMEs have difficulties in raising funding from institutional lenders, especially in their early stages. For instance, by the mid of 2013, 73% of all ECFs investments had been made into investees that were early stage SMEs at the point of investment, while the majority of firms supported had fewer than 5 years of commercial activity.

(77) The Commission notes therefore that the ECFs scheme is predominantly targeted at early stage SMEs. Based on the evidence provided by the UK authorities, the Commission understands that the rationale for investments in SMEs with longer commercial activity is to support the company at the moment of the entering into a new product or geographical area, or at the moment of the development of additional Intellectual Property.

(78) The fundamentals of the ECFs scheme in the UK show the important role that the Government plays in funding early stage SMEs, which seem to first and foremost face the equity gap. The difficulties of those SMEs in finding financing seem to have been worsened by the footprint left by the financial crisis of 2008, which has depressed to a significant extent the market for early stage SMEs and from a more general perspective the resources to the venture capital industry.

(79) The Commission appreciates that the design of the ECFs scheme, namely the fact that the asymmetry between the public-private investors is limited to profit sharing, is meant to overcome the private investors' reluctancy to invest in SMEs affected by the equity gap, while reducing the advantages for private investors to the minimum. In fact, the lack of downside protection of private investors, which are fully exposed to the first loss, and the business model of the scheme, which works on the assumption of a default rate of 30%[23], both lead the funds to be commercially oriented while investing in SMEs which would not be likely to receive any investment absent the measure. In such conditions, the Commission shares the UK authorities' view that the envisaged ratio of private capital participation reflects a reasonable balance between the risk and rewards that private investors may expect.

[23] Source: UK application Part II.11 – Supplementary Information sheet on risk capital aid

(80) A more effective investment from ECFs in SMEs in their early stages allows for a better and more appropriate funding in later stages from public and private investors, allowing therefore the ECFs scheme to structurally address the market failure in the UK through an approach that reflects the different degrees of market failure affecting the target investees according to their stage of development. Hence, the Commission considers that the higher public participation in the ECFs compared to the rules set in the RCGs of 2006 takes into consideration on the one hand the specificities of the UK capital market described above and on the other hand the ability of the ECFs to successfully follow-on their initial investments.

(81) Therefore the Commission does not raise objections with respect to this amendment. In reaching this conclusion, the Commission also takes account of the fact that the future Risk Finance Guidelines will no longer make any distinction between investees located in assisted or non-assisted areas, but will assess the private participation required for a specific measure on the basis of the development stage of the investees. In this respect, the Commission also notes that the notified measure is in line with the private participation ratios which are envisaged under the new rules on risk finance aid. The funds targeting SMEs prior to their first commercial sale will have a private participation of 33.3% while the funds targeting SMEs having been on the relevant market for less than 7 years after their first commercial sale will achieve a private participation of 40%, both values being superior to the levels of private participation envisaged in the future risk finance state aid rules.

4.4.7. Allowing secondary purchase in specific and limited circumstances

(82) The UK authorities wish to modify the current scheme in order to allow the ECFs to invest through capital replacement operations when fresh equity is issued, subject to the amount invested through the capital replacement operation being less than 50% of the total amount invested by the ECF. The UK authorities claim that replacement capital operations are current market practice, and allowing the ECF to undertake such operations not only would align the ECFs to market practice, but will also provide them with a supplementary and effective tool in addressing the equity gap.

(83) Moreover the UK authorities claim that there is a market failure with respect to funding capital replacement transactions within the £5m annual investment cap. Therefore as long as they remain below this cap, such transactions are supposed not to interfere with the private market.

(84) The evidence the UK authorities provided[24] suggests indeed that below the above cap, such operations would not be the type of MBOs (management buy-out) that the market would usually fund. The average size of MBO deals in 2012 was £27.6m (€32.5m) and therefore allowing capital replacement transactions within the cap of £5m (€5.9m) would not have a significant impact on competition as it would not crowd out private investors.

(85) It should also be underlined that the UK authorities seek the approval of investments through capital replacement operations, provided that such operations do not represent more than 50% of a total investment round. Such transactions would represent therefore only a tool that will be used by ECFs to acquire a shareholding position within an

[24] BVCA Report on Investment Activity 2012 (BVCA – British Private Equity and Venture Capital Association) http://admin.bvca.co.uk/library/documents/RIA_2012.pdf.

investee, as long as the fund will also invest fresh capital, the whole ensuring therefore that the investment will fund genuine growth.

(86) In addition the UK authorities also request the approval of small replacement capital operations in very specific situations, namely replacing a manager or a minority shareholder, *i.e.* a former employer. Such operation would allow the company to move forward and grow with a fully committed management and is to be capped at £100,000 per transaction and per company.

(87) Section 2.2 of the RCGs of 2006 explicitly exclude "pure" capital replacement operations and buy-outs from the type of venture capital operations which are defined as fulfilling the compatibility criteria for risk capital aid.

(88) The Commission notes that since their first regulation in 2001, the risk capital measures provided through publicly-backed funds have aimed at funding genuine growth of the target investees. The growth was to be financed by the capital committed into private-public funds which was subsequently invested in SMEs with a clear business plan for development such as the launch of a new product, the extension of the operations in a different territory, the strengthening of the work-force etc.

(89) The Commission understands that the combination in a single transaction of a capital replacement operation and an investment with fresh equity could be supportive of the fund's investment strategy in relation to the target investee, as it allows it to realise the control over the investee from early funding stages on while financing further growth. Therefore, a strategy that would combine the two elements facilitates the follow-up of the fund's investment and allows the fund to better target the market failure.

(90) Consequently, in the present case, the mechanism set up by the UK authorities does not confine itself to extending the scope of the ECFs operations to "pure" buy-out transactions, but either aims at stimulating new investments enhancing the investee's growth perspective by supporting only those operations where the exit for existing shareholders is strictly combined with additional capital, which the later were unwilling or unable to provide or foresees such transactions in specific situations which aim to replace under-performing managers in order to foster the investee's growth. This type of operations is not expressly excluded by the RCGs of 2006 which only prohibit "pure" buy-out transactions, which, due to the absence of an element of additionality, are unlikely to target a genuine market failure and to have an incentive effect.

(91) The Commission also notes that the envisaged modification of the scheme (see above paragraph (82)) would likely be block-exempted pursuant to the provisions on risk finance aid of the new draft General Block Exemption Regulation.

(92) As for the replacement capital operations referred to at paragraph (86), these would likely also be compatible under the new risk finance rules given their specific objective, the fact that such transactions will only concern a limited number of cases and would likely not have a significant impact on the aid to the investors as the transaction volume would be capped at £100,000. The rationale for such transactions is intrinsically linked to the need to operate a change in the management of the investees, notably in case of under-performance of the latter. Therefore, far from constituting a typical buy-out operation, the mechanism at issue aims only at ensuring an effective and efficient management of the SMEs concerned so as to protect the financial interests and the ex-ante-incentives of

private investors participating in the implementation of the measure. It should also be recalled in this connection that, by virtue of its specific design, the notified measure provides only for a limited advantage to such investors, in the form of certain up-side advantages. Hence, on balance, the Commission considers that the efficiency-enhancing effects of this mechanism offset any possible distortive effect resulting from any aid possibly involved in its implementation.

(93) For the reasons mentioned above, the Commission concludes that the capital replacement transactions as foresee for the modified ECFs scheme are not expressly excluded by the current Guidelines and that, by improving ECFs' governance over the investees, such operations are likely to foster the investee's growth with a limited impact on competition.

(94) Therefore the Commission does not to raise objections with respect to the use of capital replacement operations by the ECFs under the conditions mentioned above.

4.4.8. Extension of the scheme and budget

(95) The Commission notes that the UK authorities wish to extend the scheme for 10 years sd from the Commission's approval,. The estimated budget is £300m and will supersede the existing budget of £200m that covers the period from April 2011 to March 2015.

(96) As regards the extension of the scheme by additional 10 years and the increase of the budget, the Commission considers it to be of a technical nature, and thus does not raise objections.

5. CONCLUSION

(97) The Commission concludes that the notified amendments to the existing Enterprise Capital Funds scheme fulfil the conditions set out in the RCGs of 2006 and that the positive effects of the measure outweigh its negative effects on competition in the internal market. The Commission therefore finds the measure to be compatible with the internal market pursuant to Article 107(3)(c) TFEU.

6. DECISION

(98) The Commission considers the notified State aid measure SA.36489 (2013/N) to be compatible with the internal market, pursuant to Article 107(3)(c) TFEU. Accordingly, it decides not to raise objections to the aid measure.

(99) The Commission reminds the UK authorities that, in accordance with Article 108(3) TFEU, all plans to change this aid measure must be notified to the Commission.

(100) The Commission reminds the UK Government to provide an annual report on the implementation of the measure.

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/competition/elojade/isef/index.cfm.

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

European Commission
Directorate-General for Competition
State Aid Greffe
1049 Brussels
Belgium

Fax No: +32-2-29 61242

Yours faithfully,

For the Commission

Joaquín ALMUNIA
Vice-President