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In the published version of this decision, some information has been omitted, pursuant to articles 24 and 25 of Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, concerning non-disclosure of information covered by professional secrecy. The omissions are shown thus […].		PUBLIC VERSION This document is made available for information purposes only.

Subject: State aid SA.15373 (2013/C-18) (ex 2013/NN) - United Kingdom
Monitoring of the existing aid scheme "Enterprise Capital Funds" (C17/2004)

Sir,

The Commission wishes to inform the United Kingdom that, having examined the information supplied by your authorities on the measure referred to above, it has decided to initiate the procedure laid down in Article 108(2) of the Treaty on the Functioning of the European Union (hereafter "TFEU").

1. PROCEDURE

(1) The Enterprise Capital Funds ("ECFs") scheme (SA.15373) was approved by the Commission on 3 May 2005 under Article 87(3)(c) of the EC Treaty (now Article 107(3)(c) TFEU) and in particular on the basis of the Risk Capital Guidelines of 2001 ("RCGs of 2001")[1], in force at the time, after opening a formal investigation procedure (C 17/2004 (ex N 566/03)).

(2) In September 2006, following a meeting with the UK authorities, the services of the Commission informed the UK authorities that the ECFs scheme was not in line with the Risk Capital Guidelines adopted in August 2006 (hereafter "RCGs of 2006") and invited them to take appropriate measures to bring the ECFs scheme in line with them.

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

(3) By letter of 18 October 2006, the UK authorities committed to take appropriate measures concerning all their existing risk capital schemes.

(4) In 2011, the ECFs scheme was selected for the State aid monitoring exercise (SA.15373 (ex 2011/MX)). It was found that the UK had failed to take appropriate measures to bring the ECFs scheme in line with the RCGs of 2006.

(5) A meeting took place on 21 May 2013 between the Commission services and the UK authorities where the former proposed that the monitoring case and several changes to the scheme, which were subsequently notified on 21 August 2013 (SA.36428) by the UK authorities, be treated separately in two cases but parallel in time.

(6) By e-mail of 16 June 2013, the Commission services received information on the implementation of the existing scheme. The information was updated by e-mail of 12 July 2013.

(7) Two teleconferences took place on 1 and 2 July 2013 to discuss several elements of the case, and a meeting took place on 6 August 2013 where the UK authorities clarified several aspects of the operations that took place under the existing scheme.

2. DESCRIPTION OF THE EXISTING ECFS SCHEME (DECISION OF 2005)

(8) Combining public and private investment, the ECFs scheme aimed at improving access to expansion capital for SMEs throughout the UK. Public investment was limited to two times the private capital raised by the fund, *i.e.* minimum one third of an ECF fund was to be provided by private investors.

(9) 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 on equal terms with the private investors being fully exposed, while 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.[2] This mechanism ensured that ECFs were commercially oriented while entailing state aid.

(10) According to the rules of the scheme[3], an ECF may invest expansion capital in any company:

- that meets the EU definition of an SME;

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2 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%). 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 ECFs' partnership agreement. All further distributions to investors are to be divided between the government and all other private investors in a fixed profit-sharing ratio.

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

- 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;

- 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[4].

(11) ECF funds invested in eligible SMEs by means of equity and quasi-equity instruments between £250,000 (€357,000) and £2m (€2.9m). Pure debt investments were explicitly forbidden under the scheme[5].

(12) Follow-on investments were permitted so 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.

(13) Follow-on investments in excess of the above limit, *i.e.* £2m (€2.9m), were permitted, where necessary, only after a period of at least 6 months and to prevent dilution, subject to an upper limit of 10% of each ECF's committed capital.

(14) From the evidence provided by the UK authorities, the Commission understands that three ECFs, made follow-on anti-dilution investments in 7 companies. The Commission understands that the scheme allowed the ECFs to use a "pre-emption mechanism" whereby the ECFs could exercise a right of first refusal to acquire new shares issued by any investee in the ECF's portfolio, in order to prevent private investors from investing in such companies and thereby dilute the ECF's shareholding. However, the UK authorities have indicated that such a mechanism has never been applied in practice and that they committed not to make use of it in the future.

(15) The ECFs scheme was initially approved for a period of 10 years, until 2 May 2015, and was intended to be self-financing over 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.

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4 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

5 ECF's Partnership agreement, Point 3.6: "[ECF] may not acquire Investments in a Portfolio Company..... (d) in loan finance or debt instruments with no associated equity securities."

(16) 12 funds were created under the ECFs scheme, out of which 7 were created after 18 August 2007 that is, the date after which the scheme should have been aligned with the RGCs of 2006. The pre-2007 funds invested in 67 companies, while the post 2007 funds invested in 94 companies. Therefore, a total of 161 undertakings have benefited from the scheme.

3. OUTCOME OF THE MONITORING

(17) The ECFs scheme was monitored by the Commission services in the light of (1) the Commission's decision of 2005 approving the measure and (2) the RCGs of 2006.

(18) The assessment led to the conclusion that the scheme was not in line with the RCGs of 2006 as the UK authorities should have taken appropriate measures within 12 months from their entry into force, *i.e.* as from 18 August 2007, which they failed to do. The issue of appropriate measures arose with respect to ECFs that received public capital after 18 August 2007 *i.e.* after the date by which the UK authorities should have adopted appropriate measures, at the latest, following the entry into force of the RCGs of 2006 on 18 August 2006. In practice, this meant that only the funds created after the end of the transitional period would need to comply with the RCGs of 2006, whilst the already existing risk capital funds could continue to operate under the rules established by the RSGs of 2001.

(19) For the reasons explained in section 4 below, the Commission has doubts with respect to the compliance of the ECFs scheme's implementation with the RCGs of 2006, and particularly with respect to:

a) Eligibility for investment of several investees;

b) Use of capital replacement operations.

4. ASSESSMENT

4.1. Existence of State aid

(20) In the decision of 2005 the Commission concluded that State aid within the meaning of Article 107(1) of the TFEU is present at the level of the investors and at the level of the beneficiary SMEs. Therefore, through the implementation of the ECF scheme, the companies that are the object of the current monitoring case have received State aid in the sense of the above mentioned article. The UK authorities do not contest this conclusion.

4.2. Eligibility for investment of several investees

(21) Since the creation of the scheme, the ECFs invested in 161 companies, of which 94 were investments made after 18 August 2007. Out of the 94 companies, 40 companies had not had sales at the time of the first investment. Of the remaining 54 companies, 6 appear to have been in their expansion stage since, at the moment of ECF's first investment, they had had commercial activities for a significant number of years.

(22) The RCGs of 2006 (Point 4.3.2) limit the investment of risk capital to: (1) small enterprises up to the expansion stage and irrespective of their location, *i.e.* located in assisted or non-assisted areas (2) medium-size enterprises up to the start-up stage, irrespective of their location, and (3) medium-sized enterprises up to the expansion stage located in assisted areas.

(23) The Commission notes that four out of the six above mentioned companies fulfil the definition of small enterprises at the moment of the investment. Therefore, although they seem to have been companies in their expansion stage, given their size, the investments were made in accordance with the limits set out in the RCGs of 2006.

(24) The two other companies, Interactive Investors and Reevoo[6] exceeded, at the moment of the first investment, the threshold for a small enterprise[7]. Therefore, at the moment of the investment, the two companies qualified as medium enterprises. Moreover, given their location in London, which is a non-assisted area, they could have received investment only up to the start-up phase[8].

(25) Consequently, the Commission expresses doubts with respect to the compatibility of the aid for the investments into the two companies as they qualified as medium size enterprises, were in their expansion stage and were located in non-assisted areas.

(26) The Commission may declare compatible measures providing finance for medium-sized enterprises in their expansion stage located in non-assisted areas, subject to a detailed assessment (balancing) of the individual case under Chapter 5 of the RCGs of 2006, including any evidence of market failure. At this stage of the investigation, the compatibility of the aid for these two investments with the RCGs of 2006 seems doubtful as there is limited evidence with respect to the market failure they faced. Third parties are invited to submit comments notably on the existence of a market failure with respect to such late-stage development companies as well as any other information relevant for making an in-depth assessment of the aid measure at issue under Section 5 of the RCG 2006.

4.3. Use of a capital replacement transaction

(27) Based on the evidence provided by the UK authorities, the Commission understands that the fund [....][*] invested in one buy-in management buy-out[9] (BIMBO). The target

[6] At the moment of the first investment Reevoo had 9 years of commercial activity; it employed [....][*] persons and had an annual turnover of [....][*]. Interactive Investors had 11 years of commercial activity; it employed [....][*] persons and had an annual turnover of [....][*];Source: UK authorities

[*] Covered by the obligation of professional secrecy;

[7] See Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (OJ L 124 of 20.5.2003, p. 36), Annex I, Article 2(2) (50 employees).

[8] The Commission also notes that Reevoo had been backed by well-known venture capital firms, *i.e.* [....][*] and [....][*] (Source: UK authorities) which puts in question whether the company faced any market failure.

[9] Management buy-out is a form of replacement capital through which one or more managers of a company take control of the company's capital by acquiring the majority of shares from the actual owner(s). When the buyer is an outsider of the company who will become manager once the operation

company, Andante Travels, had 28 years of commercial activities at the moment of the investment. At the moment of the investment, the company employed [....][*] persons and had an annual turnover of [....][*].

(28) Under the RCGs of 2006 the venture capital and risk capital measures refer to new/fresh capital being provided to the investees. Since they have limited impact on the cash/balance sheet of an investee, capital replacement operations are not foreseen as compatible measures under the Guidelines. Hence, in its practice the Commission considers them as not covered by the Guidelines[10], irrespective of the location of the investee, *i.e.* assisted or not-assisted area. In order to further assess the conditions in which the operation took place and to test its impact on competition, the Commission has decided to open the formal investigation procedure with respect to the above BIMBO operation and invites third parties to present comments on it.

5. CONCLUSION

(29) Based on the foregoing analysis, the Commission considers that the ECFs may have granted aid outside of the scope of the approved scheme without prior notification. Therefore it has decided to open the formal investigation procedure provided for in Article 108(2) TFEU in relation to funding decisions by the ECFs as to the following elements:

a) Eligibility for investment into Reevoo and Interactive Investor;

b) Use of one capital replacement transaction, namely the above BIMBO that benefited Andante Travels.

(30) The Commission requires the United Kingdom and all interested parties, within one month from the receipt of this letter, to provide all documents, information and data needed for assessing the compatibility of the above-mentioned measures with Article 107(3)(c) TFEU..

(31) The Commission wishes to remind the authorities of the United Kingdom that Article 108(3) TFEU has suspensory effect, and would draw their attention to Article 14 of Council Regulation (EC) No 659/1999, which provides that all unlawful aid may be recovered from the recipient.

(32) The Commission informs the authorities of the United Kingdom that it will inform interested parties by publishing this letter and a meaningful summary of it in the *Official Journal of the European Union*. It will also inform interested parties in the EFTA

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is completed, the transaction is called management buy-in. A BIMBO occurs when existing management, along with outside managers, decide to buyout a company. Buy-in management buyout (BIMBO) is a form of a buyout that incorporates characteristics of both a management buy-out and a management buy-in.

10 See, e.g., Case SA.36489 (2013/N), recital (41)

countries which are signatories to the EEA Agreement, by publication of a notice in the EEA Supplement to the *Official Journal of the European Union* and will inform the EFTA Surveillance Authority by sending a copy of this letter. All such interested parties will be invited to submit their comments within one month of the date of such publication.

If this letter contains confidential information which should not be published, 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 publication of the full text of this letter. Your request specifying the relevant information should be sent by registered letter or fax to:

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State Aid Greffe
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Fax No: +32-2-296.12.42

Yours faithfully,
For the Commission

Joachim ALMUNIA
Vice-President