COMMISSION DECISION

of 3 May 2005

on the aid scheme 'Enterprise Capital Funds' which the United Kingdom is planning to implement

(notified under document number C(2005) 1144)

(Only the English version is authentic)

(Text with EEA relevance)

(2006/250/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular the first subparagraph of Article 88(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to those provisions [1] and having regard to their comments,

Whereas:

I. PROCEDURE

1. By letter dated 25 November 2003, registered at the Commission on 26 November 2003, the UK authorities notified, pursuant to Article 88(3) of the EC Treaty, the above-mentioned measure to the Commission.

2. By letter D/58191 dated 19 December 2003, the Commission requested further information concerning the notified measure.

3. By letter dated 30 January 2004, registered at the Commission on 3 February 2004, and by letter dated 19 March 2004, registered at the Commission on 25 March 2004, the UK authorities submitted the information requested.

4. By letter dated 7 May 2004, the Commission informed the United Kingdom of its decision to initiate the procedure laid down in Article 88(2) of the EC Treaty in respect of the measure.

5. The Commission's decision to initiate the procedure was published in the *Official Journal of the European Union* [2]. The Commission called on interested parties to submit their comments.

6. By letter dated 11 June 2004, registered at the Commission on 16 June 2004, the United Kingdom submitted a response to the Commission's decision to initiate the procedure.

7. The Commission received observations from 20 interested parties:

(a) by letter dated 20 September 2004, registered at the Commission on 23 September 2004;

(b) by letter dated 9 September 2004, registered at the Commission on 28 September 2004;

(c) by letter dated 22 September 2004, registered at the Commission on 29 September 2004;

(d) by letter dated 1 October 2004, registered at the Commission on 4 October 2004;

(e) by letter dated 6 October 2004, registered at the Commission on the same day;

(f) by letter dated 6 October 2004, registered at the Commission on the same day;

(g) by letter dated 7 October 2004, registered at the Commission on the same day;

(h) by letter dated 6 October 2004, registered at the Commission on 7 October 2004;

(i) by letter dated 7 October 2004, registered at the Commission on the same day;

(j) by letter dated 8 October 2004, registered at the Commission on the same day;

(k) by letter dated 8 October 2004, registered at the Commission on the same day;

(l) by letter dated 8 October 2004, registered at the Commission on the same day;

(m) by letter dated 8 October 2004, registered at the Commission on the same day;

[1] OJ C 225, 9.9.2004, p. 2.
[2] See footnote 1.

(n) by letter dated 8 October 2004, registered at the Commission on the same day;

(o) by letter dated 8 October 2004, registered at the Commission on 11 October 2004;

(p) by letter dated 6 October 2004, registered at the Commission on 11 October 2004;

(q) by letter dated 8 October 2004, registered at the Commission on 11 October 2004;

(r) by letter dated 8 October 2004, registered at the Commission on 11 October 2004;

(s) by letter dated 7 October 2004, registered at the Commission on 11 October 2004;

(t) by letter dated 8 October 2004, registered at the Commission on 12 October 2004.

8. By letter D/57629 dated 25 October 2004, the Commission forwarded these observations to the United Kingdom in order to give the United Kingdom the opportunity to react.

9. The opinion from the United Kingdom in response to the comments of third parties was received by letter dated 23 November 2004, registered at the Commission on 24 November 2004.

II. DETAILED DESCRIPTION OF THE MEASURE

II.1. Objective of the measure

10. The measure intends to increase the amount of equity funding for small and medium-sized enterprises (SMEs) in the United Kingdom seeking to raise equity financing between GBP 250 000 (EUR 357 000) and GBP 2 million (EUR 2,9 million).

11. The measure will provide leverage for licensed Enterprise Capital Funds (ECFs). The leverage, interest on the leverage and a profit share will be repaid by each ECF.

12. ECFs will be required to invest capital in SMEs by means of equity or quasi-equity instruments.

II.2. Description of the measure

Legal basis of the measure

13. The legal basis of the scheme is Section 8 of the 'Industrial Development Assistance Act 1982'.

Budget of the measure

14. As the leverage provided to the Enterprise Capital Funds will have to be repaid, the measure is designed to be self-financing over the medium term.

15. In terms of accounting for the scheme in its pathfinder phase, the United Kingdom has allocated GBP 44 million (EUR 63,8 million) to cover the cash-flow cost of the initial leverage.

Duration of the measure

16. The United Kingdom seeks approval for a period of 10 years.

Administration of the measure

17. The Department of Trade and Industry (DTI) will have statutory responsibility through its executive agency Small Business Service (SBS).

18. The Small Business Service (SBS) will supervise the application for ECF status.

19. The SBS will monitor ongoing investments undertaken by ECFs without having any direct control over ECFs' individual investment decisions.

20. The SBS will also ensure that each ECF complies with its business plan and adheres to the terms of its successful bid.

Beneficiaries of the measure

21. The scheme is exclusively aimed at unquoted small and medium-sized enterprises [3] in the United Kingdom.

22. Firms in difficulty as defined by the Community guidelines on State aid for rescuing and restructuring firms in difficulty [4] are excluded from investment.

[3] The definition of 'small and medium-sized enterprises' as used by the UK authorities for the purposes of the scheme corresponds fully to the definition of that term given in Annex I to Commission Regulation (EC) No 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises (OJ L 10, 13.1.2001, p. 33).

[4] OJ C 244, 1.10.2004, p. 2.

23. Enterprise Capital Funds ('ECFs') will not invest in sensitive sectors under State aid restrictions or in sectors to which the Commission Communication on State Aid and Risk Capital [5] does not apply. Low-risk sectors including property, land, finance and investment companies, or finance-type leasing companies will not be eligible for investment under the scheme.

24. Enterprise Capital Funds will also be prevented from investing in other ECFs

Size of investments

25. Enterprise Capital Funds will make investments in beneficiary SMEs in the GBP 250 000 (EUR 357 000) to GBP 2 million (EUR 2,9 million) range per single investment round.

26. Additional investments in beneficiary SMEs beyond the GBP 2 million (EUR 2,9 million) limit will not be permitted in cases where the ECF is investing on less advantageous terms than other commercial investors.

27. Follow-on investments will be permitted so long as the total equity funding raised by the beneficiary SME from ECFs and other equity investors does not exceed the GBP 2 million (EUR 2,9 million) limit.

28. In exceptional cases, after a period of at least 6 months from the ECF's initial investment in a beneficiary SME, follow-on investments in excess of the GBP 2 million (EUR 2,9 million) limit will also be permitted, where necessary, to prevent dilution. This will be subject to an upper limit of 10 percent of each ECF's committed capital that may be invested in any single beneficiary SME.

II.3. **Mechanics of the measure**

The role of the Enterprise Capital Funds

29. The Enterprise Capital Funds set up under the measure will combine private and public money for on-investment into SMEs.

30. Following a licensing process conferring ECF status, ECFs will be entitled to receive public leverage at an interest rate at or close to the ten-year government bond rate.

Restrictions on public leverage and repayment obligations

31. Public leverage to licensed Enterprise Capital Funds will be limited to no more than twice the private capital raised by the fund.

32. The leverage, interest on the leverage and a profit-share for the public contribution must be repaid by the Enterprise Capital Funds. This will ensure that the programme will be self-financing over the medium term.

Minimising public intervention

33. The exact amounts of public leverage, profit share and repayment priorities will be determined by a competitive bidding process in order to ensure minimal public support.

34. Open invitations for application through publication of the scheme in the *Official Journal of the European Union* and the relevant trade press will ensure that public support is the minimum necessary to achieve the intended objective.

35. In applying for ECF status potential funds will need to specify the required amount of public leverage (up to the upper limit of two times private capital), the profit share between public and private investors, as well as the prioritisation of repayments on:

(a) interest on the leverage;

(b) leverage;

(c) private capital;

(d) profit distribution.

Conditions for ECF eligibility

36. Potential ECF operators will submit a robust business plan including:

(a) the proposed management team, their relevant experience and evidence that they possess the competencies necessary to run an ECF effectively;

(b) the amount of private capital to be raised and the intended sources of capital;

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

(c) evidence of investor interest for the proposed ECF business plan;

(d) the proposed ECF's investment strategy, including the proportion of the fund which is intended to be invested in early stage and start up companies;

(e) repayment arrangements, including the sequencing of repayments of leverage, interest repayments on the leverage, profit distribution, as well as the public's profit share.

37. ECFs will be required to abide by British Venture Capital Association (BVCA) guidelines on accounting standards.

Assuring profit-driven investment decisions

38. Bids in which the public leverage is exposed to greater risk than the private capital will not be accepted.

39. Private investors in Enterprise Capital Funds may be exposed to greater downside risk than the public, thereby removing the scope for moral hazard to influence decisions of ECF operators and ensuring commercial best practice in the operation and decision making of the ECFs.

Drawing down of pubic leverage by the ECFs

40. Once an ECF has secured commitments for the agreed level of private capital, it will be entitled to draw down public leverage.

41. Each ECF will be free to draw down as little or as much leverage as it wishes, subject to the overall constraint imposed by the maximum leverage ratio agreed when ECF approval is granted.

42. At any point in time, the maximum leverage entitlement will be determined by applying this ratio to the amount of private capital already drawn down into the fund.

43. A maximum leverage ratio of 2:1 (public leverage will be capped at up to two times the private capital) will be applied for any ECF.

III. GROUNDS FOR INITIATING THE PROCEDURE

44. The Commission Communication on State Aid and Risk Capital [6] (hereinafter referred to as 'the Communication') recognises a role for public funding of risk capital measures limited to addressing identifiable market failures.

45. The Communication states 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.

46. The Communication further specifies that there is no general risk capital market failure in the Community, but rather market gaps for some types of investments at certain stages of enterprises' lives as well as particular difficulties in regions qualifying for assistance under Articles 87(3)(a) and (c) of the EC Treaty ('assisted areas').

47. The Communication goes on to explain that in general, the Commission will require provision of evidence of market failure before being prepared to authorise risk capital measures.

48. The Commission may however be prepared to accept the existence of market failure without further provision of evidence in cases where each tranche of finance for an enterprise from risk capital measures which are wholly or partially financed through state aid will contain a maximum of EUR 500 000 in non-assisted areas, EUR 750 000 in Article 87(3)(c) areas, or EUR 1 million in Article 87(3)(a) areas.

49. It follows that for those cases where the above-mentioned tranches are exceeded, the Commission will demand a demonstration of market failure justifying the proposed risk capital measure before assessing the compatibility of the measure in accordance with the positive and negative criteria listed under point VIII.3 of the Communication.

50. The Enterprise Capital Funds scheme proposed by the United Kingdom foresees risk capital investments in the range of GBP 250 000 (EUR 357 000) to GBP 2 million (EUR 2,9 million) per investment tranche for SMEs in the United Kingdom.

[6] OJ C 235, 21.08.2001, p. 3 ff.

51. According to the 'Regional Aid Map 2000 – 2006' for the United Kingdom, the United Kingdom consists of regions currently classified as assisted areas pursuant to Article 87(3)(a) of the EC Treaty, as assisted areas pursuant to Article 87(3)(c) thereof, as well as of non-assisted areas ([7]).

52. In line with point VI.5 of the Communication, the Commission would thus be prepared to accept the existence of market failure without further provision of evidence if risk capital funding for SMEs in the United Kingdom wholly or partially financed through state aid would be limited to the maximum amount of EUR 1 million for assisted areas pursuant to Article 87(3)(a) EC, EUR 750 000 for assisted areas pursuant to Article 87(3)(c) EC, and EUR 500 000 for non-assisted areas, respectively.

53. According to the Communication, risk capital investments proposed under the Enterprise Capital Funds scheme exceeding the above-mentioned thresholds would necessitate the provision of evidence of market failure by the United Kingdom.

54. In order to demonstrate the existence of market failure, the United Kingdom submitted two studies ([8]), concluding that there is a gap in the provision of venture capital for SMEs in the United Kingdom in the deal size range of GBP 250 000 (EUR 357 000) to GBP 2 million (EUR 2,9 million) for the following reasons:

(a) A failure in the provision of equity-type growth finance in the United Kingdom that has persisted at least since 1999 as evidenced from the most recent 2003 UK survey:

i. Although access to finance, particularly debt finance, has improved for the majority of businesses in the UK, small businesses with the potential for high growth still have problems in attracting equity capital. They can fall between the scope of individual business angels to provide sufficient financial backing and the desire of formal venture capitalists to incur the relatively higher costs of investing in SMEs

ii. A larger level of demand for equity type finance than is presently being met exclusively by professional investors. If the supply of equity finance would be increased, particularly in the equity gap region, awareness of equity could be raised overall and firms would be more willing to use external sources as a mechanism for financing growth

(b) Qualitative evidence that there are shortfalls in the funding for small entrepreneurial and high growth businesses. This equity gap has the greatest impact for firms wishing to attract initial investments between approximately GBP 250 000 and GBP 2 million (EUR 357 000 and EUR 2.9 million):

(i) Capital rationing does exist within the UK economy and particularly affects SMEs seeking small amounts of external finance for early stage, firm growth and development. The availability of external finance, and particularly sources of equity from professional investors, is particularly problematic below an investment size in the region of GBP 1,5 to GBP 2 million (EUR 2,17 million to EUR 2,9 million)

(ii) A majority of UK professional equity providers are not interested in investments which are smaller than GBP 3 million (EUR 4,35 million). While smaller tranches of money from informal investors/business angels and government/private schemes such as the regional venture capital funds are helping to address funding sources below GBP 500 000 (EUR 725 000), the UK does not yet have a system in operation that would allow the provision of 'tiered' or 'escalator' funding to attractive but capital constrained businesses

(iii) The evidence also points to a gap that has been growing over time, driven in part by the success of the private equity industry moving to larger size investments. The prognosis is that this gap is likely to grow in scale as fixed cost issues will encourage professional venture capital firms to increase the size of both their funds and their minimum acceptable deal sizes.

55. By letter dated 7 May 2004, the Commission informed the United Kingdom of its decision to initiate the procedure laid down in Article 88(2) of the EC Treaty in respect of the Enterprise Capital Funds scheme.

56. In its letter, the Commission stated that it had doubts whether the arguments presented by the United Kingdom in order to justify the existence of market failure could sufficiently justify the granting of risk capital investment tranches considerably exceeding the maximum amounts anticipated by the Communication.

([7]) State Aid N 265/2000 – United Kingdom: 'Regional Aid Map 2000 – 2006'. OJ C 272, 23.9.2000, at p. 43.

([8]) 'Assessing the Scale of the "Equity Gap" in the UK Economy', 2003; 'Assessing the Finance Gap', 2003.

57. The Commission went on to explain that it considered a more thorough analysis of the issue to be necessary. Such an analysis would need to include any observations made by interested parties. Only after consideration of third party comments could the Commission decide whether the measure proposed by the United Kingdom affects trading conditions to an extent contrary to the common interest.

IV. **COMMENTS FROM INTERESTED PARTIES**

58. In response to the publication in the *Official Journal of the European Union* of its decision to open the formal procedure, the Commission received observations by the following interested parties:

— Nelfunding

— England's Regional Development Agencies

— Confederation of British Industry

— Nederlandse Vereniging van Participatiemaatschappijen

— VNO-NCW

— Cavendish Asset Management

— The University of Warwick

— Stonesfield Capital Ltd.

— YFM Group

— Close Venture Management Ltd.

— Bundesministerium der Finanzen Deutschland

— Enterprise Corporate Finance Ltd.

— The Institute of Chartered Accountants in England & Wales

— Pénzügyminisztérium

— Interregnum

— Permanente Vertegenwoordiging van het Koninkrijk der Nederlanden

— 3i Group plc

— Northwest Development Agency

— One NorthEast

— Lietuvos Respublikos Ukio Ministerija

59. All comments received were positive and underlined the importance of the measure as well as the appropriateness of the proposed maximum investment amounts.

60. The arguments put forward by the above-mentioned interested parties can be classified and summarised as follows.

Comments from Member States

61. In its comments on the opening of the formal investigation procedure, Germany highlighted the following facts:

a. According to expert surveys conducted in Germany, there is a gap for the provision of venture capital and private equity financing for small and medium-sized enterprises in the range of up to EUR 5 million.

b. It is generally difficult to demonstrate market failure as stipulated by the Communication and there is a need for the Commission to elaborate clear criteria in order to support Member States in appraising market gaps in specific domains.

62. The Netherlands emphasised the following evidence in their comments on the opening of the formal investigation procedure:

a. The problem in the venture capital market occurs particularly at the bottom end of the capital market. For high tech start-ups, a gap between supply and demand in the range of EUR 100 000 to EUR 2,5 million per financing round has been noted for the Netherlands.

b. The thresholds set out in the Communication were based on market knowledge before 2001, when in the midst of the ICT boom private equity seemed abundant even for seed and early stage investments. The venture capital market has evolved rapidly since and the equity gap extends significantly beyond the thresholds laid down in the Communication. Venture capital funds drift towards ever larger deals and towards well established businesses.

63. In its comments on the opening of the formal investigation procedure, Hungary highlighted the following facts:

a. The ECF model proposed by the United Kingdom is a model deserving consideration for application in Hungary as well.

b. In 2003, a marked switch towards larger deal sizes could be observed in Hungary. Whereas deals below EUR 2,5 million accounted for 14% of total private investment in Hungary, deals above EUR 5 million made up for the remaining 86% of private investment. There were virtually no deals in the deal size range between EUR 2,5 and EUR 5 million.

c. An unduly strict interpretation of the already tight thresholds contained in the Communication could prevent public action in support of filling the above-mentioned important equity gap and could thereby block the growth potential of SMEs.

d. Instead of fixing maximum thresholds, the Commission should develop a control system that would enable it to survey the evolution of the markets depending upon the relative level of development of the Member States and their capital markets.

64. Lithuania accentuated the following experiences in its comments on the opening of the formal investigation procedure:

a. Private equity investment is more concentrated on large funds and investment into relatively established larger businesses, while levels of investment in smaller, young businesses are proportionally lower.

b. The ECF scheme might be an important part of the strategy to tackle barriers to successful entrepreneurship and therefore are in keeping with the Community objectives for entrepreneurship and innovation.

Comments from Associations and Academics

65. The Confederation of British Industry (CBI) fully supports the UK proposal for establishing ECFs. CBI identified the market gap as stretching from GBP 250 000 (EUR 357 000) to GBP 3 million (EUR 4,3 million) and therefore believes that ECFs meet a clearly defined market gap in the funding of growth companies.

66. The Nederlandse Vereniging van Participatiemaatschappijen (NVP) states that there is an evident equity gap at the bottom end of the market up to EUR 2,5 million. Whereas this gap may vary from Member State to Member State, the difference will not be significant.

67. The Confederation of Netherlands Industry and Employers VNO-NCW supports the observations made by the CBI and the NVP, particularly with regard to the size of the equity gap.

68. The Institute of Chartered Accountants in England and Wales believes that there is an equity gap that could be as high as GBP 5 million (EUR 7 million) for the following reasons:

(a) The majority of professional private equity providers are not interested in pursuing deals which are smaller than GBP 3 million (EUR 4,3 million).

(b) Experience tends to suggest that few venture capital houses in the UK are actively investing in businesses at or below GBP 2 million (EUR 2,9 million). Therefore the volume of small companies that receive investment at or near GBP 2 million (EUR 2,9 million) from these sources is very limited in any twelve month period. Others may be interested in this size range, but either as part of a much larger round above GBP 2 million (EUR 2,9 million), or where they are participating in the financing of a management buy out (MBO) or the change of ownership of a company, rather than its organic development.

(c) The professional venture capital community in the UK has established an active medium and large scale private equity industry, whose main focus is to acquire either large stakes in, or the control of, significantly profitable and large scale businesses. During the last 5 to 6 years, the number of venture capital houses with committed funds to invest in a reasonable volume of smaller companies with a specific range of up to GBP 2 million (EUR 2,9 million) appears to have diminished.

The Institute believes that the proposed ECF scheme will provide a valuable source of finance for businesses seeking a relatively modest amount of equity capital and will stimulate other investors to participate in small investment amounts where they can follow a fund that is dedicated to this sector, as opposed to investing opportunistically from time to time.

69. England's Regional Development Agencies state that a recent study by the Advantage West Midlands RDA shows that the barriers to accessing growth finance are most acute for those firms seeking between GBP 250 000 (EUR 357 000) to GBP 2 million (EUR 2,9 million) as demonstrated by the following facts:

(a) The study shows that the equity gap has grown since 1999/2000 as formal venture capital has migrated towards larger deal sizes of GBP 2-3 million (EUR 2,9-4,2 million).

(b) At the lower end of the risk capital market, the UK has a number of existing interventions that have successfully provided small amounts of growth capital to SMEs. However, recent reports indicate that there are significant numbers of businesses that require amounts well in excess of the GBP 250 000 (EUR 357 000) limit.

70. The Northwest Regional Development Agency makes the following observations:

(a) The funding needs of investee companies trying to raise follow-on funding between EUR 750 000 and EUR 2,9 million have been below the interest level of mainstream venture capital.

(b) The UK venture capital industry is moving its minimum thresholds per investment nearer to GBP 5 million (EUR 7 million).

(c) The real equity gap in the UK is probably at GBP 3 million (EUR 5,2 million) to GBP 5 million (EUR 7 million).

(d) The recognition of market failure below GBP 2 million (EUR 2,9 million) by the Commission will make a significant and crucial difference to the stimulation of high growth potential businesses in the UK.

71. The University of Warwick, after having conducted face-to-face discussions with technology transfer professionals from over 50 UK universities, comments on the early stage venture capital market and particularly on the issues facing university sector spin-off companies by highlighting the following aspects:

(a) Whereas it seems relatively straightforward for university spin-offs to raise small amounts of grant and equity funding up to GBP 500 000 (EUR 700 000), there is a thinning of sources of capital above GBP 500 000 (EUR 700 000). The main, and often only, source of risk equity at this stage is technology specialist venture capital.

(b) There are relatively few venture capital companies specialising in this area, all of them resource constrained. The shortage of equity at this level has both constrained and delayed the growth of individual spin-off companies.

(c) From the reference group, less than 1 spin-off company in 15 has raised equity in the GBP 500 000 (EUR 700 000) to GBP 1 million (EUR 1,4 million) range.

(d) The problems faced by university spin-off companies seeking to raise equity in the range GBP 1 million (EUR 1,4 million) to GBP 2 million (EUR 2,9 million) are overwhelmingly similar. Because they are at the same stage of development, companies looking for less than GBP 2 million (EUR 2,9 million) will face the same challenges due to the shortage of sources.

(e) Of the universities referenced, none had investment capital for spin-off companies in the GBP 1 million (EUR 1,4 million) to GBP 2 million (EUR 2,9 million) range. For university spin-off companies, there are more sources of equity available if more than GBP 2 million (EUR 2,9 million) is required.

Comments from Private Venture Capital Companies

72. Northern Enterprise Limited (Nelfunding) believes that there is market failure for risk capital investments below GBP 2 million (EUR 2,9 million) in the UK, and that this is adversely affecting SME development as a consequence.

73. Stonesfield Capital Limited is actively investing in the equity gap between GBP 500 000 (EUR 700 000) and GBP 2 million (EUR 2,9 million) targeted by the Enterprise Capital Funds and submitted the following comments:

(a) The supply of capital available throughout the UK for investments in the size range between GBP 500 000 (EUR 700 000) and GBP 2 million (EUR 2,9 million) is extremely limited. There is a severe equity gap for small businesses looking to raise these sums of money and the gap is widening rather than closing.

(b) According to the most recent 'Report on Investment Activity 2003' published by the British Venture Capital Association, there has been a 32% fall in the amount invested in early stage companies between 2001 and 2003.

(c) The performance of early stage funds has also declined markedly over the same period. The overall long term return to investors per annum for early stage funds was 14,1% in 2001 and fell to 4,7% in 2003.

(d) Both the decline in investment and performance over this period has led to a number of early stage venture investors pulling out of the market.

(e) These market dynamics have also been reflected in the average size of investment in early stage opportunities. In 2001 the average deal size was approximately GBP 1 million (EUR 1,4 million). This has increased to GBP 1,6 million (EUR 2,3 million) by 2003.

(f) This demonstrates that investors in the venture market are investing larger sums of money typically in an attempt to reduce risk, thereby contributing to a widening of the equity gap up to GBP 2 million (EUR 2,9 million).

(g) Companies requiring between GBP 1 million (EUR 1,4 million) to GBP 2 million (EUR 2,9 million) struggle the most to raise the required funds. This is because GBP 2 million (EUR 2,9 million) falls below the radar screen for most venture capitalists.

(h) The amount of funds raised to invest in early stage venture opportunities has fallen 73% from 2001 to 2003. In 2001, GBP 1,4 billion (EUR 2 billion) was raised to invest in early stage venture capital opportunities, compared to GBP 369 million (EUR 517 million) in 2003. Only 1% of the GBP 369 million (EUR 517 million) raised in 2003 was targeted at deals less than GBP 10 million (EUR 14 million).

(i) SMEs cannot justify an increase in capital requirements in excess of GBP 2 million (EUR 2,9 million) because their size and stage of development mean that they are not mature enough and the dilution to the entrepreneur would be too great. This leaves a significant funding hole that needs to be filled if these SMEs are to grow into successful larger businesses. The provision of funding between GBP 500 000 (EUR 700 000) and GBP 2 million (EUR 2,9 million) is essential for many small businesses to survive and prosper.

74. The YFM Group submitted the following observations:

(a) The latest British Venture Capital Association (BVCA) statistics show that in 2003 BVCA members invested GBP 724 million (EUR 1 billion) in sums of less than GBP 2 million (EUR 2,9 million) in 1 015 UK based companies.

(b) If one strips out sub GBP 500 000 (EUR 700 000) deals the picture changes dramatically. In 2000, GBP 482 million (EUR 675 million) was invested in sums of between GBP 500 000 (EUR 700 000) and GBP 2 million (EUR 2,9 million) with 348 companies benefiting. By 2003 the amount invested had fallen to GBP 286 million (EUR 400 million), a 41% drop on the 2000 figure, with 277 companies benefiting.

(c) These figures include management buy outs (MBOs), management buy-ins (MBIs), later stage expansions, secondary purchases and deals where bank debt has been refinanced. If these transactions were to be stripped out to focus on start up and early stage deals, the figures for monies invested and companies benefiting would be discounted yet further.

(d) Funding for start up and early stage propositions, regardless of the size of the deals completed, fell from a grand total of GBP 703 million (EUR 984 million) in 2000 to GBP 263 million (EUR 368 million) in 2003, a fall of 63%.

(e) Stimulated by the European Commission and UK government efforts, the number and value of transactions in the sub GBP 500 000 (EUR 700 000) marketplace is expanding.

(f) However, at the next level up, the migration of UK financial houses to larger and larger transactions is leaving a funding gap. Supply side constraints are becoming a major issue. Companies that have received investments in the sub GBP 500 000 (EUR 700 000) range and that are likely to need significant amounts of follow-on finance are unable to raise the monies they need because of a funding gap in the GBP 500 000 (EUR 700 000) to GBP 2 million (EUR 2,9 million) range.

75. Close Venture Management Limited highlighted the following facts:

(a) There is strong evidence that the equity gap, which has evolved over time, now covers the GBP 500 000 (EUR 700 000) to GBP 2 million (EUR 2,9 million) range. With time and increasing amounts of funds under management, venture capital investors left the sub GBP 2 million (EUR 2,9 million) segment behind.

(b) This is symptomatic of a common and inevitable trend. As investment managers establish a successful track record they raise more funds which in turn allows them to do bigger deals. As there are inherent scale economies in the venture/private equity industry, investment managers will typically leave the smaller deals behind as soon as they are able to do so.

(c) This means that there are extremely few professional or institutional investors in the sub GBP 2 million (EUR 2,9 million) segment in the UK. Currently, about 60% of all the deals between GBP 500 000 (EUR 700 000) and GBP 2 million (EUR 2,9 million) is frustrated demand with no readily available suppliers of risk capital to go to.

76. Enterprise Corporate Finance Limited has become increasingly frustrated in its endeavours to raise capital in the range between GBP 500 000 (EUR 700 000) and GBP 2 million (EUR 2,9 million) for their client companies:

(a) The main reason is not a lack of quality in the investment opportunities themselves but the increasing reluctance of venture funding to make small investments in such ventures.

(b) The marketplace has become significantly worse over the last few years to the extent that transactions requiring less than GBP 5 million (EUR 7 million) have a very slight probability of receiving funding, notwithstanding the merits of the investee company.

(c) The problem is significantly worse for those companies seeking funds in the GBP 250 000 (EUR 357 000) to GBP 2 million (EUR 2,9 million) bracket due mainly to prohibitively high costs and a lack of appropriate commercial skill. The lion's share of venture funding is targeted towards more substantial and mature businesses with assets and a track record of producing profits.

77. In its comment, 3i emphasises the following:

(a) In the past two to three years the venture capital market has gone through a significant transformation as investment returns from early stage and smaller growth companies have declined.

(b) This, combined with an industry-wide trend of making larger investments and more prudent investment strategies, has resulted in a decline in the supply of investment flowing into the smaller end of the market.

3i currently estimates that the equity gap has increased from GBP 500 000 (EUR 700 000) to GBP 1 million (EUR 1,4 million) to as much as GBP 2 million (EUR 2,9 million).

3i has significantly reduced its own investment in this segment of the market. Whereas it invested approximately EUR 1,1 billion in early-stage venture capital investments across Europe in 2001, investment in similar companies has declined significantly with 3i investing approximately EUR 150 million in this segment of the market in 2004.

78. Cavendish Asset Management Limited supports the observations made by the Institute of Chartered Accountants in England and Wales described under point 68 above.

V. **COMMENTS FROM THE UNITED KINGDOM**

79. The comments from the United Kingdom on the decision of the Commission to open the formal procedure pursuant to Article 88(2) of the EC Treaty as well as on the observations from third parties will be summarised in points (80) to (96).

80. While access to debt finance has improved for the majority of businesses in the UK since the mid 1990s, an important minority of SMEs with high growth potential still have problems in attracting equity finance.

81. Equity finance is suitable for businesses at an early stage of development that are not yet generating a sufficient stream of revenue to service debt interest repayments. It is also suitable for businesses developing new technologies, products or markets that offer the potential to achieve substantial rates of growth, but also hold a significant risk of failure.

82. The public consultation on access to growth capital for small businesses, aggregated BVCA data and academic research all point to an equity gap in the United Kingdom affecting businesses seeking to raise between GBP 250 000 (EUR 357 000) and GBP 2 million (EUR 2,9 million) of equity finance.

83. The equity gap has extended upwards in recent years, particularly since 1999, driven in part by the success of the private equity industry moving to larger size investments. Average deal sizes have risen substantially, as venture capital firms seek to benefit from increased economies of scale.

84. The equity gap has been accentuated for early stage SMEs in recent years due to a marked shift in the types of investments made by venture capitalists. Evidence shows venture capital investments have drifted towards later-stage, management buy out (MBO) and management buy in (MBI) investments.

85. The most recent BVCA data available for 2003 demonstrate that there is a continued emphasis on later-stage deals, and particularly on large buy-outs. Early stage investment accounted for just 6,5% of UK venture capital investment in 2003, or less than 0,02% of GDP. This contrasts with an average of 0,05% of GDP invested in early stage in the years 1998-2001.

86. The expected use of newly-raised venture capital funds is becoming increasingly focused on larger deals in well-established companies. The most recent data from the BVCA indicate that only 4% of funds raised are expected to be allocated to early-stage investment, 3% to expansion deals, and 1% to MBOs of less than GBP 10 million. It was expected that only 3% of funds raised would be allocated to early stage and expansion technology investments, compared to 5% in 2002.

87. Furthermore, data suggest that of those investments that take place within the equity gap of GBP 250 000 (EUR 357 000) and GBP 2 million (EUR 2,9 million), only 1 in 4 are initial, un-syndicated investments. Of approximately 1 000 investments in the sub GBP 2 million (EUR 2,9 million) range in 2000-2002, more than 70% were follow-on investments.

88. As venture capitalists are migrating towards larger fund sizes, there is little evidence of a flow of new venture capital investment teams into the lower end of the market. The importance of reputation in the venture capital sector creates a significant entry hurdle for prospective new fund management teams seeking to compete in the venture market. This trend will result in a worsening shortage of talent and experience in the equity gap segment of the market that will become increasingly hard to replace as time progresses, with quality fund managers raising larger funds, and hence making larger deals. Given the skills needed for successful smaller-scale and early-stage investing, ensuring a good flow of quality new entrants is a precondition for a dynamic early stage market.

89. The UK concludes that there appears to be full agreement among all respondents that there is a risk capital market failure that makes it difficult for SMEs with high growth potential to get funding. All third party comments have supported the UK's view that the market has changed and that an equity gap now exists beyond the level set in the Communication.

90. The United Kingdom has sought to demonstrate that a funding gap exists in investment sizes up to GBP 2 million (EUR 2,9 million). A number of respondents suggest this is a modest estimate and that the gap may now reach as high as GBP 5 million (EUR 7 million). The United Kingdom believes however that the evidence is strongest in support of GBP 2 million (EUR 2,9 million) as the appropriate figure.

91. The United Kingdom highlights that responses from those businesses operating within the UK venture capital sector are in line with those of its own detailed consultation. Respondents universally acknowledged the existence of a risk capital funding gap at the GBP 2 million (EUR 2,9 million) level or above. These respondents have practical experience of this market and have researched it from a commercial point of view. Their experience supports the United Kingdom's own research, which says that funds operating in this area are not able to attract private investors because of perceptions of risk and the economics of making smaller investments. The United Kingdom is therefore satisfied that the Enterprise Capital Funds scheme will not displace existing private provision in this market.

92. The United Kingdom also welcomes the level of support for the practical design of the ECF model. The United Kingdom welcomes the understanding amongst respondents that the proposed fund structure means that a distortion of competition will not occur and that the incentive will be for sound commercial investment decisions. The key driver for this is that the proposed ECFs give no down-side protection to the private investors. This sharpens their incentive to select good fund managers who will invest their funds to best effect. If an ECF does not make a positive return the private investor will lose his or her money. The United Kingdom believes that this is a more powerful commercial incentive than an alternative model where there is a lower proportion of public investment but where public funds are at risk before the private investment and private investors can get their money back from loss making funds.

93. By including key aspects of each fund's structure within the competitive bidding process the United Kingdom will pay the minimum necessary in fund management charges and subordination. The bidding process will set out some minimum requirements, such as the *pari passu* loss position and a prioritised return to the public but it includes the flexibility for applicants to specify alternative terms where these are more generous to the public. This opens up the possibility that private investors may be exposed to greater downside risk than the public or that less than the anticipated leverage is required where a bidder could show that this would prove attractive to investors in its fund.

94. The United Kingdom further notes that the responses from other Member States highlight a desire to update the current Communication. The risk capital market across the European Union has changed markedly since the publication of the Communication in 2001. In view of this the United Kingdom agrees that there will need to be some fundamental revisions in the Communication when it is revised in 2006. This will almost certainly need to go beyond looking at tranche sizes to look at other issues such as the balance of private sector risk as compensation for greater public funding and greater use of instruments such as block exemptions.

95. The United Kingdom considers that the ECF scheme will make an important contribution to tackling what remains an important barrier to innovation and entrepreneurship and to meeting the goals set out at Lisbon and in the Entrepreneurship Action Plan. The ECF scheme will also help meet the recommendations of the Kok report which noted that finance for SMEs in Europe is currently too lending based and called for more use of risk capital.

96. The United Kingdom concludes that the support shown both by the public and private sectors and by other Member States as well as those operating in the venture capital market positively reflects the need for an investment vehicle of the ECF type.

VI. **ASSESSMENT OF THE MEASURE**

97. The Commission has examined the scheme in light of Article 87 of the EC Treaty and in particular on the basis of the Commission Communication on State Aid and Risk Capital [9]. The results of this assessment are summarised below.

VI.1. **Legality**

98. By notifying the scheme, the UK authorities have complied with their obligations under Article 88(3) EC.

VI.2. **Existence of State aid**

99. According to the provisions of the Communication, the assessment of the presence of State aid must consider the possibility that a measure may confer aid on at least three different levels:

(a) aid to investors;

(b) aid to any fund or other vehicle through which the measure operates;

(c) aid to the companies invested in.

[9] See footnote 6.

100. At the level of investors, the Commission considers that there is State aid within the meaning of Article 87(1) of the EC Treaty. The involvement of state resources is demonstrated by the fact that the UK authorities will provide public leverage to the Enterprise Capital Funds. Private investors in Enterprise Capital Funds, who may be undertakings within the meaning of the EC Treaty may be entitled to higher returns than the public and may thus receive an advantage. Even though no person or organisation is debarred from investing in the funds, the limited size of the funds will not guarantee that all potential investment will be accepted and the Commission therefore considers that there is selectivity. Finally, the scheme affects trade between Member States, as investment in capital is an activity that is the subject of considerable trade between Member States.

101. At the level of the funds, the Commission in general tends to the view that a fund is a vehicle for the transfer of aid to investors and/or enterprises invested in, rather than being an aid beneficiary itself. However, in certain cases, notably measures involving transfers in favour of existing funds with numerous and diverse investors, the fund may have the character of an independent enterprise. Under the present scheme, the Enterprise Capital Funds will be newly created and will be prevented from diversifying into other activities than those intended by the scheme. The Commission therefore does not consider the Enterprise Capital Funds to be separate aid beneficiaries. This principle is in line with the Commission decisions on the 'Viridian Growth Fund' ([10]), the 'Coalfields Enterprise Fund' ([11]) and the 'Community Development Venture Fund' ([12]).

102. At the level of the companies invested in, the Commission considers that there is State aid within the meaning of Article 87(1) of the EC Treaty. State resources are involved because the investments of the fund in beneficiary SMEs will contain public funding. The measure distorts competition by conferring an advantage on the beneficiary SMEs as they would otherwise not be able to obtain risk capital funding at the same conditions and/or volume. The measure is selective as it is targeted at specific SMEs in the United Kingdom. The measure has the potential to affect trade between Member States, as there is the possibility that the target SMEs are engaged or will be engaged in activities involving intra-Community trade.

([10]) Commission Decision 2001/406/EC of 13 February 2001 on the aid scheme 'Viridian Growth Fund' notified by the United Kingdom (State Aid C 46/2000): OJ L 144, 30.5.2001, p. 23.
([11]) State Aid N 722/2000: OJ C 133, 5.6.2002, p. 11.
([12]) State Aid N 606/2001: OJ C 133, 5.6.2002, p. 10.

103. The Commission therefore concludes that State aid within the meaning of Article 87(1) EC is present at the level of the investors and at the level of the beneficiary SMEs.

VI.3. **Evidence of market failure**

104. In line with the provisions of the Communication, the Commission may be prepared to accept the existence of market failure without further provision of evidence in cases where each tranche of finance for an enterprise from risk capital measures which are wholly or partially financed through state aid will contain a maximum of EUR 500 000 in non-assisted areas, EUR 750 000 in Article 87(3)(c) areas, or EUR 1 million in Article 87(3)(a) areas.

105. The measure proposed by the United Kingdom foresees risk capital investments in the range of GBP 250 000 (EUR 357 000) to GBP 2 million (EUR 2,9 million) per investment tranche for SMEs in the United Kingdom.

106. According to the 'Regional Aid Map 2000 – 2006' for the United Kingdom, the United Kingdom consists of regions currently classified as assisted areas pursuant to Article 87(3)(a) of the EC Treaty, as assisted areas pursuant to Article 87(3)(c) EC, as well as of non-assisted areas ([13]).

107. In line with the provisions of the Communication, the Commission has informed the United Kingdom that in view of the fact that the proposed risk capital investments under the present scheme exceed the above-mentioned thresholds anticipated by the Communication, the United Kingdom would have to provide evidence of market failure.

108. The arguments put forward by the United Kingdom as well as the observations made by third parties demonstrating the existence of a market gap in the investment range of GBP 250 000 (EUR 357 000) and GBP 2 million (EUR 2,9 million) will be summarised in the following.

([13]) State Aid N 265/2000 – United Kingdom: 'Regional Aid Map 2000 – 2006': see footnote 8.

Economic rationale for equity gaps in the risk capital market for SMEs

109. The most important single source of external finance for SMEs is bank debt, principally in the form of overdrafts and fixed-term loans, which together account for around half of all external finance. ([14]) Bank debt is most suitable where businesses are generating sufficient cash flow to service interest payments. The availability of debt finance has improved significantly over the past decade. There is no real evidence of firms having difficulties assessing bank finance. Nevertheless, lenders can still face considerable uncertainty when assessing the prospects of individual businesses. They often rely on collateral to support SME lending, especially where the borrower lacks an established track record in business. Not all business owners are able to offer suitable security.

110. Market imperfections in the debt market arise from information asymmetries, whereby the lender is only partially informed about the prospects of a business. Information asymmetries mean that lenders are unable to quantify the level of risk involved in a particular SME. It is therefore difficult to assess the quality of investment propositions, and even harder to charge an interest rate that accurately reflects the level of risk involved. Banks typically make lending decisions on the basis of criteria such as credit history, past bank account management, the applicant's track record in business and willingness to invest their own money in the business, and evidence of repayment capability based on a business plan. However, an individual may not have a previous track record and may have no personal capital to invest in the business. As a result, lenders also place significant emphasis on the entrepreneur's willingness to provide collateral to underwrite the loan. While lenders' reliance on collateral enables many businesses to secure debt finance, this approach to SME lending can create difficulties for entrepreneurs who lack suitable assets to offer as security.

111. While debt and asset-based finance are sufficient to meet the needs of most firms, an important minority require equity finance. Equity investors inject capital in exchange for shares in the business, enabling them to receive a proportion of its future profits. This form of financing is most appropriate when the business is at an early stage of development, and is not yet generating a sufficient stream of revenue to service debt interest repayments and/or the business is developing new technologies, products or markets with the potential to achieve substantial rates of growth, but also with significant risk of failure.

112. Equity finance accounts for only 8 per cent of all external finance for SMEs, but this statistic understates its importance in a modern, enterprising economy. Businesses that are most likely to need equity finance are often highly innovative, and have the potential to make an important contribution to productivity growth. In addition, the finance provided by venture capital is sometimes accompanied by management support, advice and other expertise.

113. While equity finance is an important driver of growth of individual businesses, and more widely across the economy, there is a strong body of evidence that structural features of the private equity market give rise to a significant and growing 'equity gap' facing businesses seeking modest amounts of growth capital. These structural causes relate to both the supply and demand sides of the market.

114. The information problems highlighted for the debt market are also applicable to the equity market. On the supply side, there are commonly three issues involved, namely information asymmetries, transaction costs, and the perception of risk and reward.

115. 'Information asymmetries' mean that equity investors can face significant costs in identifying suitable investment opportunities. These information problems are typically greatest for smaller, younger firms and especially innovative businesses seeking to develop unproven technologies, products and markets. Information difficulties present a significant impediment to smaller-scale equity investments, because the costs of investment do not vary proportionally with the size of investment. In comparison with large companies that are quoted on public stock markets, the flow of information about small, unquoted companies seeking investment is much more limited. Investors can therefore incur significant search costs when seeking out suitable opportunities. Furthermore, it is often difficult to assess the prospects of a business, especially where the management team, product or technology is unproven. Before equity investors can make informed investment choices, they must therefore undertake a process of due diligence. These information gathering costs do not vary proportionally with the size of the investment and, for smaller investments, can be prohibitively large relative to the potential financial rewards from making the investment. Finally, having invested in a business, equity investors need to monitor the ongoing performance of their investment. They will often do this by taking a seat on the board, and may contribute significant time and effort to providing management support, especially where a business' management team is relatively inexperienced. This can make an important contribution to the performance of the investee business but, again, these costs do not vary proportionally with investment size.

([14]) Bank of England: 'Finance for Small Firms – A Tenth Report', 2003.

116. There are significant fixed costs involved in making equity investments, for example in negotiating the terms of investment and putting in place the necessary legal agreements ('transaction costs'). As with other fixed costs, these transaction costs tend to militate against investing in smaller sums.

117. Investment decisions will be driven by perceptions of risk and likely financial returns. If investors have incorrect expectations, this will result in a sub-optimal allocation of capital.

118. Demand-side constraints are equally significant in limiting the flow of equity finance from investors to SMEs. Research has highlighted a number of issues that deter small businesses from seeking equity capital. Loss of control and restricted management freedom are the concerns most commonly cited by SMEs, but the costs of securing equity finance and a lack of knowledge of external sources of finance are also common obstacles. Many of those businesses that actively seek equity investment are also constrained by a lack of 'investment readiness'. SMEs may be hampered by a limited awareness and understanding of the various forms of risk finance available and how to access it, and by insufficiently developed or poorly presented business plans. Inadequate business preparation and planning will deter potential investors, not least by increasing the information and due diligence costs involved.

119. An equity gap arises where viable businesses are unable to attract investment from either informal investors or venture capitalists, which are the principal sources of equity finance for SMEs. Informal investors (business angels and other informal investors) have access to limited financial resources and therefore generally invest relatively small amounts of equity. By contrast, formal venture capital investors typically incur far greater costs in evaluating potential investments. For the structural reasons mentioned above, these costs are often prohibitive where a business is seeking only a modest amount of equity finance.

120. An equity gap therefore affects businesses that are seeking a sum of money that is beyond the financial means of most informal investors, but below the level at which it is viable for venture capitalists to invest.

Evidence for an upward-moving equity gap in the UK venture capital market

121. According to recent BVCA data ([15]), large MBO funds showed good returns in 2003 and over the longer term, whereas average returns from early stage and technology funds continued to be depressed in 2003.

122. As to the overall performance by investment stage, funds focusing on early stage investments made an average return of - 18,1% in 2003 compared to an average 3-years return of - 25,1% and an average 5-years return of - 12,5%.

123. Funds specialising in development stage investments recorded an average return of - 3,4% in 2003 compared to an average 3-years return of - 8,2% and an average 5-years return of 2,7%.

124. At the same time, funds concentrating on MBOs (management buy outs) performed significantly better. For mid-sized MBOs, the average return in 2003 was 12,2%, compared to an average 3-years return of 2,9% and an average 5-years return of 6,7%. The difference becomes even more evident when looking at large MBOs, with an average return of 15,3% in 2003, an average 3-years return of 9,1%, and a corresponding return figure of 13,6% for a 5-years period.

125. The data presented above underlines the current pattern in the UK venture capital market. Venture capital providers migrate towards larger deal sizes as the associated returns are higher, thereby widening the equity gap between smaller-scale early stage and expansion investments and larger-scale investments in well-established companies.

126. This trend towards ever larger investment sizes is further underlined by recent figures on investment activity in the United Kingdom ([16]). The average financing across all stages of investment increased to GBP 4,3 million (EUR 6 million) in 2003 from GBP 3,8 million (EUR 5,3 million) in 2002. This is explained by the fact that smaller-scale expansion stage investments fell by 57% to GBP 477 million (EUR 670 million) in 2003 from GBP 1,2 billion (EUR 1,7 billion) in 2002. The average amount received by an expanding company fell from GBP 2 million (EUR 2,9 million) in 2002 to GBP 800 000 (EUR 1,1 million) in 2003.

127. Of the total funds raised in 2003, the vast majority of 92% (GBP 8,2 billion or EUR 11,5 billion) has been invested into MBOs and MBIs, up from an 87% allocation in 2002. The report anticipates that only 3% (GBP 290 million or EUR 406 million) will be invested into expansion stage companies, compared to 6% in 2002. For early stage investments 4% of total funds raised in 2003 (GBP 368 million or EUR 515 million) compare to 3% in 2002.

([15]) BVCA: 'Performance Measurement Survey 2003', 2004.

([16]) BVCA: 'Report on Investment Activity 2003', 2004.

128. Within the MBO/MBI category, 58% is expected to be allocated to the largest MBOs/MBIs (over GBP 100 million or EUR 140 million total deal value), compared to 45% in 2002. 20% will be allocated to MBOs/MBIs between GBP 50 million (EUR 70 million) and GBP 100 million (EUR 140 million), up from 17% in 2002, and 13% will be allocated to MBOs/MBIs of between GBP 10 million (EUR 14 million) and GBP 50 million (EUR 70 million), compared to 24% in 2002. Like in 2002, a mere 1% will be allocated to MBOs/MBIs of up to GBP 10 million (EUR 14 million).

129. Both the decline in investment and performance presented above has led to early stage venture investors pulling out of the market. This is further highlighted by the fact that the average financing (across all stages of investment) is steadily moving upwards and has reached GBP 4.3 million (EUR 6 million) in 2003. Investors in the UK venture market are investing larger sums of money typically in an attempt to reduce risk, thereby contributing to a widening of the equity gap.

130. The amount of funds raised to invest in early stage venture opportunities has fallen 73% from 2001 to 2003. In 2001, GBP 1,4 billion (EUR 2 billion) was raised to invest in early stage venture capital opportunities, compared to GBP 369 million (EUR 517 million) in 2003. Only 1 % of these GBP 369 million (EUR 517 million) raised in 2003 was targeted at deals less than GBP 10 million (EUR 14 million).

131. In its decision to initiate the procedure laid down in Article 88(2) of the EC Treaty in respect of the proposed aid measure, the Commission stated that in view of the proposed maximum investment amounts proposed under the scheme, which considerably exceed the maximum investment amounts anticipated by the Communication, potential observations made by interested parties were necessary in order to decide whether the measure affects trading conditions to an extent contrary to the common interest.

132. All comments received from interested third parties were positive and underlined the importance of the measure in general as well as the appropriateness of the proposed maximum investment amounts.

133. Taking into account the information presented in the initial notification, the comments submitted by interested third parties as well as the additional information delivered by the United Kingdom following the Commission's decision to open the procedure pursuant to Article 88(2) of the EC Treaty, the Commission concludes that the United Kingdom has provided sufficient evidence for the existence of an equity gap in the deal size range between GBP 250 000 (EUR 357 000) and GBP 2 million (EUR 2,9 million) in the venture capital market of the United Kingdom.

VI.4. **Compatibility of the measure – Conformity with the positive elements of the Communication**

Restriction of investments

134. ECFs will be restricted to investments in small and medium-sized enterprises within the Commission definition. This is to be considered positively.

Focus on risk capital market failure

135. ECFs will be required to invest capital in SMEs by means of equity or quasi-equity instruments. Investments that are composed wholly of debt instruments with no equity features will not be permitted. The Commission considers this as a positive element.

Decisions to invest should be profit-driven

136. A link between investment performance and the remuneration of the commercial managers responsible for investment decisions is established. The public authorities will not be involved in the investment choices and decision making of ECFs apart from setting restrictions to ensure that investments are limited to SMEs. Investment decisions will be taken by commercial managers of the ECFs with an interest in ensuring a maximum return for the fund. The administrative body SBS will only approve ECFs where operators have a clear incentive to maximise returns. The terms on which the public authorities will invest in ECFs will give private investors very strong incentives to ensure that their funds are profit-driven and perform successfully. These incentives arise because private investors will have to pay interest on the public capital, and fully repay capital to both the public and private investors, before any profits can be distributed. As a result, private investors will bear at least a proportionate share of any losses made by ECFs. ECFs or their operators will be required to act in line with industry standards (British Venture Capital Association BVCA guidelines). All these elements have to be assessed positively.

Level of distortion of competition should be minimised

137. The UK authorities will ensure that the ECF scheme is publicised and that applications are invited from across the EEA with notices in the *Official Journal of the European Union* and the relevant trade press. There will be no restriction on location for any investor or operator. This is again considered as a positive element.

Sectoral focus

138. Enterprise Capital Funds will not invest in sensitive sectors under State aid restrictions or in sectors to which the Communication does not apply. Low-risk sectors including property, land, finance and investment companies, or finance-type leasing companies will not be eligible for investment under the scheme. This has to be regarded positively.

Investment on the basis of business plans

139. All investments undertaken by ECFs will be made on the basis of robust business plans. This is a further positive element.

Avoidance of cumulation

140. The UK authorities have committed themselves that the beneficiary SMEs' eligibility for other publicly funded grants, loans or other forms of investment aid outside of this notification will be reduced by 30% of the aid intensity that would otherwise be permissible. The Commission considers this to be a positive element.

VII. **CONCLUSION**

141. The Commission therefore concludes that the aid granted under the Enterprise Capital Funds scheme fulfils the conditions of the Commission Communication on State Aid and Risk Capital. It has therefore found the measure to be compatible with the common market pursuant to Article 87(3)(c) of the EC Treaty.

HAS ADOPTED THIS DECISION:

Article 1

The State aid which the United Kingdom is planning to implement is compatible with the common market pursuant to Article 87(3)(c) of the EC Treaty.

Implementation of the aid is accordingly authorised.

Article 2

The United Kingdom shall submit an annual report on the implementation of the aid.

Article 3

This Decision is addressed to the United Kingdom.

Done at Brussels, 3 May 2005.

For the Commission

Neelie KROES

Member of the Commission