ROYAL NORWEGIAN
MINISTRY OF TRADE AND INDUSTRY

EFTA Surveillance Authority
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Your ref	Our ref	Date
	12/2895-14	.12.2012

NOTIFICATION – NATIONAL SEED CAPITAL SCHEME

1. INTRODUCTION

The Norwegian Government hereby notifies the National Seed Capital Scheme. The notification is based on the meetings on 27th September and 27th November, between the EFTA Surveillance Authority (hereinafter the Authority), and the Norwegian Ministry of Trade and Industry (hereinafter the Ministry), and the pre-notifications dated 6th August and 2nd November.

Article 61(3)(c) of the Agreement on the European Economic Area stipulates that aid to facilitate the development of certain economic activities may, where such aid does not adversely affect trading conditions to an extent contrary to the common interest of the Contracting Parties to the EEA Agreement, be found compatible with the Agreement.

In the White Paper on State Ownership[1], launched on 1st April 2011, the Government wrote that it will propose new seed capital funds with national coverage. In the White Paper on Innovation Norway and SIVA launched on 27th April 2012, the Government gave the overall design of the scheme, and the details were presented in the Revised National Budget 2012. Total budget allocation to seed capital through the scheme is up to a maximum of NOK 1.5 billion in investment capital, through up to six national seed funds. In the Revised National Budget 2012, NOK 500 million in investment capital for the two first funds was allocated.

The Ministry ordered a report on the Norwegian early stage risk capital market in 2011, which was delivered on 7th November 2011. The report *"The need for government*

[1] Meld. St. 13 (2010-2011) Aktivt eierskap – norsk statlig eierskap i en global økonomi.

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supported capital measures in the market for early stage risk capital in Norway" [2] concludes that *"…the supply of seed stage capital in Norway is now severely low"*.

Norway has previously established two generations with three separate seed capital schemes, in 1998 and in 2006, with a total of 15 funds. The new scheme will have the approved nationwide seed capital scheme as its starting point (decisions 61/06/COL and 181/05/COL). The two other schemes primarily have a regional objective and consist of smaller funds than the nationwide scheme. The financial results of the first generation are poor, while the second generation has better prospects and more successful exits with return of capital to both investors and Innovation Norway. In total, the two first generations have made investments in about 300 companies, of which about 65 are from the nationwide scheme. Based on experience and evaluations of the old schemes, the new scheme is improved especially with regard to capital structure, size, risk-relief, investment area and follow-on investments. In principle we believe that there should be as few restrictions as possible attached to the scheme, except those necessary to make the funds make initial investments in the seed and start-up stages. Unnecessary restrictions will make it harder to attract private capital and will reduce the funds expected returns.

This letter explains the reasons for the elements of the scheme, while the enclosed notification lists them.

2. EVALUATIONS OF PREVIOUS NORWEGIAN SCHEMES

There have been two evaluations of the Norwegian seed capital schemes, in 2003[3] and 2009[4]. They were written by two independent and different consultants, and the contracts were awarded through an open tender procedure. The first concluded that any new funds should:

- be based on state participation with equity, with state aid through share premium account to aid investors;
- have no regional limits;
- have arm-length distance to universities and their projects;
- have professional selection of managers

The evaluation also recommended that the state should organize its participation through a fund-of-funds model.

The second evaluation concluded that new funds should:

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[2] MENON-publication no. 18/2011, page 3.
[3] Wassum Investment Consulting, "Evaluering av Såkornordningen", 2003.
[4] MENON Business Economics, m. fl., "Veksthus eller såkorn til spille – Evaluering av ordningene for såkornfond i Norge, 2009.

- be larger – NOK 500 mill each;
- have national investment areas;
- have state participation through equity

The new scheme follows these recommendations, which to some extent is repeated in the report made on the early stage risk capital market in Norway from 2011. However, it was not in the scope of that report to recommend models.

3. COMPARISON TO SCHEMES IN OTHER COUNTRIES

The Norwegian Government has looked into schemes in Finland (Start-up fund Vera – N395/2007), Germany (Saxony Early Stage Fund – N 263/2007) and the United Kingdom (UK) (Venture Capital Trust (individual investments)/Enterprise Investment Scheme (collective investments) – SA 33849 (2012/N)) to find similar cases. However, the measures intended at developing the early-stage risk capital markets that we have found are quite different from our proposed scheme. There could be several reasons for this, including history, the innovation eco-system the schemes are part of, and the political willingness to use tax-measures. We would however like to list some findings on key elements in our scheme:

<u>Aid level</u>
The UK and German schemes provide direct aid to investors. The UK scheme provides income tax relief and capital gains/dividend tax relief to private investors. The direct relief on the income tax is 30 pct. of the invested amount up to £ 200 000 annually, on condition that the investment is kept for five years. If the return on investment without the tax-incentive is zero, the incentive according to our calculation, provides an annual return on investment of 5.39 pct. Over a 15-year period the total income tax relief could amount to £ 900 000. Potential capital gain and dividend reliefs are additional. In the German scheme the investors get a guarantee covering 50 pct. of losses on individual investments. In seed and start-up funds all or some capital is frequently lost on more than 80 pct. of the investments, so this is substantial aid to investors covering their downside risks. The aid will in turn increase total returns to the investors as losses from seed and start-up funds on individual investments are highly likely. In the approval it is stated that the annual return rate will increase from below 10 pct. to above 12 pct. The actual numbers are not disclosed because they are trade secrets. There is no up-front aid in the Finnish scheme.

The aid to investors in the New Norwegian scheme could be calculated as an increased return to investors at between 0.94 and 1.76 pct. annually over a 15-year period. Given total investments from the largest single investor like in the present nationwide funds of NOK 147 million and otherwise zero return on investment, the aid to investors in NOK will be NOK 22.05 million for the entire period. If the aid level is calculated from the stipulated maximum allowed participation of NOK 125 million from one investor in a single fund of NOK 500 million (ref. enclosed Seed Capital Funds Framework

Agreement, point 1.11), the aid will be NOK 18,75 million. This participation limit is established to spread ownership of the funds and to limit aid to single investors. The aid level is described in further detail and compared with the present scheme in paragraph 4 below. In our opinion the aid level in the New Norwegian scheme is within the boundaries of Commission practice in the UK and German cases regarding aid level in percent and within the boundaries of total aid in the present Norwegian schemes.

<u>Private participation and investors</u>
The German and Finnish schemes are state dominated. In Saxony (two funds for assisted areas), the private participation is weighted at about 25 pct., but down to 10 pct. in the seed scheme. In addition, publicly owned banks which run their businesses on a commercial basis are deemed as private participants. In the Finnish scheme the state supplies about 93 pct. of the capital in the funds, and does not require any private co-investors when investing. The UK scheme is 100 pct. private capital, but with heavy tax-incentives, on income, capital gains and dividends, the private share should thus be counted as considerably less.

The New Norwegian scheme calls for at least 50 pct. private participation, with a definition of private investors in line with Commission practice in the German case and the previous generations of Norwegian seed funds. In addition, there is a requirement in the new scheme for private co-investors in each invested enterprise. Under normal circumstances co-investors, including founder(s) should own at least 51 pct. of the enterprise. The reason for this requirement is to ensure second opinions and ensure a high degree of private financing. For further details on private participation, see paragraph 6 below.

<u>Cumulation of aid</u>
All the three schemes comply with the cumulation rules. However, only the UK and German schemes have described how this will be implemented. The target companies will be informed that they have received aid and that they must notify other aid providers.

The Norwegian government will implement the same safeguard as in the German and UK schemes to ensure compliance with cumulation rules (which is also implemented in the present Norwegian seed schemes). In addition, a register of companies aided through the new seed capital scheme will be established by Innovation Norway.

<u>Follow-on investments</u>
Follow-on investments are allowed in the measures looked into. The Finnish scheme has no written limit on follow-on investments if there are private participants as co-investors, but states that it *"will be consistent with the initial investment and the size of the fund".* There are however clear limits if there are no private investors in the initial investment or in following rounds of capital injections.

The German scheme (two funds of respectively EUR 40 and 20 million) may invest up to EUR 5 million each in single enterprises. This is 25 pct. of the capital under management in the smallest fund and 12.5 pct. in the largest.

The British Venture Capital Trust Scheme has 15 pct. of the fund value as the maximum investment in any company. A 15 pct. limit is also the recommendation of the Norwegian Venture Capital & Private Equity Association in the enclosed letter dated 8th October 2012, and other enclosed e-mails. It should also be noted that investments through the UK scheme are independent of phase as long as investments are made in smaller unquoted companies.

We would thus argue that a total investment limit of 15 pct. of capital under management in any company is reasonable, and in line with point 5.2.3.3 of the Risk Capital Guidelines, which calls for large enough funds to finance *"the later more profitable financing stages of target companies."* For further information on follow-on investments in the New Norwegian scheme, see also paragraph 7 below and enclosed e-mails from potential participants in the scheme on the subject.

4. COMPARISON TO THE PRESENT SCHEME

4.1 Equity and loans

A main difference between the new and old schemes is the fact that this time the Norwegian government will supply equity rather than loans to the funds. Equity investments in and through funds are industry standards because of the high risk and potentially high returns associated with this type of investments. The main reason for state participation with subordinated loans rather than equity in the two first generations of seed funds was the already substantial ownership by the state in Norwegian businesses, and an aim to strengthen private ownership. The result was a complex model which is difficult to understand and manage for both the state and the investors. The state will therefore participate through equity in the new scheme.

4.2 Aid element

In the new scheme the investors will receive total aid of up to 15 pct. of their committed capital. Over a 15 year life-span, and based on the presumption that investors have all their capital in the funds all the time, the added annual return to investors from the aid, given otherwise 0 pct. pooled internal rate of return (IRR)[5] is 0,94 pct. However, as the committed capital is drawn down in tranches and paid back in tranches, it is more likely that half the capital on average is paid out to the funds. This will increase the added annual return to 1.76 pct. Such an annual return is still far from the percentages for

[5] See table 2 in the notification.

returns for private equity investments[6], and should thus be assessed as a moderate incentive to investors.

In the present schemes the equivalent added annual returns from the 25 pct. loss fund are calculated at 1.5 pct. and 2.74 pct., given the same assumptions as for the new scheme. Of the biggest investor participation, 25 pct. of NOK 147 million equals NOK 36.75 million. However, these funds must pay an annual compounded interest rate of average 12 month NIBOR for the last year and a 2 pct. risk premium[7]. In 2011 this interest rate was 5.48 pct and has fluctuated between 4.87 and 8.24 pct since 2007. Given the historical returns with large losses, the aid is non-existent in most cases, but could be higher on high returns[8]. In some expected outcomes for the existing regional funds, the loan structure means that the investors will receive nothing while the principal sum of the state's loans is repaid at fund termination. If the present funds should perform as good as buy-out funds traditionally have done, the aid in the operational funds is unquestionably higher than in the new funds. In total the schemes are on average at the about the same aid levels, but the schemes produces different outcomes. The report *"The need for government supported capital measures in the market for early stage risk capital in Norway"* labels the risk relief in the present seed capital schemes *"highly moderate"*.

The aid level in the new scheme is more independent of the outcome, and the structure is more symmetric, securing a more even distribution of returns. This aligns the interests of both the state and the private investors to a higher degree, giving the best approach to secure profit-driven and commercial funds at all outcomes.

The terms of the new seed scheme are structurally closer to industry best practice, but with less direct state aid. Thus, we have reason to believe that the terms presented here are fairly close to necessary and acceptable for investors and thus in line with the proportionality criterion.

4.3 Results of the previous Norwegian seed capital schemes

The financial results of the first generation seed funds are to a large extent known, and the results are generally poor. In practice, three of the six funds have gone bankrupt, and from one of the funds we only expect the principal sum of the loan returned. The private investors have fared worse because of the capital structure in some funds, which means that the state will be repaid first if large losses occur. Of 175 invested companies only six investments have shown more than 100 pct. return on investments. There are

[6] See table 2 in the notification.
[7] This interest rate level applies to the nationwide seed capital scheme. The other schemes have different risk premiums, ranging from 0,5 pct. to 3 pct.
[8] A detailed comparison is provided in the spread sheet "Comparison of Outcome New and Old Scheme – Calculations and Assumptions". The assumptions in the spread sheet is somwehat differing from the assumptions presented here, but still showing the same overall picture.

still investments in the portfolio, but we do not expect these investments to contribute significantly to improving the results.

The second generation of seed funds has after six years seen better preliminary results compared to the first generation. Investments have been made in 124 companies as of first half 2012. There have so far been 19 exits of which five have generated a positive return to the funds. Furthermore, a comparison of the differences in the two operational generations shows that there are relatively fewer losses and more successes in the second generation after six years of operation. We thus have reason to believe that we are on the right track with the scheme model. However, there is still room for improvement as detailed in this notification.

Innovation Norway's seed fund report for first half 2012 is enclosed and details the results of the first two generations. This report also includes the mentioned comparison of actual results.

5. FINANCE GAP

Measuring the finance gap is not an exact science. On page 57 (figure 35) in the Menon report it is indicated that the finance gap is between EUR 0.1 and 1.7 million for initial investments. Figure 26 (on page 48) indicates that the finance gap is below EUR 1 million, as this is where the main bulk of seed investments were made in the period 2007-2010, and that the Norwegian Venture Capital & Private Equity Association activity report for 1. half 2012[9] shows that there are very limited seed investments presently.

In the OECD-report *"Financing high-growth firms: The role of angel investors"*[10], the equity gap is estimated to be in USD 500 000 to 3 million range. To safeguard that initial investments are made where the finance gap is found, we will limit the first round of finance to up EUR 1.5 million in each enterprise. Furthermore, the enterprises must be small and younger than five years from incorporation. Typically, the target enterprises will be micro-enterprises.

6. PRIVATE PARTICIPATION AND INVESTORS

The investors in the previous round of seed capital funds were in the notification specified as: *"An important aim of the scheme is to attract the competence of (former) entrepreneurs/business angels in establishing new companies. Individuals or companies deemed to possess these competences will therefore be given first priority to invest. Second priority will be given to all other privately or publicly held companies. Included in this*

[9] http://menon.no/upload/2012/09/04/activity_report_h1_2012_-__private_equity_funds_in_norway__seed__venture__buy_out..pdf
[10] http://www.oecdbookshop.org/oecd/display.asp?sf1=identifiers&st1=9789264118782

group are also state-, county- or municipality-owned companies, which run their businesses on a commercial basis."

6.1 The Norwegian commercial enterprises' ownership structure

The table below shows the stock of unquoted shares in Norway over a time period of six years in the second quarter. This shows that the owners of unquoted stocks in Norway are frequently publicly owned and that this has been consistent over time. The investors/enterprise are counted as publicly owned if public institutions own more than 50 pct. of the investors/enterprises, which generally gives the right of control and consolidation of the company. The statistics thus includes Statoil ASA, but not DNB ASA. This structure is also shown in the enclosed excerpt from the White Paper on Ownership from 2011, showing the public owning about 35 pct. of the equity on the Oslo Stock Exchange and 33 pct. of the market value of all Norwegian businesses.

	2006Q2	2007Q2	2008Q2	2009Q2	2010Q2	2011Q2	2012Q2
	Stock	Stock	Stock	Stock	Stock	Stock	Stock
Publicly owned non-financial enterprises	254 900	312 283	387 537	450 983	502 463	511 906	543 551
Privatly owned non-financial enterprises	439 825	615 118	621 010	639 478	676 586	757 185	720 055
Banks	19 650	24 553	32 405	36 179	56 810	67 358	82 149

Table 6.1 Stocks of unquoted shares – source: Statistics Norway

A main reason for the importance of publicly owned enterprises is the Norwegian policy to secure public ownership in natural resources, especially sectors such as hydropower and petroleum. In the hydropower sector, the Norwegian legislation lays down the principle of public ownership to hydropower resources and prescribes that only Norwegian public bodies or undertakings owned directly or indirectly by such public bodies can obtain concession for acquiring ownership to waterfalls above the concession limit. There is competition between electric suppliers/producers as the grid to transport the electricity is open. The electric suppliers/producers therefore act on commercial terms. In the petroleum sector, Statoil ASA has majority state ownership, but is listed on stock exchange both in Norway and New York and must comply with their rules.

In other countries the ownership of these sectors could be private. We therefore see no reason to discriminate enterprises in these sectors or any other publicly owned and commercially operating (according to the Market Economy Investor Principle) enterprises from investing in the schemes, just because of ownership.

6.2 Investors in present funds

The actual investors in the nationwide funds from the second generation is listed in the enclosed table *"Investor overview – present nationwide funds"*, and range from private equity funds and business angels to fully publicly owned electric utilities like BKK AS and Statkraft AS. Statoil ASA is the biggest investor in the present nationwide scheme. Of the about NOK 683 million invested in the four nationwide seed funds established from 2006, about NOK 200 million is from partly state-owned enterprises listed on the

Oslo Stock Exchange. Further, about NOK 100 million are from fully publicly owned enterprises, operating commercially. This means brings the total investment capital from wholly or partly publicly owned investors to about NOK 300 million, and roughly reflects the ownership structure shown above. This participation has been necessary to establish the funds. To prove the commercial basis of a company like BKK AS (which also is the largest fully publicly owned investor in the present funds) we have provided this excerpt from their strategy[11]:

"BKK shall be run on sound business principles with emphasis on long-term value creation for the owners. BKK is one of the leading companies in Western Norway and in the Norwegian power sector. By realizing the Group's vision, "We provide new opportunities for tomorrow", we will show that BKK is a "prime mover". Our main financial goal is to achieve a return over time of 7 per cent based on the market value of the company's equity."

6.3 Raising capital for the new funds

Investors were hard to attract in the previous round, and one of the regional funds, was not established because of lack of investor interest. This time we need to raise NOK 1.5 billion – more than double the amount raised for the present nationwide scheme, and more than NOK 400 million more than was raised for both the schemes in the second generation. Banks will be less likely to participate this time because of the ongoing financial crises, and new regulations particularly linked to new capital requirements (Basel III).

To secure that financing is from investors with a strictly commercial purpose, the selection of investors for the new scheme will be based on the following elements:

- A general invitation to investors to participate in the scheme. As the investors principally are unknown, it is difficult to provide an ex ante description of all potential publicly owned investors as was done in the Saxony case.
- Preference will be given to entirely private investors. These include:
  - Business angels
  - Family businesses
  - Private companies
  - European Investment Fund
- Second priority will be given to partly publicly owned investors listed on stock exchanges.
- Third priority will be given to partly publicly owned investors not listed on stock exchanges operating commercially.
- Fourth priority will be given to fully publicly owned investors operating commercially according to their strategy and have more than one (public) owner, such as BKK AS. The criterion for more than one owner is established because this means that any departure from the official strategy would be harder

[11] http://rapport.bkk.no/engasjementverdiskaping2011/arsrapport/aarsberetning/strategi/

to implement. An exception to this rule is companies owned entirely by the state, and that must comply with the state ownership policies for commercial enterprises (ref. White Paper on State Ownership) such as Statkraft, as these companies are open to scrutiny by the Parliament.

- All investors will have to be approved by Innovation Norway.

Based on Commission and Authority practice, we consider that there is no obligation to introduce a general exclusion of commercially run publicly owned investors. The expanded private investor definition that was used in the previous round of Norwegian seed capital funds is in line with the decision on the Saxony Early Stage Fund. Alternatively, the scheme could be approved as a scheme with more than 50 pct. state participation, in accordance with RCG 5.1.d, as we have shown the difficulties of finding strictly private investors. If a strict definition is applied and there is no approval under RCG 5.1.d, the New Norwegian funds will not be fully financed, and risk not being established.

7. FOLLOW-ON AND TOTAL INVESTMENTS

In the new scheme the 15 pct. investment limit means that largest investments are NOK 75 million, given funds of NOK 500 million total. 15 pct. equals NOK 52.5 million given the minimum possible fund size of NOK 350 million. About NOK 35 million is the maximum for the present nationwide funds, and NOK 27 million for the largest regional fund. The increase in amount is both due to increased fund size and the proposed increase in investment limit from 10 to 15 pct. There are no requirements regarding size, age or stage of investee companies for the follow-on investments, as opposed to for the initial investment. The funds need this flexibility to operate commercially.

When examining the first half 2012 report for the second generation funds on this issue, we find that six out of about 65 investments in all from the national scheme are above NOK 20 million and two of those are above NOK 28 million – or about 8 pct. of the capital under management. Five of the investments from the regional funds are above NOK 20 million, of which three are close to their respective limits.

As of 2012 the nationwide funds have reached the end of their active investment period. This means that they primarily do follow-on investments and execute exits for the remainder of their lifetime. The funds haven't yet reached their investment limits. This is not to be expected as the funds have eight years or more left of their stipulated 15 year lifetime, and adapt to the restrictions they are subject to. They need to keep reserves in case of added capital needs in investee enterprises, and as a safeguard against the danger of undue dilution. The 10 pct. limit accepted in 2006, is in our opinion not sufficient to attract private capital to the new scheme.

Ordinary market based funds do not normally have explicit limits regarding investment level in single enterprises, but they need a diversified portfolio to spread risk. The present 10 pct. limit reflects what was possible to achieve under the former Risk Capital Guidelines, but not the most preferred alternative. According to Argentum Fondsinvesteringer AS – the Norwegian fund-of-funds investor – the 12 venture funds in their portfolio have average largest investments in their portfolio of 18.17 pct. of the capital invested as shown in table 8 below:

Table 8 – Argentum - average largest investments in pct.[12]

Argentum VC-portfolio	Share of largest investment as percentage of capital invested
Fund 1	12.88
Fund 2	14.78
Fund 3	18.74
Fund 4	17.36
Fund 5	22.65
Fund 6	11.28
Fund 7	15.44
Fund 8	16.21
Fund 9	30.78
Fund 10	20.43
Fund 11	19.87
Fund 12	17.59
Median	17.48
Average	18.17

The funds listed have an average size of about NOK 640 million, while the largest has NOK 1 340 million under management. The figures show percentage of invested capital, because only a few of the funds listed are fully invested. The percentages as share of capital under management are likely to slightly decrease when the funds are fully invested, estimated as to be on average 13-14 pct.

Furthermore, Argentum Fondsinvesteringer AS claims that seed funds need more flexibility to take higher relative stakes in single invested companies to avoid dilution, because they are generally smaller and invests earlier than VC-funds. The need for a 15 pct. limit is also underlined in the two enclosed e-mails received from managers in the New Norwegian funds.

We would therefore principally argue that there should be no percentage limits, alternatively that 15 pct. should be the limit. The 15 pct. limit would in practice be in line with the proposal for an overall investment cap in the new General Block Exemption Regulation (GBER) of EUR 10-15 million in the issues paper from DG Competition "*Revision of the State aid rules for SME access to risk finance*" dated 22nd November 2012. If such a cap is introduced in the new GBER, we intend to use it for the new funds.

[12] The list is randomised, but the funds in question are Creandum II, Energy Ventures, Energy Ventures II, Energy Ventures III, Neomed Innovation III, Neomed Innovation IV, Nexit Infocom II, Northzone IV, Northzone V, Teknoinvest VIII, Viking Venture II og Viking Venture III.

8. CROWDING OUT

The formal supply of seed capital in Norway consists mainly (90 pct.) of State supported schemes[13], as there is a general lack of capital in this phase. The main safeguards against crowding-out are the requirements for minimum 50 pct. private participation and the ownership limit in investee companies. Furthermore the Menon-report points out that *"several private investment managers stress the importance of government-backed funds as co-investors"*. However, to reduce the risk of possible crowding out, business angels will be given preference to invest in the scheme.

9. TARGET COMPANIES

The long term objective of the scheme is to contribute to growth and the establishment of knowledge intensive workplaces in Norway. Startups normally have very limited activities abroad. Target enterprises must thus be located in Norway. However, there is no requirement that the owners of the target enterprises are Norwegian or reside in Norway. Spinoffs from foreign multinationals or other foreign owned projects in Norway may thus be financed, on equal terms with Norwegian owned projects. Furthermore, as there are few restrictions on how the equity finance provided through the funds may be used, the capital may be used to finance expansion abroad.

10. SEED CAPITAL FRAMEWORK AGREEMENT

Innovation Norway has during the fall had talks and discussions with some of the core investors in the second generation of seed capital funds, with potential investors in the new scheme throughout the country and with other stakeholders who have experience with investments in early stage and the behavior of potential investors who may invest private capital in the new scheme. The aim of these talks and discussions has been to negotiate the detailed terms of a framework agreement for the new funds, and to have potential stakeholders accept the terms. The resulting draft for the Seed Capital Funds Framework Agreement is enclosed, but we will highlight two important elements of the agreement:

- The minimum size of the funds is established at NOK 350 million, as this is the limit for the first closing (point 2.1 of the Framework Agreement). The reason why is that we expect challenges raising private capital and that this size is sufficient to ensure robust and professional management of the funds.
- Minimum investments in the funds are NOK 2.5 million (point 1.5 of the Framework Agreement). The reason for the minimum requirement is that we want to attract competent investors who are willing to invest time and competence in addition to capital because they have a large stake.

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[13] MENON-publikasjon nr. 5/2009 Veksthus eller såkorn til spille, page 37.

The Ministry will work to complete the Seed Capital Funds Framework Agreement. If substantial changes are made, we will send you the final agreement.

11. TENDER PROCEDURE – FUND MANAGEMENT SELECTION

The Ministry and Innovation Norway want the best and most competent managers to manage the new funds to ensure the highest possible level of wealth and job creation, as well as a financially successful outcome. The most important criteria for selecting management are track record, competence, network and possibility to attract investors. Price (management and success fees) will also be included in the criteria and should be market based. Price details will be left to final negotiations for each fund as investors will be invited after fund managers are selected. The criteria and evaluation process are undergoing updates based on industry best practice. The fund's management must be located in Norway.

The tender for management will be published in national and European newspapers and on Innovation Norway's homepage. The closing date for application will be 6-8 weeks to ensure sufficient time for interested parties to apply, but also ensure progress. In order to ensure free and fair competition for management, alternatives may not receive any kind of public funding. We believe this will contribute to preventing complaints. However, it must be admitted that many of the present managers of the operational funds will have a good starting point based on their experience and track record, and the low number of experienced seed fund managers in Norway.

12. CHANGES FROM THE REVISED PRE-NOTIFICATION

The notification has the following major changes from the revised pre-notification of 2nd November 2012:

- Management fee/price is included as a criterion for the selection of managers;
- The age criterion for target companies is reduced from six to five years

13. DATA AND REPORTS SUBMITTED

Enclosed with this letter:

- The Notification
- Seed Capital Funds Framework Agreement – draft
- Excerpt of White Paper on Active Ownership
- Comparison of Outcome New and Old Scheme – Calculations and Assumptions
- Investor overview – present nationwide funds
- Halvårsrapport Såkornfondordningen 1H 2012
- Two e-mails from potential managers of the scheme, especially regarding investment limits of 15 pct.

Previously submitted

- The report *"The need for government supported capital in the market for early stage risk capital in Norway"* which was presented to the Ministry n November 2011 and purchased through a tender procedure. The basis for the report was the requirements of point 5.2 and point 5.3 of the Risk Capital Guidelines.
- A letter fr*om the Norwegian Venture Capital & Private Equity Association regarding industry standards for follow-on investme*nts, dated 8th October 2012.

14. CONCLUSION

The notification of the new National Seed Capital Scheme is hereby submitted. We believe that the elements of the scheme presented are necessary to attract private capital and create first class funds with first class results. The Norwegian authorities would be pleased to provide any further information the EFTA Surveillance Authority may require regarding the scheme.

Yours sincerely,

Bjørn Kåre Molvik
Deputy Director General

Karl G. Johannesen
Senior Adviser

This document has been signed electronically and therefore it is not signed by hand

1 Introduction

In the White Paper on State Ownership[1], launched on 1 April 2011, the Government wrote that it will propose new seed capital funds with national coverage. In the White Paper on Innovation Norway and SIVA,[2] the Government gave the overall design of the scheme, and the details were presented in the Revised National Budget 2012[3]. The total budget allocation to seed capital through the scheme is up to a maximum of NOK 1.5 billion in investment capital, through up to six national seed funds. In the Revised National Budget 2012, NOK 500 million in investment capital for the two first funds was allocated. The new seed capital funds will in our opinion need approval under the Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium-Sized Enterprises (hereinafter the RCG).

2 Justification and evidence of market failure

2.1 Study of the early-stage risk capital market

The Norwegian Ministry of Trade and Industry (hereinafter the Ministry) ordered a report on the Norwegian early stage risk capital market in 2011, which was delivered on 7 November 2011. The report *"The need for government supported capital measures in the market for early stage risk capital in Norway"* [4] concludes that *"…the supply of seed stage capital in Norway is now severely low"*. An important reason for the low supply is found in the table below which shows the annual pooled IRR (internal rate of return) over different time intervals:

Fase	3 years	5 years	10 years	20 years
Seed	2.3	-4.7	-1.1	0
Start-up and later stage	6.9	1.2	7.1	8.5
All venture	4.4	0.9	1.8	4.6
Buyout	21.9	15.9	16.6	16.2
All Private Equity	17.1	11.5	11.5	11.9

Source EVCA Thomson 2008 (in the Menon report)
Table 2 – IRR from all private equity

Although the figures are from 2008, we have little reason to believe the situation has improved over the years with the still ongoing financial crisis. The claim to low supply is supported in the evaluation of the present Norwegian seed capital schemes from 2009, where it is stated that *"there is ample reason to claim that there is a lack competent*

[1] Meld. St. 13 (2010-2011) Aktivt eierskap – norsk statlig eierskap i en global økonomi.
[2] Meld. St. 22 (2011-2012) Verktøy for vekst – om Innovasjon Norge og SIVA SF, page 126.
[3] Prop. 111 S (2011-2012) Tilleggsbevilgninger og omprioriteringer i statsbudsjettet 2012, page 67.
[4] MENON-publication no. 18/2011, page 3.

seed capital in Norway"[5]. The activity report from the Norwegian Venture Capital & Private Equity Association for the first half of 2012 underlines this picture.[6]

3 The features of the new scheme

3.1 Aim of the scheme

The aim of the scheme is to support and help small Norwegian-based innovative young enterprises with a high-growth and international potential in the seed and start-up phases to grow by providing competence and capital. The funds in the scheme aim at making a sound financial return. The definitions of seed and start-up in the RCG will apply. The target enterprises must have a potential for profitability. There will be no regional limitations within Norway on where single funds may invest, but enterprises must be Norwegian based. There are no restrictions regarding nationality of ownership in target enterprises.

3.2 Aid at different levels

The scheme will support private investors in order to make it commercially interesting for them to invest in the seed and start-up phases, by providing better returns to them than they would have achieved without aid. The Ministry accepts that this also indirectly is aid to the target enterprises, although all investments in target enterprises must be made *pari-passu* with private investors.

There is no aid to management as they will be selected through an open tender procedure and because their remuneration (management fees and profit-sharing based on performance) will be based on market standards and the proposals from the tender procedure.

3.3 Fund sizes and numbers

In order to secure economies of scale, a stable management and a sufficiently diversified portfolio of target companies, the funds will have about NOK 500 million under management. Minimum size will be NOK 350 million (which is the limit for the first closing of the funds, ref. Seed Capital Funds Framework Agreement, point 2.1). In comparison, the largest of today's funds has about NOK 340 million under management. Up to six funds located throughout Norway will be established in order for the funds to have a wide sectoral and geographical coverage.

3.4 Form of State participation and aid

- The State will participate with equity in new funds up to maximum 50 pct. of the total capital in the fund.
- 15 pct. of the State's involvement is intended to be as a support element. In the previous round of seed capital funds, the support element was in the form of a loss-

[5] MENON-publication no. 5/2009 Veksthus eller såkorn til spille, page vi.

[6] http://nvca.no/userfiles/Activity_report_H1_2012_-__Private_Equity_Funds_in_Norway__Seed__Venture__Buy_Out..pdf

fund for the investors of 25 pct. This time the support element will be in the form of payments through extra shares to the private investors.
- In a case where capital is injected on the basis of a 50/50 split between State and private capital the State will receive a 42.5 pct. ownership in the funds. Private investors may inject more, but never less than 50 pct. of the capital.
- Except for that, the State will take part in the funds *pari-passu* with other investors.
- In total the state will supply the funds with up to NOK 1 275 million as equity and NOK 225 million as aid to investors.

NOK 74.4 million was allocated in the Revised National Budget 2012 to a loss deposit mechanism. The deposit is equivalent to 35 pct. of the state capital injected into the funds less the aid of 15 pct., to make up any losses on the State's equity investment. In total for six funds, this deposit will amount to NOK 446.4 million.

The deposit is meant to show and budget the real effect of the scheme on the national fiscal balance corrected for oil revenues. Since the equity allocation by definition is a capital investment for the Government, the equity allocation alone will not affect the fiscal balance. Showing the effect of financial allocations is desired, when the expected rate of return is lower than the predefined rate of return of the Government pension fund, the technical opportunity cost of the capital[7].

As table 2 shows the historical returns from seed funds are low and frequently negative. If the return is as negative for the 15-year period envisaged for the new seed capital funds, as for the five-year historical return, the total repayment to the state will only be 49 pct. of the invested amount. If the ten-year historical return turns out to be right, then the repayment would be 85 pct. In order to budget correctly for potential negative outcomes, the deposit is necessary, and is set at 35 pct.

This amount will not be available to the market, and does not constitute state aid.

3.5 Private capital

The following conditions will apply for private capital:
- Private investors' participation must be at least 50 pct. of the total capital in each fund. Investors will be invited to participate in the scheme through an open invitation.
- There will be no restrictions regarding foreign investors' participation provided that they are profit-seeking.
- Business angels will be preferred as investors if there is an oversubscription among private investors, as they are believed to possess relevant competence. However, it is likely that business angels to a large degree will act as co-investors in target enterprises as this gives them more control over their investment, and because the minimum requirement of NOK 2.5 million (ref. Seed Capital Funds Framework Agreement, point 1.5) for participation may be too high for some potential investors.

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[7] This is also in accordance with the NOU 2016:16 Samfunnsøkonomisk analyser, chapter 7.

- Maximum stipulated investment from any single investor in any single fund is NOK 125 million or 25 pct. of funds of NOK 500 million.
- The European Investment Fund (EIF) will be allowed participant as a private investor.
- Other investors will be allowed as participants if they are profit-seeking and act according to the Market Economy Investor Principle. This may include State-, county- or municipality-owned enterprises, provided that they do business on a commercial basis. Such investors were allowed as investors in former schemes. Details on selection of investors are found in section 6.3 of the cover letter.

3.6 Maximum level of investment tranches and follow-on investments

Few restrictions on investment tranches and total investments are crucial in securing commercial and profit-driven funds as well as private investors' participation.

The maximum level of each investment tranche will be EUR 2.5 million in any 12-month period, in line with the RCG. However, to secure that actual seed stage projects are supported, the initial investment must be below EUR 1.5 million and made in small companies younger than five years from incorporation. The maximum total investment in any single enterprise, including follow-on investments will however be 15 pct. of each fund's capital under management, even though this is financing beyond the defined capital gap. The percentage is according to industry standards. Restrictions on follow-on investments beyond the financing gap could lead to:

- Low investor participation, and no funds established;
- Investors demanding a higher support element;
- A lower return for the funds;
- Dilution of the seed funds in target enterprises and subsequently to a transfer of support to other investors by picking up the target companies at a favorable price.

In our experience such funds invest in about 15-20 companies. The average total investment in each company will thus be around 5 pct. of the capital under management.

The funds will as part of their reporting obligation need to report on how much is invested in single enterprises as sum of equity and quasi-equity investments, to ensure that the limit is not breached. The Norwegian government does however not envisage any control procedure when investments in single enterprises approaches the 15 pct. limit. We do not possess the competence to assess what the correct investment amounts in single enterprises should be, and leave this for fund bodies formally in charge of investment decisions.

If a cap of EUR 10-15 million on total investments is introduced in the new General Block Exemption Regulation (GBER), that cap will apply from the day the new GBER is valid, as this will leave more room for the funds to operate as commercially as possible (capped 12-month tranches are not necessarily commercially founded).

3.7 Investment phases
The initial investments will be restricted to micro and small enterprises in their seed or start-up phases, pursuant to applicable definitions set by the Authority. However, follow-on investments will be allowed in later stages for the reasons stated above.

3.8 Equity and quasi-equity investments
All investments made by the funds in target enterprises will be in the form of equity or quasi-equity. This could include a variety of instruments, which we would not specify as such instruments tend to evolve over time and the funds should have the flexibility to operate according to industry standards as they develop. The main checkpoint is that the return on investments is based on the profits and losses of the target company, and that the investment is unsecured in the case of default of target companies.

3.9 Sectoral focus
The Ministry will not point out sectors for the funds. However, as specialization is a way of reducing risk, the funds will be allowed to specialize according to their managers' and investors' competence. Firms in difficulty or in the shipbuilding, coal, steel, real estate and financial industries are excluded from receiving investments.

3.10 Profit-driven character of investment decisions
- Private investors will participate with minimum 50 pct. of the capital in each of the funds, and all investment will be made based on a business plan and with profit prospects. The seed funds will therefore under normal circumstances not exceed 49 pct. ownership in target enterprises. This ownership limitation applies for all the seed funds combined.
- An exit-strategy will be made for each single project/enterprise in which the funds invest.

3.11 Commercial management
- Fund managers will be selected on the basis of an open tender procedure to ensure that the best available managers are chosen.
- The managers' remuneration will be market based and linked to performance.
- An advisory committee will be established in relationship to each of the funds.
- Best practices will apply for the management in line with the standards of the Norwegian Venture Capital & Private Equity Association.

3.12 Cumulation of aid
The cumulation rules described in the RCG will be respected. All enterprises invested in will be made aware that they have received risk capital aid through the National Seed Capital Funds. It will be their obligation to notify any other aid providers that they have received aid. In addition, Innovation Norway will establish a register over all companies invested in through the funds to provide a further safeguard. The cumulation restrictions will apply three years from the last capital injection.

There will be no cumulation rules regarding other aid received before the initial first risk investment through the funds. There will be no cumulation restrictions regarding research, development and innovation aid.

3.13 Other features

- Board members will mostly be appointed by private investors. However, Innovation Norway will have the option of appointing minimum one board member on behalf of the state. Competence will be the primary criterion for any appointments by Innovation Norway. Being represented with at least one board member with such high ownership stake is normal corporate governance. The details of the board appointment are part of the Seed Capital Funds Framework Agreement, and in line with national public ownership strategies.
- The duration of the funds is up to 15 years, but could be less, subject to the results of negotiations with investors in each fund.
- The scheme will comply with any new regulations concerning the funds stemming from the implementation of the AIFM-directive (Alternative Investment Fund Managers Directive).

4 Reporting and monitoring

The funds must comply with industry reporting standards and Norwegian law. In addition, annual and bi-annual aggregated reports for the funds will be submitted from Innovation Norway as part of the ordinary reporting procedure between Innovation Norway and the Ministry. These reports will as a minimum contain details on size of tranches, the size of companies invested in, the development stage (of initial investments), sector, deal flow and the management of the funds, in accordance with point 7.2 of the RCG.

The funds will not make investments before the full text of the scheme (except any documents containing trade secrets) is published on Innovation Norway's website, www.innovationnorway.no.