

- ERDF
- EUR 54.1 million
- Equity, loans and microfinance
- SMEs support
- Scotland, United Kingdom

...involving stakeholders closely to draft a first ex-ante assessment...

Ex-ante assessment for financial instruments in Scotland

Case Study



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The authors of this study are a consortium of five companies: Sweco (lead), t33, University of Strathclyde – EPRC, infeurope and Spatial Foresight.

Abbreviations

Abbreviation	Full name
CPR	Common Provisions Regulation ¹
EIB	European Investment Bank
ERDF	European Regional Development Fund
ESIF	European Structural and Investment Funds
OP	Operational Programme
SME	Small and medium-sized enterprise

1 Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).



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1. Summary

Despite a relative easing of bank lending, there remains a notable financing gap for viable small and medium-sized enterprises (SMEs) in Scotland. Many of those affected by the financing gap are exporters or are firms with significant growth potential. This market failure in recent years provides the rationale for Scotland's continued and expanded use of ERDF-funded financial instruments. The drafting of the ex-ante assessment took place between September 2014 and January 2015 and was led by the Scottish Government's European Structural Funds Division in their role as managing authority. It was based on widespread consultation with relevant stakeholders and made extensive use of interviews, written sources and statistics.

This case study outlines how the ex-ante assessment for financial instruments under the 2014-2020 Scotland ERDF OP was drafted. An ex-ante assessment is not only a regulatory requirement but offers the sound evidence base for a managing authority's decision-making in the design and implementation of financial instruments, providing inter alia an assessment of market performance and a rationale for intervention.

This ex-ante assessment benefited from the preparation of a detailed plan at the outset and from extensive consultation with stakeholders. The consultation then formed part of the assessment's foundation and allowed the drafters to draw upon the expertise of stakeholders who facilitated open access to sources and assisted in drafting.

The ex-ante assessment of financial instruments to be supported under the Scottish ERDF OP demonstrates the difficulties of determining the exact nature and scale of the SME funding gap and identifies the need for flexible investment strategies. It recommends a regional fund of funds model, with a separate block of ERDF funding allocated to a dedicated SME fund of funds², which would invest directly in a small number of loan and equity funds. The proposed model for implementation of financial instruments is for an initial period of three years, allowing for an extensive mid-term review to ensure it achieves its objectives.

2 'SME holding fund' is the title used in Scotland's ex-ante assessment. However, to avoid confusion with previous programme terminology, it is referred to throughout as 'SME fund of funds'.

Ex-ante assessment for financial instruments in Scotland, United Kingdom, 2014-2020

PROPOSED FINANCIAL INSTRUMENTS³

Funding source

ERDF, Scotland ERDF OP 2014-2020

Type of Financial instrument

Equity, loans and microfinance

Financial size

EUR 54.1 million total (GBP 40 million) ERDF with additional public and private resources to be leveraged in. Further ERDF contributions top-up will be considered in 2018.

Thematic focus

SME support, with a particular focus on SMEs which can have a disproportionate impact on the Scottish economy, namely exporters and those with significant growth potential

THE EX-ANTE ASSESSMENT

Players involved in the ex-ante assessment

European Structural Funds Division, Scottish Government (managing authority)

Timing of the ex-ante assessment

September 2014 to January 2015⁴

Main results of the ex-ante assessment

A single regional fund of funds was proposed to support viable SMEs who were identified as encountering difficulties in accessing finance.

Scotland's previous experience of using ERDF-funded financial instruments proved vital in the development of the ex-ante assessment and will play a key role in the design and set-up of future financial instruments.

Potential financial instruments in the areas of broadband provision and low carbon and energy efficiency were explored but considered unsuitable at this time, and will be revisited as part of the mid-term review.

Exchange rate: EUR 1 = approx. GBP 0.7387

Ex-ante assessment definition

According to Article 37 of the Common Provisions Regulation, the support of financial instruments shall be based on an ex-ante assessment which has established evidence of market failures or suboptimal investment situations and the estimated level and scope of public investment needs, including types of financial instruments to be supported. According to the Common Provisions Regulation ESI Funds can be used to support financial instruments under one or more programmes, to contribute to different specific objectives under a priority (Article 37). The ex-ante assessment must be completed before the managing authority makes programme contributions to a financial instrument.

The ex-ante assessment must not be confused with an ex-ante evaluation of the OP.

³ 'Ex-ante assessment of financial instruments, European Regional Development Fund 2014-2020', Scottish Government, January 2015, available at <http://www.gov.scot/Resource/0047/00470051.pdf> (as accessed 30/09/2015).

⁴ With stakeholder consultation taking place between June and September 2014.



2. Design and set-up of the ex-ante assessment

In Scotland, ERDF-supported financial instruments already play a key role in improving SME access to finance and, for the 2007-2013 programming period, they provided essential support in adverse credit conditions. The Scottish Co-Investment Fund and Scottish Local Authority Loan Funds are examples of successful financial instruments using ERDF. Nevertheless, the 2012-2013 'Risk Capital Market in Scotland'⁵ report identified a GBP 35 million (EUR 47 million) funding gap in the early stage risk capital market, while the Scottish Government's latest Small Business Survey⁶ found that 55 per cent of Scottish SMEs who applied for finance were unable to obtain bank loan finance. Therefore, the use of financial instruments was proposed in order to address the market failures identified in the ex-ante assessment with the aforementioned studies being constitute a key element of the 2014-2020 ERDF OP, utilising Scotland's existing experience targeting early stage innovative SMEs.

2.1 Objectives of the ex-ante assessment

The overall objective of the ex-ante assessment was to provide a foundation for evidence-based decision making when designing and implementing financial instruments, and illustrating how the proposed instrument would address the identified market failures and suboptimal investment situations. The assessment sought inter alia to capture expertise and experience in the delivery of financial instruments, and ensure that any future financial instruments complemented national measures to promote SME access to finance.

The ex-ante assessment focused on analysing other forms of public financial support to SMEs in Scotland, seeking to avoid any conflicts or duplications with existing instruments. This consideration of current measures is essential to ensuring that any recommended financial instruments do not compete with public sector initiatives or 'crowd out' private sector finance solutions and investment. This approach provides an opportunity to enhance the scale of private sector activity and do so under the same market conditions, ensuring wider public value.

2.2 Consistency with the Operational Programme

The 2014-2020 ERDF Scotland OP outlines support for potential financial instruments under Thematic Objectives 1 to 4 and 6⁷, subject to the satisfactory results of the ex-ante assessment. As part of the development of the OP, early scoping work was conducted into the potential use of financial instruments. This set clear parameters for the ex-ante assessment by indicating the relevant areas where the possibility should be investigated and helped ensure that any resulting financial instruments would be coherent with the objectives of the OP. Moreover, this process established early contact between the managing authority and other institutional partners, providing the foundations for close collaboration throughout the implementation stage.

5 The Risk Capital Market in Scotland 2012 – 2013, Young Company Finance for Scottish Enterprise, December 2014.

6 Small Business Survey Scotland 2012, Office of the Chief Economic Advisor, Scottish Government, March 2013.

7 Thematic Objective 1 'Strengthening research, technological development and innovation', Thematic Objective 2 'Enhancing access to, and use and quality of, information and communication technologies, Thematic Objective 3 'Promotion of competitiveness in small and medium-sized enterprises', Thematic Objective 4 'Supporting the shift towards a low carbon economy in all sectors' and Thematic Objective 6 'Preserving and protecting the environment and promoting resource efficiency'.



2.3 First steps of the ex-ante assessment

Early scoping work was carried out as part of the development of the OP. This involved extensive consultation with relevant stakeholders previously involved in the delivery of financial instruments. It was conducted in June 2014 through the circulation of a detailed survey and the organisation of a series of workshops. Stakeholders consulted included both public and private financial intermediaries and final recipients, with the aim of understanding their previous experience in using ERDF financial instruments and how this could be improved. This consultation marked the initial step for the ex-ante assessment and, following an evaluation of the available resources and expertise, it was decided that the managing authority would be well-placed to produce it. A dedicated, multi-disciplinary drafting team was established in September 2014. It included two civil servants with experience in the implementation of ESI Funds and project evaluation. Through the stakeholder engagement process, a fund manager from Scotland's economic development agency, Scottish Enterprise, agreed to join the team while economists from the Scottish Government provided support in the collecting, analysing and processing of data. A target completion date of January 2015 was set to enable any recommended financial instruments to be set up as early as possible in the programming period.

Once set up, the first step taken by the drafting team was consultation with the European Commission to ensure clear understanding of the requirements of the ex-ante assessment. This was followed by attendance at European Commission-EIB organised methodological workshops. With this advice and support, the team laid out a research framework which built upon the stakeholder consultation, conducting a review of existing literature and including a study of best practice of financial instruments which had been launched elsewhere, both those funded domestically and ESI funds. This was supplemented with statistical information provided by Scottish Government economists and combined to provide a balanced view of conditions in Scotland.



3. The ex-ante assessment study

In early autumn 2014, the managing authority's team began drafting the ex-ante assessment. Its objective was to determine market failures in SME access to finance, low carbon and energy efficiency, broadband and resource efficiency markets and recommend, if and where suitable, a financial instrument to address the market gap. The focus of this case study is on the SME access to finance dimension as the other areas outlined were found to be unfeasible to progress at present. The managing authority encountered difficulties in ascertaining the exact nature and scale of market failures for low carbon and energy and resource efficiency. There was a perceived lack of appetite for repayable methods, with an enduring preference for grants and concerns of being unable to attract sufficient private investment. A further detailed assessment is to be carried out in 2017 to determine the exact funding needs for such projects with the hope of launching a financial instrument afterwards. For broadband provision, despite a clear market failure being identified, the analysis indicated that a financial instrument would not be suitable at that stage due to a lack of private investment in Scotland's rural areas and that it would be better supported through grants.

3.1 Market assessment part

Article 37(2)(a)

Market failure, suboptimal investment situations and investment needs

- Market failure in Scotland's early-stage risk capital market.
- Particular failure for exporting and growth SMEs, with higher rejection rates.
- Scottish SMEs encounter greater difficulties than SMEs in the rest of the UK.
- Existence of a 'confidence gap' with many SMEs discouraged from applying.
- Adverse effect from changes in bank regulatory conditions.

1

In addition to analysing the sector specific markets of broadband and low carbon energy solutions, the ex-ante assessment sought to assess market failures in SME financing. It examined three market segments separately, based on areas where financial instruments had been used and those highlighted in the consultation with stakeholders. These segments were defined as:

- debt finance (EUR 27 000 – 135 000);
- microfinance (EUR 0 – 33 000); and
- equity.

The methodology to determine the market failures in each segment was developed by making extensive use of the *fi-compass* ex-ante methodology guidance. This provided a clear

structure through which to carry out the market assessment and ensured it covered all aspects laid out in the CPR, addressing each in a logical manner.

While the surveys carried out at the planning stage formed the initial evidence base, this study drew heavily on a number of published reports. For over 10 years, the Scottish Investment Bank⁸ has annually published detailed analyses of Scotland's risk capital market, which proved vital to determining market failures for early stage risk capital. Moreover, the ex-ante assessment used a number of national and EU-level studies, from the European Commission, EIB and the British Business Bank. Data on SME financing conditions compiled by Scottish Government economists allowed the ex-ante drafters to focus on the scale and nature of market failures.

⁸ The Scottish Investment Bank (SIB) is a wholly public-owned investment vehicle, which aims to stimulate the SME funding market in Scotland. SIB does this by investing in SMEs, offering SMEs financial readiness support and working with investors from all around the world.

The ex-ante assessment found that, despite many SMEs being able to obtain finance, a number of **market failures and suboptimal investment situations exist** in Scotland. It showed:

Market failure in the early-stage risk capital market: The gap in the Scottish early-stage equity market was quantified at GBP 35 million (EUR 43 million) annually, with a number of viable and innovative SMEs failing to obtain finance.

Particular failure in financing SMEs with growth and/or export potential: The study showed that export and growth firms have different financing requirements and have the highest rates of rejection from private lenders. The growth of these SMEs is considered to have the potential to make a significant impact on the Scottish economy.



Difference in SME financing throughout the UK: A UK-wide survey⁹ indicated that Scottish SMEs encountered greater difficulties in accessing finance than SMEs elsewhere. The most common reasons for Scottish SMEs struggling to obtain necessary finance was not meeting the lender's criteria and having insufficient collateral.

Existence of a 'confidence gap': Despite credit conditions improving, many SMEs in Scotland are discouraged from applying for bank finance as they believe they will be rejected, indicating failures on the demand side as well as the supply side.

Adverse effect from changes in bank regulatory conditions: Tighter lending conditions have resulted from changes in UK banking regulations, meaning that many firms with viable business plans but no collateral have struggled to obtain finance.

The expected level of **additional resources** has been largely based on the managing authority's experience with ERDF financial instruments in the past and through consultation with private sector actors. The additional resources will be raised at the level of each fund, with differing

9 Small Business Survey: SME Employers, Department of Business, Innovation and Skills, HM Government, March 2013.



leverage ratios for each. It is anticipated that this will be achieved through a combination of public and private resources.

Article 37(2)(d)

Lessons learned

- Importance of existing expertise and relationships with intermediaries – essential to build on this.
- Combine FIs to increase scale and achieve critical mass.
- Need for more effective and timely monitoring and evaluation arrangements.
- Importance of business angels in funding landscape.

4

In developing the proposed investment strategy, a number of **lessons learned** were identified from the 2007-2013 period.

Firstly, the importance of existing expertise was acknowledged. Scotland has significant experience in the delivery of financial instruments and these relationships, particularly with the private sector, will form a key element of the implementation of such instruments in the future.

Secondly, the need to combine financial instruments to increase scale and achieve critical mass was identified. Greater economies of scale can be achieved by combining instruments allowing for a Scotland-wide fund which enables uniform coverage and improved governance.

Thirdly, effective monitoring and evaluation arrangements must be in place. Monitoring and evaluation activities should align with key programming dates (for reviews, reports etc.) to ensure that sufficient performance data are available to allow for effective amendments to the investment strategy, if required.

Lastly, experience demonstrated the importance of business angels in the funding landscape. The study highlighted the essential role business angels and business angel syndicates are playing in Scotland and how their activities require further support.

3.2 Delivery and management of the proposed financial instrument(s)

Article 37(2)(e)

Proposed investment strategy

- Establishment of a Scotland-wide EUR 55 million fund of funds.
- Individual funds in equity, loans and microfinance.
- Investments made on a pari-passu basis.

5

The ex-ante assessment recommends a **regional fund of funds model**. This was considered the most effective solution following a SWOT analysis of its suitability to address the problems identified. The fund of funds offers flexibility to address the differing gaps in Scotland across microfinance, mid-size loans and early stage equity. It was considered to be of sufficient size to achieve critical mass, building on the lessons learnt from the previous period to scale up future financial instruments. Also, the regional model will enable Scotland to continue to build on its expertise in the delivery of financial instruments. According to the

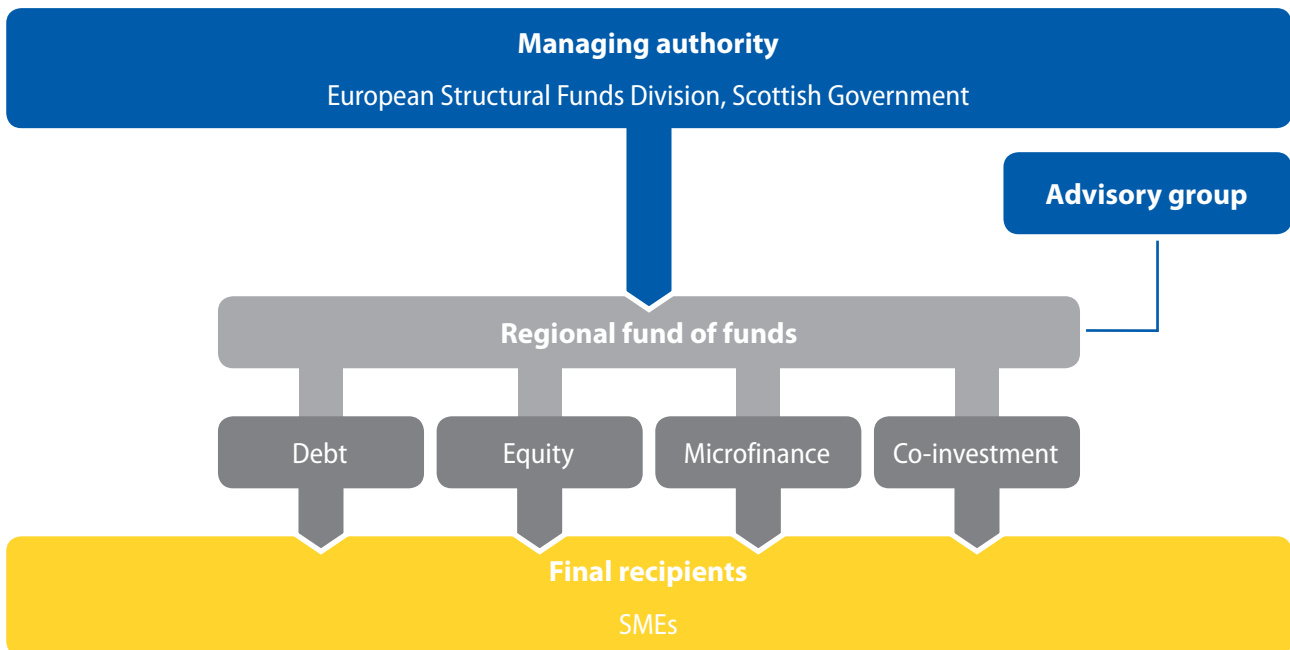
ex-ante assessment, the proposed financial instrument would contribute to the activities under Thematic Objective 1: 'Strengthening research, technological development and innovation' and Thematic Objective 3: 'Promotion of competitiveness in small and medium-sized enterprises'.¹⁰ The ex-ante assessments recommends the fund of funds to invest directly in equity and loan funds, as illustrated in **Figure 1**, with each fund providing SME support at various scales.

The SME fund of funds will be initially capitalised with GBP 40 million (**EUR 54.1 million**) until the end of 2018. The breakdown between funds is as follows:

- **Risk Capital:** GBP 25 million (EUR 33.8 million) has been allocated for equity funds investing in deals of up to EUR 2.7 million with most deals anticipated at early stage.
- **Loans:** GBP 12 million (EUR 16.2 million) has been allocated for debt funds focusing on loans in the range EUR 27 000 – EUR 135 000.
- **Microfinance:** GBP 3 million (EUR 4.1 million) has been allocated for further loan funds primarily focused on microfinance, under EUR 33 000.

With regard to **State aid**, the proposed investment strategy outlines how investments will be made on a *pari-passu* basis and thereby not providing any aid to investors or, fund managers. This significantly reduces the administrative burden for the financial instrument manager.

Figure 1: Governance structure



The ex-ante outlined the need for the fund of funds to be delivered by an experienced investment team with expertise in the delivery of financial instruments and the management of ESI Funds. This team is part of Scottish Government but separate from the managing authority and was entrusted with implementing the fund of funds. The team's suitability was appraised by an expert panel chosen by the managing authority and drawn from a variety of key stakeholders.

¹⁰ At the time the ex-ante assessment was being produced, it was envisaged that only Thematic Objective 3 would contribute to the fund of funds. However, some time after the ex-ante assessment was completed, it was decided that funding under Thematic Objective 1 would also make up part of the GBP 40 million (EUR 54.1 million).



The fund of funds team acts as fund manager, selecting managers for the specific funds through an open public procurement procedure, supported by an advisory group made up of public and private sector financial instrument experts. The fund of funds manager will report directly to the managing authority and be responsible for monitoring and reporting performance in line with CPR requirements and the OP objectives and indicators.

As stated, the **additional resources** will be leveraged at the level of the specific funds with varying rates of leverage expected.

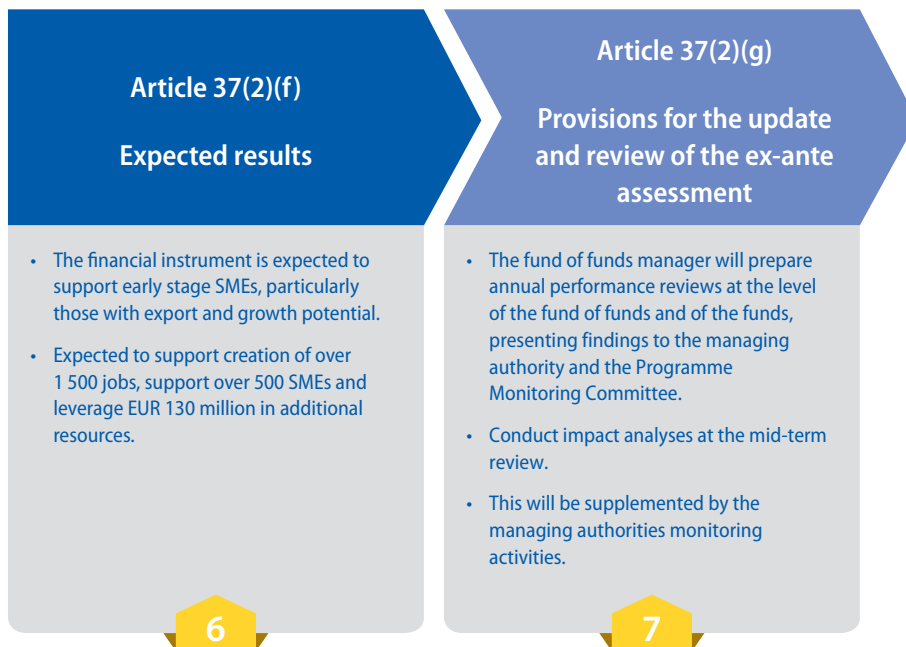
Table 1: Overview of proposed investment strategy for the 2014-2020 programming period

	Regional fund of funds
Purpose	Early stage risk capital Provide finance to innovative SMEs and microenterprises Enhancement of business angel syndicates
Product and target group	Equity and loans, including microfinance, for SMEs, in particular those with export and/or growth potential
Phase (seed, start-up, expansion)	All phases, with a particular focus on early stage, innovative SMEs
Investment range	Microfinance: < EUR 33 000 Loans: EUR 27 000 – EUR 135 000 Equity: EUR 0 – EUR 2.7 million
Possible asymmetry, i.e. potential advantage in favour of private capital	None. All deals involving private capital are expected to be conducted on a pari-passu basis
Implementation and governance	One fund of funds, reporting directly to the managing authority with support from an expert advisory group
State aid	No aid anticipated. All deals to be conducted on fully commercial terms

Source: Adapted from 'Ex-ante assessment for financial instruments: 2014-2020 Scotland ERDF Operational Programme'.

The **expected results** of the proposed investment strategy were based upon the managing authority's experience with previous financial instruments. They were defined in line with the output and result indicators of the 2014-2020 Scotland ERDF OP, and focus on job creation and safeguarding. The strategy anticipates over 500 SMEs receiving support in the first three years of operation (2016-18), generating more than 1 500 jobs and leveraging EUR 130 million from public and private sources.

The **update and review** process is a key element of the ex-ante assessment. The proposed investment strategy outlines the plan for the first three years of the OP and attaches particular significance to the mid-term review. This will consist of an impact analysis to determine the effect of each fund on their respective markets. The mid-term review will be supported by annual reviews carried out by the fund of funds management team, who will present the findings to the managing authority and at Programme Monitoring Committee meetings. This provides the proposed investment strategy with significant flexibility, ensuring that the fund of funds management team has accurate information to amend the strategy should it not perform as expected.





4. Successes and shortcomings

The ex-ante assessment identified market failures for SME finance in Scotland. It offered a clear investment strategy which builds on Scotland's experience in delivering financial instruments and was consistent with the 2014-2020 ERDF OP.

4.1 Main success factors

A key success factor of the drafting process was the close cooperation between the managing authority and stakeholders. The initial consultation ensured that all relevant parties were aware that the ex-ante assessment was being conducted, resulting in quick access to evaluation data and an understanding of what the analysis would cover. Related, longstanding expertise contributed to the success of the ex-ante assessment as it enabled active, knowledgeable participation in the workshops and surveys.

Another positive factor was the highly detailed *fi-compass* ex-ante methodology guidance which proved a vital tool, helping the managing authority to understand what was required by the regulations. Likewise, the workshops organised by the European Commission-EIB provided an ideal opportunity to discuss finer details and seek clarity on particular issues.

4.2 Main shortcomings

The two main shortcomings were time constraints and inexperience. With respect to timing, the managing authority was under pressure to obtain findings from the ex-ante assessment as soon as possible, given that the financial instrument could not be launched without the assessment being completed. Organisation of the ex-ante assessment coincided with the launch of the new OP, limiting the resources available to manage the assessment.

A second problem was the lack of experience with the process. This was the first time the managing authority had conducted an ex-ante assessment in line with the CPR and this posed some initial problems in fully understanding what was required, resulting in a delayed start.



5. Lessons learned

The managing authority identified three main lessons learned during this process. These concern timing, development of the proposed investment strategy and monitoring arrangements.

First, **dedicating time to plan, prepare and conduct the ex-ante assessment is critical.** It is important that each step has been mapped out - the *fi-compass* handbook “ex-ante methodology” can play an important role in this. The completion deadline should be realistic; it should allow for significant desk research, and extensive consultation. There are also benefits of **forming a multi-disciplinary team**, where possible, with expertise in the evaluation of financial instruments and experience of fund management.

Second, **a well-developed proposed investment strategy can facilitate the implementation of the financial instrument.** Close consideration should be given to the development of the strategy to ensure it can adapt to changing market conditions while also providing a clear direction and target group. Widespread consultation is recommended, especially engaging with the private sector. Doing so gains access to wider expertise and establishes relationships with key stakeholders before implementation.

Lastly, **monitoring and evaluation processes need to be in place to deliver accurate and timely performance data.** This is not only due to the more extensive reporting requirements under the regulations for 2014-2020 programming period, but it is vital to ensure such data are available to inform the mid-term review and any changes that may need to be made to the proposed investment strategy.

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