



Using Financial Instruments in England during the 2014-2020 Programming Period

SME Access to Finance Market Assessment
Block Two
Proposed Investment Strategy(ies) for the
'North East Region' of England

September 2016

Final Report

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1 Proposed Investment Strategy

This Proposed Investment Strategy report (PIS) was developed by the EIB Group with the purpose of assisting the Managing Authority in England, namely the Department of Communities and Local Government (DCLG) and the European Commission in the programming of financial instruments under the ESI Funds 2014-2020. This particular PIS has been developed based upon a detailed review of the Ex-ante Assessment (Block One) undertaken by EIB Group with support from Regeneris Consulting and is intended to be fully consistent with the Common Provisions Regulation Article 37.2 and its requirements. It should be read in close connection with the Block One report and in particular with the 'Area Market Overview' for this region. Furthermore, it has been developed through careful consideration of the input delivered to EIB Group from the local entities and in particular from 'North East Finance' operating within the geographical region known as the North East Region.

1.1 SME Market Analysis (2014/15) – the Summary of Findings

The main market failures, and potential financing gaps, analysed in the Ex-ante Assessment (Block One) at a summarised national level were found to be as follows:

- **There are significant structural market failures affecting parts of the finance market for SMEs;**
- **Whilst these market failures vary across England to some extent (for example, access to private venture capital can be better for some classes of SMEs in London and the South East for example), they nevertheless exist and restrict access to finance for start-ups and growing SMEs across England as a whole;**
- **The financial crisis has exacerbated these issues facing SMEs, especially in terms of the behaviour of the high street banks which have both reduced their lending overall and concentrated on lending larger amounts to less risky SMEs as part of their strategy of rebuilding their balance sheets;**
- **Survey evidence points to SMEs in England experiencing more difficulties in securing the finance they need for working capital and new investment over the past 3-4 years;**
- **As the economy recovers, the evidence points to an improvement in the level of business start-up, the growth of existing SMEs and indeed an upswing in business confidence, which is feeding into a greater demand for external finance;**
- **As a consequence there is a substantial finance gap affecting SMEs even allowing for the range and scale of public sector backed initiatives that are operating in this space (although many of the existing ERDF backed schemes have now or will cease investing in 2015).**

The Block One report concluded that at a national level and drawing on existing survey evidence, “around £1.6 billion per year of theoretical unmet demand for external finance from SMEs, assuming on a fairly cautious basis that 10% of the businesses seeking and unable to secure finance are viable.”

1.1.1 A Regional Perspective

The Block One report went further to provide a more regional perspective and provided an 'Area Overview' for the geographical region known as the North East Region. It is not the intention of this report to repeat the detail and findings from Block One but it is important to use those findings to set the context for the Proposed Investment Strategy. This regional perspective provided clear further evidence of market failure and/or sub-optimal investment situations for the region. Firstly, the North East Region is a significantly important economic area for England and the region is home to 135,200 SMEs of which 128,500 (95%) are microbusinesses (less than 10 employees), 5,600 are small (10-49 employees) and 1,000 are medium sized firms (50-249 employees). Of the microbusiness stock, 78,500 are unregistered for VAT/PAYE and 6,000 are sole traders.

By using the BIS SBS survey data and then regionalising the findings, the analysis indicates that, assuming the experience of SMEs in the region is similar to those in the UK as whole:

- In 2012 there were around 8,500 SMEs in the region looking for external finance, of which 6,300 were microbusinesses
- Of these, around 4,000 had difficulties of some sort in obtaining this finance
- 2,700 SMEs obtained none of the finance they were looking for, and 500 received some, but not all of what they were seeking (the national data indicates that the likelihood of successfully obtaining finance varies directly with business size).
- 1,800 SMEs had a need for finance did not apply, for the reason that they thought they would be rejected (there is no further detail available from the survey on why they thought they would be rejected).

The Block One report goes further to suggest "It is possible to use national survey data on the amount of finance being sought by businesses of different sizes to generate indicative estimates of the scale of unmet demand. **This analysis shows that total unmet demand in the region could be of the order of £560 million per year** (Section 1.4.2 Theoretical Unmet Demand). It is not possible to determine from this type of analysis how much of this comes from SMEs that had viable business plans those that could be supported in such a way that the financial and economic returns to the public sector from doing so would represent value for money, and hence constitute a market failure). However, scenarios on the proportion of firms that might have been viable have been set out below to illustrate the potential scale of market failure. For example, if 10% of these were viable, this would imply unmet demand of:

- Around £2 million per year for microfinance;
- Around £60 million per year of unmet demand amongst larger established SMEs.

It should be noted that this is, in effect, the gap over and above that what is already being addressed by JEREMIE and other public sector backed initiatives."

The European Investment Fund¹ (EIF) has been asked to provide its expert input based upon the abovementioned information sources and utilising its own knowledge and expertise as a major deliverer of financial instrument activities across the European Union and beyond. To undertake this exercise, EIF has analysed the Block One report and Area Overviews, considered input from the EIB's

¹ EIF is a specialist provider of risk finance to benefit small and medium-sized enterprises (SME) across Europe. EIF is part of the EIB Group and the shareholders are the European Investment Bank (EIB), the European Union, represented by the European Commission, and a wide range of public and private banks and financial institutions www.eif.org.

own internal reviews of the first experiences of implementing JEREMIE funds and alongside its own knowledge of implementing similar activities across the EU and in the UK market, undertaken the exercise of delivering a 'Proposed Investment Strategy' after appropriate levels of consultation with the Department for Communities and Local Government, Local Enterprise Partnerships and their partners and other stakeholders. This consultation involved meetings held with LEP representatives and local fund managers in April 2015.

1.1.2 The Evolution of the Geographic Scope of Financial Instruments in the North East Region

Since the completion of the Block One report, the proposed arrangements for the North East Region have evolved on the basis of stakeholder requirements.

Originally incorporating the geographic areas of Northumberland, North Tyneside, South Tyneside, Newcastle, Gateshead, Sunderland and Durham (the North East Local Enterprise Partnership – NELEP area²) as well as Stockton, Hartlepool, Middlesbrough, Darlington and Redcar & Cleveland (the Local Enterprise Partnership area for the Tees Valley), a decision to refocus future investment strategy development (from the original geographic scope envisaged by the Block One report) was announced by the Chancellor of the Exchequer in his Autumn Statement on the 25th November 2015 which outlined the following:

- a) The development of a North East Local Enterprise Partnership area specific investment fund programme (the subject of this Proposed Investment Strategy)
- b) The development of a Northern Powerhouse Investment Fund Programme (led by the British Business Bank) and incorporating the Tees Valley Local Enterprise Partnership area.

This report sets out the overall analysis, the originally proposed Investment Strategy for the North East region – which contributes to the need and demand for the Northern Powerhouse Investment Fund, as well as the revised Investment Strategy for the NELEP area alone. It is understood that a composite proposed investment strategy for the Northern Powerhouse Investment Fund which combines each of the relevant regional Block Two reports, will be prepared by DCLG and stakeholders.

Based on the original Block One analysis (detailed in section 1.1.1 above); the fact that the NELEP area constitutes circa 75% of the total business and economic base of the previous combined NELEP and Tees Valley areas³ and the fact that the NELEP area based businesses received circa 85% of total

² In England, Local Enterprise Partnerships (LEPs) are voluntary partnerships between local authorities and businesses set up in 2011 by the Department for Business, Innovation and Skills (BIS) to help determine local economic priorities and lead economic growth and job creation within the local area. They carry out some of the functions previously delivered by the regional development agencies which were abolished in March 2012. To date there are 39 local enterprise partnerships in operation.

³ EKOS: North East Access to Finance – Fund Evaluation Research (June 2013) based on analysis of ONS VAT and PAYE statistics.

investment under the JEREMIE 1 programme the following conservative assumptions have been made with regard to demand for funding in the NELEP area:

- Total unmet demand of circa £420 million per annum exists (£560m x 0.75)
- £1.5 million per annum of unmet demand for microfinance exists (£2m x 0.75)
- £45million per annum of unmet demand amongst larger established SMEs exists (£60m x 0.75).

Similarly, the Northern Powerhouse Investment Fund draws on the same analysis, and the following assumptions have been made by DCLG and local stakeholders regarding demand for funding in the Tees Valley LEP area:

- Total unmet demand of circa £140 million per annum exists (£560m x 0.25)
- £0.5 million per annum of unmet demand for microfinance exists (£2m x 0.25)
- £15million per annum of unmet demand amongst larger established SMEs exists (£60m x 0.25).

1.2 Proposed Investment Strategy and Implementation Arrangements

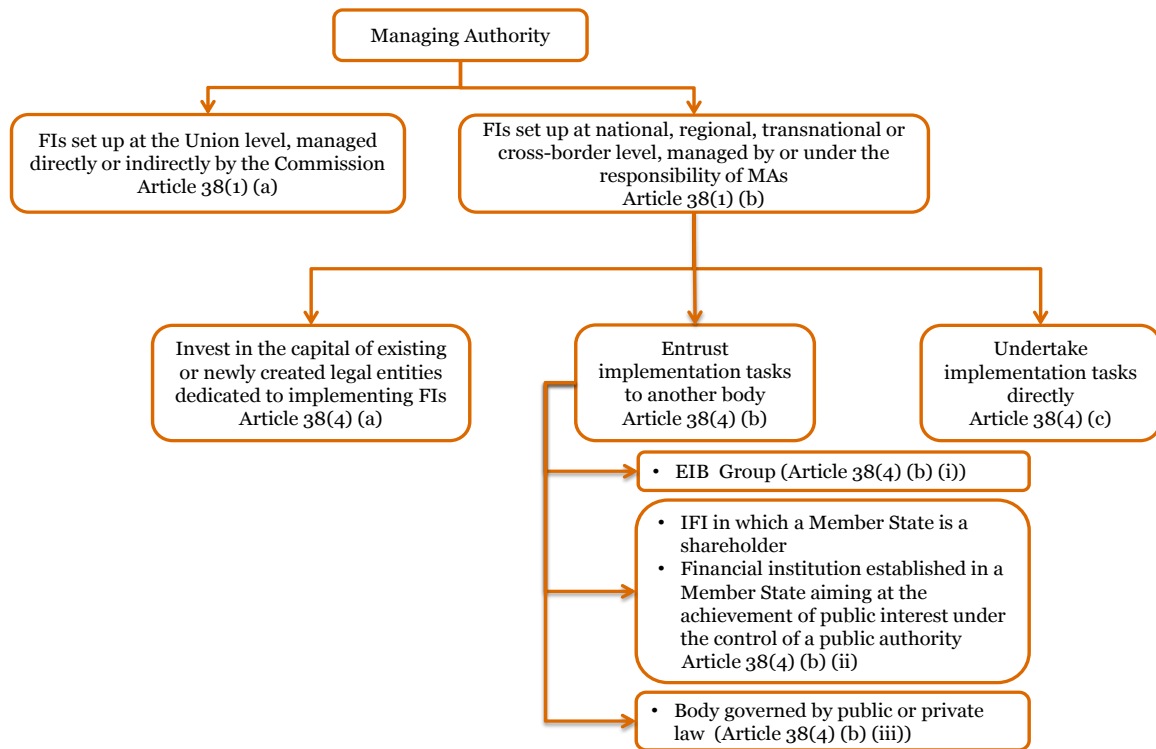
1.2.1 Options for implementation arrangements

Article 37 (2) (e) CPR specifies that the proposed investment strategy will include an examination of options for implementation as foreseen by Article 38.

A comprehensive picture of the implementation options for the setting up of a financial instrument, as provided in the general ex-ante methodology⁴, is shown in the figure below.

Figure 1: Implementation options for the setting up of an FI

⁴ “Ex-ante assessment methodology for financial instruments in the 2014-2020 programming period. General methodology covering all thematic objectives. Volume I”, European Commission, European Investment Bank, PriceWaterhouseCoopers, April 2014.



Source: European Commission, EIB, PwC, 2014.

The proposed investment strategy includes an analysis of the following options:

- A. Implementation options for financial instruments within the meaning of Article 38,
- B. Financial instruments on offer,
- C. Targeted beneficiaries and the proposed terms of combining financial instruments with grants.

Financial Instruments created centrally at the level of the EU and managed directly or indirectly by the EC - Article 38 (1) (a)

The possibility to contribute ESI funds to centrally launched and managed instruments is a new possibility introduced for the 2014-2020 programming period and is foreseen in Article 38 (1)a).

Figure 2: Article 38 of the new CPR

| | Centrally managed by EC | Shared management |
|--|---|--|
| Thematic Objective 1 Research, Development & Innovation | Horizon 2020 | Instruments under ESI funds <i>Off-the-Shelf instruments</i> <i>Tailor-made instruments</i> |
| Thematic Objective 3 Competitiveness of SMEs | Competitiveness & SMEs (COSME) | |
| Thematic Objective 4 Supporting the shift towards low-carbon economy in all sectors | Life Programme | |
| Thematic objective 5 Promoting climate change adaptation, risk prevention and management | | |
| Thematic objective 6 Preserving and protecting the environment and promoting resource efficiency | | |
| Thematic Objective 7 Sustainable transport and network infrastructures | Connecting Europe Facility (CEF) | |
| Thematic Objective 9 Promoting social inclusion and combating poverty | Social Change and Innovation | |
| | Creative Europe | |
| Thematic Objective 10 Education, skills and lifelong learning | Erasmus for All | |

Source: PwC Financial instruments in Cohesion Policy 2014-2020: Ex-ante assessment training, June 2014

Apart from the SME Initiative, covered further below, the centrally launched instruments, directly or indirectly managed by the EC, and which most target SMEs, are COSME and HORIZON 2020 (see table above). The implementation of these instruments has been mandated by the EC to EIF. In early August 2014, EIF launched calls for expression of interest with regard to COSME and HORIZON 2020⁵, targeting financial intermediaries across the EU involved in lending, the provision of equity (venture capital), and others active in SME financing.

Under COSME, EIF will support equity investments as well as lending to eligible SMEs, including at the higher risk early stage and start-ups and, as always, through financial intermediaries. Under Horizon 2020, EIF will issue guarantees and counter-guarantees to interested and selected lending intermediaries for loans to innovative enterprises of between EUR 25k and EUR 7.5m.

These instruments will, therefore, allow financial intermediaries in the UK to apply directly as partners of EIF for SME financing outside of any nationally-launched initiative.

Also at Union level is the EU SME Initiative: a joint instrument, blending EU funds available under COSME and Horizon 2020 and ESIF resources in cooperation with EIB/EIF, for which a single ex-ante assessment has already been prepared by the EIB Group and issued by the EC. Three implementation options are available: the Joint SME Guarantee Instrument and the Joint Securitisation Instruments for both new and existing SME loan portfolios. It is understood that to

5 See: www.eif.org/what_we_do/news/2014/eu-finance-sme.htm

date the UK authorities has already declined to contribute to the EU SME Initiative, and therefore this option is not explored in detail.

Table 1: Advantages and disadvantages of FIs managed by the EC

| Financial Instruments created centrally at the level of the EU and managed directly or indirectly by the EC | |
|--|---|
| ADVANTAGES | DISADVANTAGES |
| <ul style="list-style-type: none"> • Effectively a delegation of tasks to an entity experienced with using EU structural funds for supporting SME access to finance. • Quicker implementation (selection of financial intermediaries, conclusion of funding agreements etc.). • A centrally managed instrument can contain several compartments and thereby achieve greater critical mass and benefit from certain economies of scale. • There would likely be no need for the managing authority to carry out on-the-spot checks, or any need for the audit authorities to cover either these operations or the associated management and control systems (to be confirmed by DG REGIO). • Allows for relaxing of ESIF eligibility criteria. | <ul style="list-style-type: none"> • A certain loss of control at the level of the managing authority. • A certain loss of targeting instruments to meet regional market failures and suboptimal investment solutions. • More detached monitoring and controls: the managing authority still remains responsible for the operations, including payments and reporting when contributing to a centrally managed instrument. • Limited synergies between the instruments. |

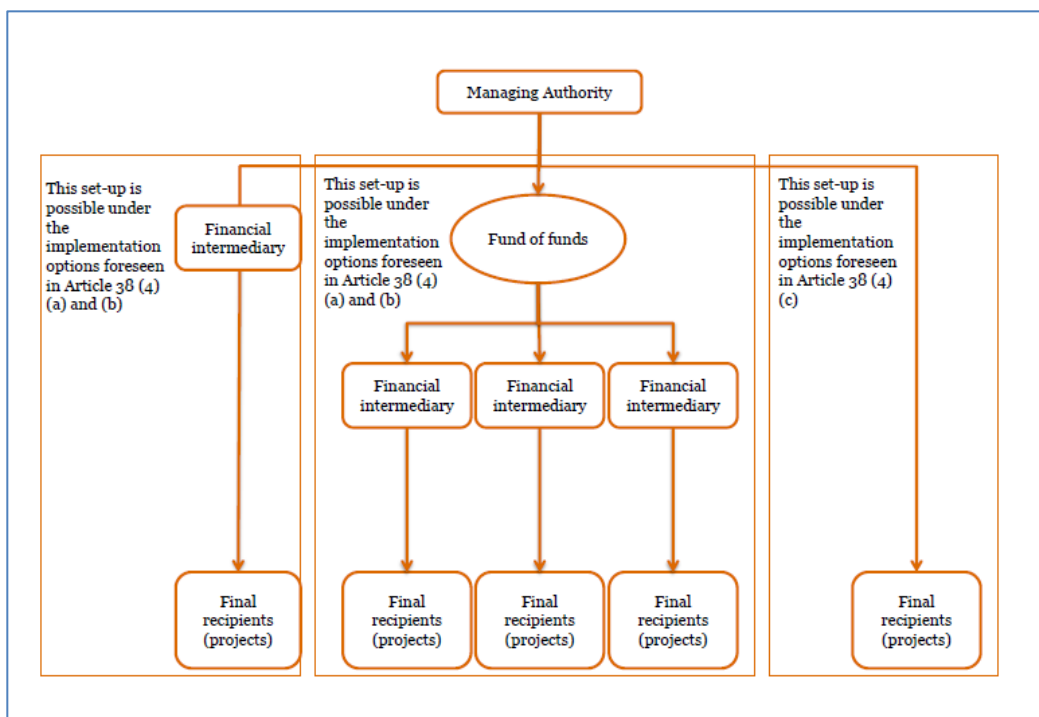
Source: EIB

In the general ex-ante methodology, it is further stated “this choice may be appropriate for instances when the technical capacity and/or the expertise of the MA is considered insufficient or where the critical mass for establishing an FI has not been reached and the existing EU-level instruments are well aligned with the Programme objectives. This option avoids duplicating FIs at lower levels and gives assurance to MAs that resources will be used through tested vehicles and experienced teams.” Given the good levels of experience of the relevant authorities in the UK having experience of implementing financial instruments for several decades now and the comparatively mature levels of market infrastructure that exists, it is understandable that a conclusion could be drawn not to utilise the possibility foreseen in Article 38 (1) (a).

Financial Instruments created and managed directly by a managing authority or under its responsibility – Article 38 (1) (b)

The figure below displays the options available under this implementation route.

Figure 3: Implementation options for the governance of FIs



Source: PwC Financial instruments in Cohesion Policy 2014-2020: Ex-ante assessment training, June 2014

The individual options set out in the above figure, which are to be managed under the responsibility of the managing authority, are currently being explored. Careful consideration will be undertaken by the central Managing Authority (DCLG) to select the best option for the English Regions with reference to all the relevant regulations.

1.2.2 Other points with respect to implementation options

“Off-the-shelf” instruments

In the case of option B, the MA is also able to use “Off-the-shelf” instruments (outlined in Article 38 (3)(a)). This is a possibility foreseen by the EC, which is working on the development of product specifications for such instruments.

For SMEs, these will consist primarily of:

- i) A loan instrument;
- ii) A guarantee instrument; and
- iii) An equity instrument.

For each instrument, the EC develops term sheets. The declared objective of DG Regio is to ensure the exemption for these instruments from the need for a notification under state aid rules.

Table 2: Advantages and disadvantages of the “Off-the-shelf instruments”

| Off-the-shelf instruments | |
|--|---|
| ADVANTAGES | DISADVANTAGES |
| <ul style="list-style-type: none"> • Benefit of defined product terms for convenience and speed of implementation; • Oversight over implementation terms and conditions; • These would represent clear examples of what the EC perceives as suitable financial instruments for ESI funds. | <ul style="list-style-type: none"> • Even if the these instruments have been developed on the basis of EC experience from the 2007-2013 programming period, certain new parameters envisaged for these instruments are yet to have been deployed; • To be assessed whether the off-the-shelf instruments are able to cater for any potential national or regional specifics. The instruments would also need to potentially be adjusted for any local jurisdiction requirements; • Lack of assurance on the possibility of exemption from notification requirements under State aid rules, meaning that notification cannot be excluded. |

Source: EIB

Most of the financial instruments (FIs) currently or previously available in UK, with perhaps the exception of the previous regional JEREMIE instruments, are, or have been, implemented by public institutions of a centralised nature. This is a perfectly understandable position to take and does entail certain advantages. However, after several reviews and considerations, a major rebalancing of responsibilities for economic development between central and local government, and between government and the private sector took place. As a result, 39 Local Enterprise Partnerships (LEPs) have been formed across England with a key role to drive local development priorities. It is therefore entirely understandable that the most appropriate delivery model for financial instruments within the ESIF 2014-2020 period is the one that is most closely aligned to the local economic development infrastructure, namely Article 38 (4) (b).

Implementation options under consideration by the Managing Authority

Within Article 38 (4) (b), there are a number of delivery routes – namely:

- (i) the EIB;
- (ii) international financial institutions in which a Member State is a shareholder, or financial institutions established in a Member State aiming at the achievement of public interest under the control of a public authority; and
- (iii) a body governed by public or private law.

Following lengthy consideration of the merits of each option, and having regard for European Commission guidance on selection of Financial Instruments, DCLG as MA has indicated that its preference is for entrustment of a body governed by public or private law.

Multi-regional approach

It is understood that the MA is considering establishing a Fund of Funds which covers multiple regions (with local stakeholder feedback indicating that such an approach is supported in the North

West, Yorkshire & Humber, and the Tees Valley). This is on the basis that a larger multi-regional Fund of Fund could help to maximise the impact of the ERDF funding and minimise overlaps in provision within a demographic of SMEs experiencing broadly similar market failures when seeking particular types of external finance. The Block One work has established that whilst each geography area has particular nuances, they have all identified the need for a mix of micro finance, seed, debt and equity.

The possible benefits of this approach under consideration by the MA include:

- Benefits of scale of operating one flexible overarching fund for each type of finance that reflects the 3 comparable regional investment strategies, as opposed to operating multiple smaller funds in each geographic area
- There are potentially high fixed costs of procuring, establishing and operating lending/ investment funds, especially for smaller loans and equity investments. Where there are comparable regional investment strategies and regional governance structures allow a single or a smaller number of multi-regional funds could allow these fixed costs to be spread out with less duplication
- An amalgamation of funds will potentially attract higher levels of public and private investment and also different types of private investment.
- As the MA develops the multi-regional Fund of Fund approach and further refines the proposed investment strategy, attention will need to be given to the need to ensure appropriate diversification and local presence.

Mono-regional approach

In addition, the MA is also considering establishing a Fund of Funds which covers smaller areas (with local stakeholder feedback indicating this is preferred in the North East LEP area alone). This is on the basis that a larger multi-regional Fund of Fund could exacerbate the periphery disadvantage experienced by small and medium sized enterprises in peripheral locations in England.

This approach needs to be justified by the MA from a value for money perspective and needs to be deliverable at a sufficient scale to secure private co-financing (which is indicated at a minimum of £100m investment capital). The MA also needs to satisfy itself that such a proposal would result in a better outcome in terms of deal flow and integration with local economic infrastructure than a multi-regional approach.

Appropriate delivery vehicles

Given the MA's preference for entrustment to a publicly owned or controlled entity, the Managing Authority will need to be satisfied that appropriate delivery vehicles exist, or could be identified, to deliver either approach and are compliant with EU rules.

1.2.3 Proposed financial instruments, target market and target final recipients

Given the above, it is therefore entirely appropriate that when considering the financial instruments to be utilised within a PIS for the region known as the North East Region, that EIF has received input

from representatives from the region assigned to consider this important subject area. These representatives have significant and valuable localised knowledge of the issues facing their region and often have directly relevant experience of ESIF financial instrument implementations. EIF has therefore sought and considered their views in reaching these conclusions. A number of key stakeholders have been consulted in this process either by Regeneris or by EIF.

1.2.3.1 Originally proposed financial instruments (for NELEP and TVU combined areas) – Summary for information

On the basis of the above analysis and consultation process and pursuant to the priorities established in the relevant Partnership Agreement and the Operational Programme, FIs were proposed for the North East Region, taking account of the market analysis identified in the Block 1 report, whilst maintaining the ability to adapt the strategy and allow for possible subsequent re-allocations between financial instruments, depending on the actual implementation experience and economic circumstances.

The overarching Proposed Investment Strategy for the North East LEP and Tees Valley LEP areas, is described below for information. However, this has been superseded by separate proposed FIs for the North East LEP area, and the Northern Powerhouse Investment Fund (incorporating the Tees Valley LEP area).

Table 3 (a): Financial Instruments – Programming Period 2014-2020 – North East Region (TVU and NELEP areas)

| Financial Instrument | Proposed contribution £ m and ranges | Funding Source & Other Aspects |
|--------------------------|---|--|
| Innovation Fund | £40m Investment range between £10,000 and £400,000 for initial investments. | Large volume of smaller high risk investments expected often acting as ‘proof of concept’ finance often working with universities, science parks etc. Portfolio expected to be 37.5% seed capital; 50% equity and 12.5% debt. |
| Early Stage Fund | £40m Investment range between £150,000 and £1m with the possibility to follow-on above that upper threshold by way of exception. | This Fund is expected to be generalistic in nature and concentrate on equity provision (70%) with around 30% offered as debt-type facilities (loans or convertible loans). |
| Growth Capital Fund | £35m Investments/Loans expected to range from £10,000 to £300,000 in size. | This Fund is expected to be generalistic in nature and provide loans or mezzanine facilities to enterprises seeking debt facilities to expand their business. 33% will be for smaller loans; 56% for mezzanine and 10% for equity. |
| Development Capital Fund | £45m Loans or mezzanine facilities expected to range from £200,000 to £2m in size. | This Fund is later stage focussed and expected to be generalistic in nature and later stage focused. Portfolio expected to be 70% debt or convertible loans and 30% equity. |

| | | |
|--------------------------|----------------------------|--|
| TOTAL⁶ | Approximately £160m | The overall size of these instruments is estimated on the assumption that the implementing model will benefit from EIB Lending. |
|--------------------------|----------------------------|--|

Source: EIF

Such a portfolio of instruments is best structured as a Fund-of-Funds (FoF) structure for the implementation of these instruments which offers the significant added value of combining the contributions from the involved LEPs alongside a loan arrangement with the EIB. The FoF approach enables a diversification of risk which is an important element in the process of attracting EIB financing. It is considered that no commercial bank would be willing to undertake such a financing arrangement on the same terms and conditions as EIB. Such financing brings significant advantages but requires careful and financially disciplined implementation to ensure repayment via a diversified portfolio. Whilst some instruments are similar in nature they are not identical and are intended to co-exist in a complimentary manner whilst enabling the flexibility to reallocate capital should any particular instrument face difficulties in the implementation process or underperform. It is further expected that an experienced implementing entity would be selected/procured to undertake the role of manager of the FoF working closely with the central Managing Authority (DCLG) and the EIB in this process. It would also be expected that any regional FoF structure such as this will require appropriate governance structures to ensure implementation is completed as planned.

In the paragraphs below, there is a short form explanation of each instrument that was considered to become a constituent part of the overall PIS. Specific State Aid considerations for each instrument will need to be considered in detail at a later stage but are mentioned where relevant below. In principle, it is expected that all such instruments would be either state aid free or fully compliant with the relevant state aid schemes. No additional state aid notification processes are to be expected.

Instrument One – Innovation Fund £ 40m

The Block One report and the Area Market Overview have highlighted the ongoing Financing gaps which illustrates the continued shortage of early stage equity capital, particularly at regional level. This instrument targets this market failure and is expected to be implemented by an experienced Fund manager with the skills, track record and local network to develop a strong portfolio of equity investments in start-up or young enterprises. The selected Fund Management team will also be expected to commit between 1 and 3% of the fund size from personal sources or be able to implement similar mechanisms in order to ensure full alignment of interest and therefore respecting normal market practices and to be consistent with the General Block Exemption Regulations No 651/2014⁷. Any additional investors to the fund would be considered a further advantage and the normal market standards of a limited partnership would be expected to be adopted wherever possible.

⁶ Management costs impact not considered in the total.

⁷ Article 15 (b) states that the fund manager(s) 'shall receive a remuneration linked to performance, or shall share part of the investment risks by co-investing own resources so as to ensure that their interests are permanently aligned with the interests of the public investor'.

This fund would be expected to create a portfolio of equity investments ranging £20,000 to £150,000 for initial investments whilst retaining a certain percentage of capital for follow-on investment purposes. It will act as a 'proof of concept' fund with high volumes expected to be generated from working closely with universities, incubators and science parks in the region. Should a particularly successful portfolio company require investment above an agreed threshold of £150,000, this would be possible with the prior agreement of the appropriate body within the governance structure. Given the expected fund size, seed stage focus and the normal market practice of retaining up to 40% of the capital for follow-on investments⁸, and on the assumption that an average deal size will be approximately £100,000, a portfolio in the range of between a 200 to 300 investments could be expected. Any larger level of diversification than this may lead to an unsustainable situation. This Fund should be positioned to offer differing forms of finance depending upon the need of the enterprise and hence a mixture of convertible loans or debt (45%) and equity (55%) is considered appropriate.

No specific sector focus is advised but due to the evidenced comparative strengths of this region in certain sectors, this Fund may well have a focus on the Digital, Technology, Science and Creative sectors and whilst not being limited to these areas, the selected Fund Management team would need the appropriate skills and experience to make this a success (or a viable sub-contracting proposal).

Instrument Two – Early Stage Fund £40m

The Block One report and the Area Market Overview have highlighted the ongoing Financing gaps which illustrates the continued general shortage of equity capital, particularly at regional level. This instrument targets this market failure and is expected to be implemented by an experienced Fund manager with the skills, track record and local network to develop a strong portfolio of equity investments in established enterprises. The selected Fund Management team will also be expected to commit between 1 and 3% of the fund size from personal sources or be able to implement similar mechanisms in order to ensure full alignment of interest and therefore respecting normal market practices and to be consistent with the General Block Exemption Regulations No 651/2014⁹. Any additional investors to the fund would be considered a further advantage and the normal market standards of a limited partnership would be expected to be adopted wherever possible.

This fund would be expected to create a portfolio of seed/early stage equity investments ranging from £150,000 to £1 million whilst retaining a certain percentage of capital for follow-on investment purposes. Should a particularly successful portfolio company require investment outside of these lower and upper thresholds, this would be possible with the prior agreement of the appropriate body within the governance structure. Given the expected fund size and the need to retain up to 40%¹⁰ of the capital for follow-on investments, a portfolio in the range up to 100 initial investments could be expected. Any larger level of diversification than this may lead to an unsustainable situation. This Fund should be positioned to focus on equity (70%) but retaining a degree of

⁸ EIF is one of the largest European Fund of Fund investors with over 500 investments made into Private Equity and Venture Capital investors. The 40% figure mentioned here is based upon actual evidence from within that portfolio and reflects normal market practice.

⁹ As before.

¹⁰ As before.

flexibility depending upon the need of the enterprise and hence convertible loans or debt (30%) is considered appropriate.

Instrument Three – Growth Capital Fund £35m

The Block One report and the Area Market Overview have highlighted the ongoing Financing gaps which illustrates the continued general shortage of both debt and equity finance which has been particularly affected by the impact of the recent credit crisis at national and at regional level. This instrument targets this market failure and is expected to be implemented by an experienced Fund manager or Financial Intermediary with the skills, track record and local network to develop a wide portfolio of loans expected to range from £10,000 to £300,000 in size. Dependent upon the implementation model proposed by the applicant, different forms of ensuring alignment of interest will need to be considered.

Such a fund should be focussed on enterprises that have faced difficulties to attract such financing from more established routes and where this debt financing will enable expansion plans to be undertaken. No sectorial requirements are required for this activity but certain sectorial exclusions are likely to be required for ESIF and EIB compliance reasons. With investment/loan sizes expected to average approximately £150,000 per enterprise and only a limited expectation of follow-on financing, a portfolio of up to 450 loans could be anticipated giving a good degree of diversification. This instrument has a proposed loan size range and average expected loan size based upon current experience of a successful implementation in the North East Region that gives evidence that a focussed financial intermediary can give positive results in terms of absorption and returns. This Fund should be positioned to focus on smaller loans (30%); mezzanine (50%) but retaining a degree of flexibility depending upon the need of the enterprise and hence equity investments (20%) are also considered appropriate.

Instrument Four – Development Capital Fund £45m

The Block One report and the Area Market Overview have highlighted the ongoing Financing gaps which illustrates the continued general shortage of debt/mezzanine finance which has been particularly affected by the impact of the recent credit crisis at national and at regional level. This instrument targets this market failure and is expected to be implemented by an experienced Fund manager with the skills, track record and local network to develop a wide portfolio of larger investments/loans expected to range from £200,000 to £2million in size. Should a particularly successful portfolio company require an investment/loan size above this upper threshold, this would be possible with the prior agreement of the appropriate body within the governance structure. Dependent upon the implementation model proposed by the applicant, different forms of ensuring alignment of interest will need to be considered.

Such a fund should be focussed on enterprises that have been unable to attract such financing from more established routes and where this debt financing will enable expansion plans to be undertaken. No sectorial requirements are required for this activity but certain sectorial exclusions are likely to be required for ESIF and EIB compliance reasons. With investments/loan sizes expected

to average around £750,000 per enterprise and only a limited expectation of follow-on financing, a portfolio of up to 50-70 investments/loans could be anticipated giving a good degree of diversification. This Fund should be positioned to offer differing forms of finance depending upon the need of the enterprise and hence a mixture of convertible loans or debt (85%) and equity (15%) is considered appropriate.

As all of the above instruments are foreseen to cover a mix of financing types, this will enable to selected fund managers to consider the most appropriate financing type for each case. This can be seen as a clear benefit to the implementation, however, as the overall balance between debt to equity is important for the expected matched funding provider, it will be important that the implementation process carefully monitors the actual results. To avoid any possible 'drift' from the required balanced strategy, contractual clauses may need to be implemented to prevent implementation problems appearing.

1.2.3.2 Proposed Financial Instruments for NELEP only area – Summary

On the basis of the above analysis and consultation process and pursuant to the priorities established in the relevant Partnership Agreement and the Operational Programme, and taking account of the UK Government's announcement at the Autumn Statement 2015, the following FIs are proposed to be deployed in the new programming period in the North East LEP area alone, whilst maintaining the ability to adapt the strategy and allow for possible subsequent re-allocations between financial instruments, depending on the actual implementation experience and economic circumstances.

Table 4 (b): Financial Instruments – Programming Period 2014-2020 – NELEP areas

| Financial Instrument | Description |
|--------------------------|--|
| £30m Innovation Fund | <p>The fund will focus on investment into early-stage innovative companies through the provision of both mezzanine and equity finance.</p> <p>The fund is modelled to make circa £11.75m Proof of Concept type investments (circa 80% convertible loan at an average of circa £130,000) and approximately £18.25m of seed stage investments (anticipated 80% equity at an average investment size of £330k).</p> |
| £30m Early Stage Fund | <p>This Fund is expected to be 'generalist' in focus; providing 90% of its investment through equity or quasi-equity instruments.</p> <p>An average investment of circa £500,000 is envisaged.</p> |
| £20m Growth Capital Fund | <p>This Fund is expected to be 'generalist' in nature and provide loans or mezzanine finance to enterprises seeking to expand their business.</p> <p>An anticipated portfolio of 70 investments (around 85% mezzanine finance) is anticipated.</p> <p>The average investment size modelled is £285,000.</p> |

| | |
|-----------------------------------|--|
| £30m Development Capital Fund | <p>This Fund is later stage and generalist in focus. The portfolio is expected to comprise 70% debt or convertible loans and 30% equity investments.</p> <p>An average investment of circa £750,000 (with a maximum investment of £2m) is modelled – delivering an anticipated 40 investments / loans from the fund.</p> |
| £10m Small Loans Fund | <p>This fund will provide debt finance for start-up and existing micro businesses and SMEs.</p> <p>With an average loan of circa £30,000 it is anticipated that the fund will make approximately 320 loans.</p> |
| TOTAL¹¹ = £120m | <p>The overall size of these instruments is estimated on the assumption that the implementing model will benefit from EIB Lending.</p> |

At its meeting in January, the North East LEP area Fund of Funds Project Board¹² considered closely the findings of the ex-ante and consultation programme. On the basis that the fund of funds programme would only be investing in the North East LEP area, they recommended that a fund of £120m be developed. Key considerations were the:

- Ability of the portfolio to meet the strategic requirements of the North East LEP and its stakeholders
- Ability of the portfolio to deliver a regulatory compliant suite of funds (i.e. observing all relevant ERDF and EC State aid Regulations)
- Ability of the portfolio to be compliant with this ex ante assessment and its findings
- Ability of the portfolio to continue to offer the financial ‘robustness’ required by the European Investment Bank (as a key lender / source of leverage to the project).

Initial analysis undertaken as part of the ex-ante process for the Tees Valley and NELEP areas (summarised above) had resulted in a proposal with four sub funds. It was felt that this mix suited the stakeholders engaged at that time. The current Board have considered carefully the fund makeup. They concluded that five sub funds provides the most relevant and deliverable fund for North East LEP area. The sub funds proposed reflect the discussions and views expressed in both the ex-ante and market consultation exercises in relation to size and sector specialisms.

The Board determined that:

- the fund portfolio should contain a separate small loan fund provision (reflecting the different nature of this fund compared with other proposed funds in the Investment Strategy);
- following the inclusion of a separate loan fund, the product fund mix would: be aligned to regional demand, in line with ex ante reports and North East LEP area focus;
- a proportion of the £120 million investment capital of the fund be ‘held back’ to facilitate

¹¹ Management costs impact not considered in the total.

¹² A stakeholder body set up by the North East LEP, with observers from the MA and Government, overseeing the development of FI proposals for the North East LEP area.

portfolio flexibility / re-allocation going forward,
and has submitted a proposal to the MA for consideration.

This portfolio of instruments is best structured as a Fund-of-Funds (FoF) structure for the implementation of these instruments which offers the significant added value of combining the contributions from the involved LEPs alongside a loan arrangement with the EIB. The FoF approach enables a diversification of risk which is an important element in the process of attracting EIB financing. It is considered that no commercial bank would be willing to undertake such a financing arrangement on the same terms and conditions as EIB. Such financing brings significant advantages but requires careful and financially disciplined implementation to ensure repayment via a diversified portfolio. Whilst some instruments are similar in nature they are not identical and are intended to co-exist in a complementary manner whilst enabling the flexibility to reallocate capital should any particular instrument face difficulties in the implementation process or underperform.

It is further expected that an experienced implementing entity will be selected to undertake the role of manager of the FoF working closely with the central Managing Authority (DCLG) and the EIB in this process. It would also be expected that any regional FoF structure such as this will require appropriate governance structures to ensure implementation is completed as planned.

In the paragraphs below, there is a short summary of each instrument that is proposed to become a constituent part of the overall portfolio. Specific State Aid considerations for each instrument will need to be considered in detail at a later stage but are mentioned where relevant below. In principle, it is expected that all instruments will be either state aid free or fully compliant with the relevant state aid schemes (in particular the General Block Exemption Regulation). No additional state aid notification processes are to be expected.

Fund 1 – Innovation Fund (£30m)

The Block One report and the Area Market Overview have highlighted ongoing financing gaps and a continued shortage of early stage equity capital, particularly at a regional level in the UK and specifically in the NE LEP area. This instrument targets this market failure and is expected to be implemented by an experienced Fund Manager (financial intermediary) with the skills, track record and local networks to develop a strong portfolio of equity and mezzanine investments in innovative start-up or young enterprises.

No specific sector focus is anticipated but due to the evidenced comparative strengths of this Region in certain sectors, this Fund may well have a particular focus on the Digital, Technology, Science and Creative sectors and whilst not being limited to these areas, the selected Fund Management team would need the appropriate skills and experience to deliver the Fund's objectives on this basis.

The £30m innovation Fund has been structured to facilitate investment into early-stage innovative companies at the pre-revenue and seed funding stages through both equity and mezzanine finance. The financial model developed for the Innovation Fund (IF) envisages two main types of investment:

- I. Circa £11.75m of Proof of Concept investment – comprising around 80% convertible loan and 20% equity with an average investment of approximately £130,000
- II. Circa £18.25m, of Innovation Fund (seed stage) investment - comprising around 80%

equity and 20% debt with an average investment in the region of £330,000.

Fund managers will however have the discretion to structure transactions as they see fit, subject to (a) ensuring that all appropriate regulations are followed and (b) ensuring that annual cash return targets are achieved.

This fund manager would be expected to create a portfolio of initial investments whilst retaining a certain percentage of capital for follow-on investment purposes. Given the expected fund and investment size, investment stage and the normal market practice of retaining up to 40% of the capital for follow-on investments; a portfolio of around 150 investments could be expected. Any larger level of diversification than this may lead to sub-optimal performance.

Fund 2 – Early Stage Fund (£30m)

The Block One report and the Area Market Overview have highlighted ongoing financing gaps which illustrate the continued general shortage of equity capital, particularly at regional level. This instrument targets this market failure and is expected to be implemented by an experienced Fund Manager with the skills, track record and local network to develop a strong portfolio of equity investments in established early-stage enterprises.

This fund would be expected to create a portfolio of seed/early stage equity investments with an average investment of circa £500,000 after taking into account capital for follow-on investment purposes. Given the expected fund size and the need to retain up to 40% of the capital for follow-on investments, a portfolio in the range of 60 initial investments could be expected. Any larger level of diversification than this may lead to sub-optimal performance.

This Fund will be positioned to focus on equity or quasi equity instruments (90%) but will retain a degree of flexibility depending upon the needs of specific enterprises and hence an expected element of convertible loans or debt (10%) is considered appropriate.

Fund managers will however have the discretion to structure transactions as they see fit, subject to (a) ensuring that all appropriate regulations are followed and (b) ensuring that annual cash return targets are achieved.

Fund 3 – Growth Capital Fund (£20m)

The Block One report and the Area Market Overview have highlighted the ongoing financing gaps which illustrate the continued general shortage of mezzanine / debt finance which has been particularly affected by the impact of the recent credit crisis at national and at regional level. This instrument targets this market failure and is expected to be implemented by an experienced Fund Manager with the skills, track record and local network to develop a wide portfolio of mezzanine / debt finance investments at the average investment size envisaged by the fund (circa £285,000).

The fund will focus on enterprises that have faced difficulties in attracting such financing from more established routes (typically the main clearing banks which account for over 80% of SME lending) and where this financing will enable expansion plans to be undertaken. There will be no sectoral focus for the fund (other than observing all relevant excluded sectors).

An anticipated portfolio of circa 70 investments (around 85% funded with mezzanine finance) is

envisaged. Fund managers will however have the discretion to structure transactions as they see fit, subject to (a) ensuring that all appropriate regulations are followed and (b) ensuring that annual cash return targets are achieved.

This instrument has a proposed loan size range and average expected loan size based upon current experience of a successful implementation of a similar intervention in the North East Region that gives evidence that a focussed fund manager can generate positive results in terms of absorption and returns with a fund of this type.

Fund 4 – Development Capital Fund £30m

The Block One report and the Area Market Overview have highlighted the ongoing financing gaps which illustrate the continued general shortage of mezzanine / debt finance. This shortage has been particularly exacerbated by the recent credit crisis at national and at regional levels. This instrument targets this market failure and is expected to be implemented by an experienced Fund Manager with the skills, track record and local network to develop a wide portfolio of larger mezzanine investments /loans of up to £2,000,000 in size.

The fund will be focussed on established enterprises that have been unable to attract competitive financing from more ‘traditional’ routes and where this financing will enable expansion plans to be implemented. No sectoral requirements are required for this activity (other than observing all relevant regulatory excluded sectors).

With investments/loan sizes expected to average around £750,000 per enterprise and only a limited expectation of follow-on financing, a portfolio of up to 40 investments/loans could be anticipated giving a good degree of diversification.

This Fund should be positioned to offer differing forms of finance depending upon the needs of specific enterprises and hence a mixture of convertible loans or debt (70%) and equity (30%) is considered appropriate. Fund managers will however have the discretion to structure transactions as they see fit, subject to (a) ensuring that all appropriate regulations are followed and (b) ensuring that annual cash return targets are achieved.

Fund 5 – Small Loan Fund (£10m)

The Block One report and the Area Market Overview have highlighted the ongoing financing gaps which indicate a continued general shortage of finance for microbusinesses –defined as businesses with fewer than 10 employees. This area of finance covers debt funding for start-ups, microfinance (typically defined as up to £20-£25,000) and small loans (defined as being up to around £70-£80,000).

The Small Loan Fund targets this market failure and is expected to be implemented by an experienced Fund Manager with the skills, track record and local network to develop a strong portfolio of small loans in established and start-up enterprises.

With an average loan of circa £30,000 it is anticipated that the fund will make in the region of 320 loans.

1.2.3.3 Proposed Financial Instruments for TV area (forming part of the Northern Powerhouse Investment Fund)

As noted in s1.1.2 above, based on feedback from local stakeholders, a governmental decision was taken in November 2015 to refocus investment strategy development (from the original geographic scope envisaged by the Block One report) on:

- a) The development of a North East Local Enterprise Partnership area specific investment fund programme
- b) The development of a Northern Powerhouse Investment Fund Programme (led by the British Business Bank) and incorporating the Tees Valley Local Enterprise Partnership area.

A separate multi-regional Financial Instrument is proposed by the MA, to address the need, demand and opportunities in the North West England and Yorkshire and the Humber regions and Tees Valley Local Enterprise Partnership area.

A composite approach has been developed, with the multi-regional Financial Instrument drawing on the Block 1 and Block 2 findings for the three regions (including the findings detailed at 1.2.3.1 above).

Each region is considered to demonstrate broadly comparable need and demand characteristics, and proposed investment strategies. These have been used to inform the proposed delivery arrangements for the Northern Powerhouse Investment Fund. In the case of Tees Valley, need and demand at 25% of the North East region totals has been assumed.

It is understood that the decision to include the Tees Valley Local Enterprise Partnership area within the proposed multi-regional FoF as opposed to within the specific North East FoF was based on a number of stakeholder considerations. These included a wish on the part of the Tees Valley stakeholders to benefit from being part of a FoF with potentially greater critical mass and economies of scale. It also reflected a view amongst stakeholders that Tees Valley shares a greater number of economic challenges and opportunities with the geography of the proposed multi-regional FoF.

Table 5: Financial Instruments – Programming Period 2014-2020 – Revised DCLG Tees Valley/Combined Northern Powerhouse Fund

| Financial Instrument | Proposed contribution £ m and ranges |
|----------------------|--|
| Equity Fund | <p>£140m</p> <p>Building on the originally proposed Early Stage Fund and Innovation Fund. DCLG propose an investment range usually between £50,000 and £1m for early stage and technology businesses.</p> <p>Building on the equity component of the proposed Development Capital Fund. Investments expected to range up to £2m in size. DCLG is considering the circumstances under which this upper limit may be increased.</p> <p>Overall, average investment size is expected to be £550k.</p> |
| Micro Loan Fund | £20m |

| | |
|------------------------------|---|
| (Small Business Loans Focus) | Building on the originally proposed debt component of the Innovation Fund, DCLG propose an investment range of £25,000 to £100,000 in size. Average investment size is expected to be £28k. |
| Debt | £190.5m Building on the debt component of the originally proposed Growth Capital and Development Capital Funds. Investments expected to range from £200,000 to £2m in size. Although it is understood that DCLG may wish to narrow the range further following market feedback Overall, average investment size is expected to be c£450k. |
| TOTAL¹³ | Approximately £350.5m |

1.2.3.4 Target market

As illustrated, there are clear benefits for the financial instruments to be set up at a regional level through a fund of funds, thereby ensuring their cohesive, effective implementation, critical mass, and efficient deployment in the targeted regions and groups. Regional expertise and local knowledge are therefore key success factors in the implementation. Additionally, the Block One report Area Overview has given some insight into the industries and sectors where this region has established a degree of comparative advantage which creates a good foundation to be built upon and therefore involvement of the appropriate skill sets in sectors of comparative advantage is considered an important success factor.

The grouping together of localities to form a critical mass of committed ERDF capital is an important component of this regional exercise. This enables the possibility of additional financing from EIB but also requires a greater level of cooperation. For a region where multiple localities are grouping together, the benefits of critical mass can be undone if any form of ‘ringfencing’ becomes prerequisite. If any commitment is made with additional requirements on geography and sector focus, this can quickly undermine the required element of critical mass needed to make functional investment instruments deployable and contribute to EIB repayment. Additionally, the General Block Exemption Regulation No 651/2014 Article 14 states that ‘Risk finance measures shall ensure profit-driven financing decisions’ and later states ‘including an appropriate risk diversification policy aimed at achieving economic viability’. This implies that artificial geographic targets placed on instruments could contravene this regulation.

1.2.3.5 Target final recipients

As recognized in the general ex-ante methodology, predefining final recipients of future financial instruments “can be particularly challenging on a time horizon of up to ten years (i.e. the duration of the eligibility period, running until 31 December 2023), especially in some sectors such as

¹³ Management costs impact not considered in the total.

microcredit. Therefore, the proposed investment strategy should set a target for the final recipients, leaving room for changes (e.g. sectors of industry classified as innovative may develop over time) and be sufficiently prudent when selecting the financial product. Indeed, during the implementation phase, a reasonable level of flexibility can be beneficial to the effective disbursement of the funds.”

From gathered implementation experience, being too prescriptive in the definition of targets can lead to implementation difficulties and limited market impact and hence a more general and flexible approach is advised as long as the target final recipients of the proposed FIs are still within the EU definition of SMEs.

1.2.4 Envisaged combination with grant support

Eligibility rules under the ERDF-funded FIs in the 2007-2013 period did not allow for the combination of FIs and grants for the same eligible expenditure. This was seen as a problem by the Member States, especially given the difficulties faced by grant beneficiaries to secure the pre-financing or co-financing necessary to implement investment projects.

Whilst pre-financing will continue to remain ineligible, in the 2014-2020 programming period the CPR allows a combination of grants and FIs, as detailed in the EC’s Short Reference Guide: “For the combination of ESIF financial instruments with ESIF grants or other assistance, there are two possibilities.

- Firstly, it will be possible for certain types of grants (interest rate subsidy, guarantee fee subsidy or technical support as specified in Article 5 of the Delegated Act) and financial products to be combined within the same operation and to be treated as a financial instrument. Other types of grants cannot be presented under a single financial instrument operation.
- Secondly, it will be possible for the grant operation and financial instrument operation support to be combined to finance the same investment at the level of final recipient, however as separate operations.
- The overall guiding principle for all cases is that the same expenditure cannot be declared twice to the Commission. Grants shall not be used to reimburse support received from financial instruments and financial instruments shall not be used to pre-finance grants.”

In the case of the North East Region (proposed NELEP area FoF and Northern Powerhouse Investment Fund) in particular, practical examples of FI/grant combinations that should be considered should include:

- Creation of a supporting infrastructure for new enterprises and first-time borrowers as SMEs in terms of investment readiness (such as mentoring; legal advice etc.).

In the instruments proposed, one of the issues raised by grant-FI combination is the compliance with state aid/de minimis aid cumulation rules. Final recipients may have the option to benefit from a grant and also from co-financing ESIF-funded loans, as long as the total aid intensity thereby provided does not breach the maximum intensity allowable under state aid rules. FIs and grant combination options could be even predefined at the instrument design stage, either by imposing certain structures derived ideally from the de minimis, or from the GBER rules for ease of

implementation.

1.3 Lessons learnt

The Lessons learnt from the use of FIs have been developed in the Block One report. However, another overview is provided in the following section to complement the PIS(s).

1.3.1 The relevant past experience

The implementation of financial instruments in the 2007-2013 programming period was undertaken only to a limited extent in the European Union. Yet, given that SMEs were the main recipients of the instruments, that process provided sufficient experience to draw some lessons learnt for the purpose of this document.

1.3.2 Lessons Learnt

1.3.2.1 *Lessons learnt – UK specific*

Whilst the UK has significant experience of setting up and implementing a variety of financial instruments, a new type of structure was developed with EIB Group and implemented with four different regional authorities in the 2007-2013 period. This new structure involved EIB lending to the regional structure to boost the critical mass of capital alongside allocated ERDF funding. These 'leveraged' JEREMIE Holding Funds were implemented in Wales, the North West, the North East and the Yorkshire & Humberside region. As this was a new concept, understandably the EIB looked closely for any lessons that could be learned from the process and undertook an internal mid-term review. From this exercise, certain lessons were learned which have influenced the views of EIB and hence impacted certain aspects of the PIS for the 2014-2020 period. These can be briefly summarised as follows:

- In order to ensure an appropriate diversified investment strategy is adopted for such structures to be in a position to meet loan servicing contractual obligations, a minimum critical mass of such structures is required. EIB estimates this to be at least GBP 100m.
- In order to ensure an appropriate level of predictable reflows from the underlying financial instruments in order to service the debt element of these structures, at least 50% of the capital is required to be allocated to coupon-bearing or similarly predictable financial instruments.
- In order to maintain the overall critical mass of capital in the structure dedicated to be invested into financial instruments, any expected management fees and similar costs need to be covered by sources of funding outside of the structure itself.
- In order to maintain the required levels of implementation diligence and timely focus on deliverables, appropriate levels of independent corporate governance will be required.
- In order to respond to differences in implementation success of the underlying instruments and to accommodate any unforeseen changes in economic conditions, a flexible approach to capital allocation at the Fund of Funds level is to be recommended wherever possible.

- In order to avoid any unintended difficulties in the implementation and resultant utilisation of capital commitments within the underlying instruments, the central authorities are asked to consider carefully the impact of any national initiatives.

Additional feedback received directly from financial intermediaries involved in the implementations in the current programme includes the following points:

- The biggest factor perceived at limiting the impact of the existing activities has been the sector restrictions imposed on the investment scope. In particular, the exclusion of the 'retail' and 'business to customer (B2C)' sectors has hindered the provision to a greater number of enterprises.
- The restriction preventing investments that are categorised as 'management buy-outs' are regarded as further limiting factors.
- The formal EC definition of SMEs can be too restrictive with the upper limits on medium-sized enterprises preventing investments that are needed.
- The ESIF period end dates prevent the possibility to create follow-on investments into successful business thereby undermining the potential to create positive returns to investors¹⁴.

1.3.2.2 *Lessons learnt - general*

Clear, market-oriented and flexible eligibility rules

At a higher level, it should also be noted that the implementation of the financial instruments at the very outset of the previous programming period 2007-2013 had been impeded by the initial lack of clear regulatory provisions related to the implementation of financial instruments under Structural Funds. The publication of a comprehensive COCOF guidance note on the implementation of financial instruments in 2011 clarified the majority of questions relating to the eligibility of expenditure. It was later amended (in 2012) to address the urgent need for financing on working capital, which for instance continues to remain the bulk of demand in the current economic context.

The new regulatory framework for the 2014-2020 period, generally represents an acceptable basis for the future implementation of decentralised financial instruments. However, the following principles are to be carefully considered in all future implementations.

Flexibility

Given that eligibility and state aid rules may hamper final recipients in benefitting from FIs, it is important to limit the eligibility rules only to the strictly necessary ones, and to try and preserve for the instruments as much flexibility in meeting demand as possible. It is also important to allow for an easy re-allocation of resources from the non-performing to performing instruments, by grouping them under a fund of funds structure at regional or national level.

Suitability of the selected FIs

¹⁴ Now resolved under the ESIF Regulations for 2014-2020 period.

The role of the FIs in the deployment of funds is crucial to maximise such benefits of instruments portfolio as: utilisation of public resources, leveraging of private resources and investors, deployment of the instrument in accordance with the contractual obligations to ensure transfer of benefits to the beneficiaries with transparency, accountability and compliance with national legislation and EU regulations. The selection of the FIs should be carried out in the framework of all the above with full impartiality, and on the basis of a thorough assessment that includes technical expertise and know-how.

Availability of funds

During the previous programming period, all funds were available at the beginning of the operations. This ensured that the HF manager could enter into agreements and deploy financial instruments of varying risk profiles and of duration exceeding the programming period. This could be achieved without any additional conditions that could reduce the benefits transferred to the final beneficiaries, diverge from market practice, or trigger additional legal provisions. In the 2014-2020 ESIF period, the new concept of tranching of ESIF payments presents an additional operational aspect to the implementation of FIs which has to be carefully considered.

Combination with grants

As the new regulations allow to combine grants with financial instruments, it is up to the implementing bodies to decide if grants and instruments should work as an embedded or connected product(s) and potentially be managed by the financial instruments manager, or if the grant element would better work as an external component to be managed separately (perhaps in collaboration with a grant focussed authority).

Appropriate evaluation of financial results

An accurate evaluation of the results of financial instruments can only be made after the instruments have been wound down, returns fully generated and any losses have been incurred, and the equity funds have closed. It is well known that such instruments have a slow start and most equity gains or guarantee portfolio losses occur towards the end of their lives. Furthermore, the indicators used in the FIs evaluation must be different from those used in grant evaluation.

Capital Relief

In the course of implementation of certain debt instruments under the previous programming period, the intermediaries expressed interest in the applicability of regulatory capital relief under guarantee and debt products. The provision of regulatory capital relief should be carried out in a way that is compatible with national legislation and capital markets regulatory framework in close connection with legal experts and the national regulator, respectively.

It is expected that the provision of regulatory capital relief will remain a key element for the future implementation of debt products under ESIF and for that reason it should be considered at the stage of Funding Agreement negotiation whether its provisions would be compatible with this objective.

In accordance with the Basel regulatory framework, the benefit of the capital relief can be fully utilised when the entity providing the guarantee enjoys the maximum credit rating.

Transfer of benefits

Most of the instruments that are deployed through banks as FIs incorporate an element of support

that is directed at the final beneficiaries. Continuous monitoring and sophisticated reporting through contractual arrangements with the FIs are required to ensure that the full benefit is transferred to the SMEs in a transparent and uninterrupted manner.

Attracting quality fund managers

Small country-specific funds rarely manage to attract top talent, as far as concerns fund managers, due to their size. To counterbalance that, equity instruments could offer an attractive fee/carry ratio. This approach would require a careful balancing act between the interests of fund managers and private investors, and must in any case retain the alignment of interest principle. A more attractive carry might make investors less interested, and so such incentives might only be possible with regard to public participation in the fund.

Local and committed teams

Strong local teams, or international teams with substantial capacity on the ground, have been shown to help an equity instrument achieve the impact sought by ESIF funding, especially from the developmental perspective.

1.4 Value added of the financial instruments

1.4.1 Value added of the proposed financial instruments

1.4.1.1 Qualitative value added

Given the market failures identified in the relevant chapter, the qualitative value added of financial instruments is significant in many respects, including:

- A more responsible approach, better performance and financial discipline at final recipient level in the case of financial instruments (“repayable assistance”) compared to non-reimbursable assistance.
- Stimulation of a new generation of entrepreneurs in the innovative sector through the microfinance or early stage equity investments;
- Supporting the build-up and modernisation of the financial system, including also the non-banking financial institutions previously not used as intermediaries under the ERDF FIs, by using new instruments and gaining new SME customers, including in the social economy.
- Creating a degree of competition and complementarity among banks, fund managers, and other intermediaries which, as it has been shown in the past, usually leads to better terms for the final recipients;
- The mathematical leverage effect is supplemented by the stimulation of greater interest of private investors in a country or sector they would not have considered otherwise, potentially leading to further investments undertaken by them in the future.

1.4.1.2 Quantitative value added

The main element of quantitative value added of the proposed FIs is the leverage on ESIF resources

and the subsequent market impact. At instrument level, leverage can occur at multiple different layers in the proposed structure. For example, at the FoF level itself, if structured correctly, the ESIF funding can be used to attract the EIB loan financing which immediately offers a leverage factor of 2. Additionally, underlying instruments may need to be designed to attract additional investment either by the selected fund managers themselves (to ensure alignment of interest) or other private investors wishing to engage in this opportunity (as limited partners) and to respect the relevant regulations. Furthermore, particularly for equity instruments, additional equity investment can often enable to enterprise to be in a position to secure additional loan financing.

However, the quantitative leverage is perhaps best viewed at the FoF or instrument portfolio level, which gives an overall aggregated account of the effectiveness in the spending of ESIF resources from the point of view of stimulating private financing. Additionally, within the implementation of FoF structures that enjoy the ability to attract an EIB loan, this further enhances the overall leverage and market impact aspects.

Table 6 (a): Indicative leverage effect of a notional NE LEP and TVU portfolio (Original PIS)

| Financial Instrument | Instrument size £ m | Estimated total SME loans/investments facilitated | Potential Leverage on ESIF |
|--------------------------|--------------------------------|--|---|
| Innovation Fund | £40m | 200-300 | EIB 2x and possibly a further 0.5x from private investors |
| Early Stage Fund | £40m | 100 | EIB 2x and a possibly a further 0.5x from private investors |
| Growth Capital Fund | £35m | 450 | EIB 2x and a minimum of 40% from private investors |
| Development Capital Fund | £45m | 70 | EIB 2x and a minimum of 40% from private investors |
| TOTAL | Approximately £160m | 820-920 | |

Source: EIB

Table 6 (b): Indicative leverage effect of the proposed instruments (NELEP only)

| Financial Instrument | Instrument size £ m | Estimated total SME loans/investments | Potential Leverage on ESIF |
|----------------------|------------------------|--|-------------------------------|
| Innovation Fund | £30m | 145 | At FoF level: |

| | | | |
|---------------------------------|--------------|------------|---|
| | | | EIB & Legacy circa 2.5X At fund level: additional 0.83X from private investors. |
| Early Stage Fund | £30m | 60 | At FoF level: EIB & Legacy circa 2.5X At fund level: additional 1.5X from private investors. |
| Growth Capital Fund | £20m | 70 | At FoF level: EIB & Legacy circa 2.5X At fund level: additional 1X from private investors. |
| Development Capital Fund | £30m | 40 | At FoF level: EIB & Legacy circa 2.5X At fund level: additional 1X from private investors. |
| Small Loan Fund | £10m | 320 | At FoF level: EIB & Legacy circa 2.5X |
| TOTAL | £120m | 635 | |

An important additional benefit to the leverage effect calculated above, while difficult to estimate in advance, consists in the revolving nature of the current (JEREMIE) and future ESIF FIs. Even with the assumed losses, the revolved resources, which will need to be again targeted towards SMEs, will add further value in the form of further “rounds” of SME financing (Legacy Funds).

As part of the ongoing development work for the proposed multi-regional FoF, DCLG and stakeholders have modelled the possible returns and leverage of the revised financial instruments. It is understood that it is now estimated that £407m of private sector investment will be levered for the combined Northern Powerhouse Fund. This estimate and the underlying assumptions have not been reviewed by EIB.

1.4.2 Consistency of the proposed financial instruments with the OPs' objectives

1.4.2.1 England Operational Programme (OP)

The central Managing Authority (DCLG) has finalised this Operational Programme which is expected to have a significant total financial allocation of ERDF. ERDF (and ESF) can be spent on a number of objectives defined in EU legislation and known as Thematic Objectives. The England programme will cover the following objectives:

- (1) Strengthening research, technological development and innovation;
- (2) Enhancing access to, and use and quality of, Information Communication and Technology;
- (3) Enhancing the competitiveness of Small and Medium Sized Enterprises;
- (4) Supporting the shift towards a low carbon economy in all sectors;
- (5) Promoting climate change adaptation, risk prevention and management;
- (6) Preserving and protecting the environment and promoting resource efficiency;
- (7) Promoting sustainable transport and removing bottlenecks in key network infrastructures;
- (9) Promoting social inclusion, combating poverty and any discrimination.

For the purpose of this PIS, the focus will be on Priority Axis (PA) 3 namely "Enhancing the Competitiveness and Growth of SMEs". This PA has been allocated 38.8% of the funding allocation representing an actual amount of EUR 1.409 billion and this is based upon the following justification provided within the OP itself.

"There is a wide variation in the competitiveness of small and medium sized enterprises. The majority do not show growth in any given year. Separate research shows that only approximately seven per cent of small and medium sized enterprises between 2002 and 2010 could be classified as 'high growth' according to the Organisation for Economic Co-operation and Development definition and these were responsible for creating nearly a quarter of all new jobs over three years.

There are various factors that limit the ability of a small and medium sized enterprise to grow:

- *Business owner awareness of and access to business support. Businesses report significant benefits from using business information and advice. However, less than half of United Kingdom small and medium sized enterprises currently use business support due to difficulties in accessing information or advice and; doubts about the benefits of business support;*
- *The internal capacity and capability of a business including their ability to innovate;*
- *The external environment including procurement, access to finance and exporting.*

Access to finance is a particular area of difficulty for small and medium size enterprises. While 38 per cent of small and medium sized enterprise employers consider obtaining finance an obstacle to their

business success, seven per cent of these employers report it as the main obstacle. Finance is also a disproportionately important obstacle for high growth firms compared to other businesses. Evidence suggests there has been a decline not only because of reduced supply of funding but also a reduced demand appetite for risk.

Exporting small and medium sized enterprises are more productive, innovative and resilient than non-exporting firms. The contribution of small and medium sized enterprises is significant – contributing to 80 per cent of the quantity of exports. A recent study found that 25,000 to 150,000 non-exporting United Kingdom small and medium sized enterprises have the potential to be competitive in export markets. “

As a direct result of these factors, the OP lays out that use of Use of European Regional Development Fund will be focussed on:

“Small and Medium sized Enterprises are therefore seen by the EC and by Local Enterprise Partnerships as the highest priority for the 2014-2020 Growth Programme in terms of value of investment, focussed predominantly on access to finance and business support measures. There are three separate investment priorities in this axis which are:

- Access to finance through grants, loans and equity to help businesses grow where some groups of Local Enterprise Partnership areas are looking to build on current financial instruments to improve access to finance for small businesses while others look to collaborate to set up new financial instruments*
- Business support including advice services for entrepreneurship, commercialisation, and exports;*
- Business support for new business start-ups;*
- Premises for SMEs including managed workspaces and business incubators where demand is shown to exceed supply.*

The support provided through this priority will aim to increase the growth capability and capacity of Small and Medium Sized Enterprises and in doing so develop the pipeline of future high growth business as well as increase entrepreneurship across England, but there will also be a particular focus on territories with low levels of enterprise activity, and amongst under-represented groups. The projected number of enterprises receiving support from the funds (including match funding) by 2023 is about 65,000.”

The creation and the acceptance of the OP lays out the background and framework for this PIS and enables a high level of consistency between the overall national priorities and the more regional focus of both the PIS and the subsequent implementation.

In respect of Priority 4, which is expected to be utilised by the NELEP area FoF, and the Northern Powerhouse Investment Fund, the Managing Authority also confirms that access to finance is an appropriate means of support enterprises in or seeking to enter the low carbon sector, to develop new products, goods and services, in response to the needs and demand specified in the OP.

1.4.3 Consistency with other forms of public assistance addressing the same market

1.4.3.1 Consistency with current SME financing instruments

Block One of the Ex-ante Assessment undertaken by EIB with the support of Regeneris Consulting has covered this subject in depth and explained the array of previous and current initiatives to support greater SME access to finance within England and the UK. It is therefore not the intention of this PIS to duplicate that analysis however it is important that any final decisions on financial instruments at a regional level take into account activities planned at a national level, particularly those of the British Business Bank (BBB). Block One of the report has argued that the overall size of the market failure or suboptimal investment situation is significant and that a mixture of national and regional activities are considered appropriate to address the needs and stimulate further growth.

1.4.3.2 Consistency with activities of the British Business Bank (BBB)

Given its role, the BBB works closely with central government authorities to devise value-adding financing instruments for the SME marketplace. The British Business Bank's Small Business Finance Markets report, published in December 2014, shows that increased numbers of smaller businesses are expected to seek finance for growth in the coming years, as nearly half (46%) of small businesses plan to grow their turnover in the next 12 months, with 17% of these expecting to fully or part fund this expansion with commercial finance. The BBB website (www.british-business-bank.co.uk) lists the following debt and venture capital solutions to encourage lenders to fund smaller businesses:-

- Debt programmes
- Start-Up Loans
- Enterprise Finance Guarantee
- Equity programmes
- Enterprise Capital Funds (ECFs)
- Business Angel CoFund
- UK Innovation Investment Fund
- Aspire Fund

Whilst these initiatives are predominantly national in nature and do not target regional weaknesses, they remain an important part of the publicly-funded SME financial instrument landscape.

1.4.3.3 Consistency with EU-level instruments managed by EIF

The newly launched central EU instruments have been entrusted to EIF for implementation by the EC and implementation activities have already begun. These instruments are open to engagement with financial intermediaries across all Member States and it should be expected that a certain volume of transactional activity will result in England. These instruments, do not specifically address the local market needs and their predecessors CIP and FP7 RSSF, as well as the first PROGRESS Microfinance, have been used only to a limited extent in the country. The EU-level instruments include the COSME Loan Guarantee Facility (successor of the CIP SMEG) and InnovFin Guarantee

(HORIZON 2020) instruments amongst others and also remain an important part of the publicly-funded SME financial instrument landscape.

1.4.4 Possible State Aid implications

Block One of the report has covered this subject in detail and utilises external advice of this matter. Hence, this paper will not cover this subject in detail other than to state that each of the instruments detailed above needs to be carefully considered against State Aid regulations. As EU funds create advantages for SMEs on a selective basis, and their utilisation is decided upon by the state, they have the potential to be considered state aid under Article 107 of the TFEU. Although the new EC regulations for block exemption and de minimis aid entered into force in 2014, the principles of state aid are the same, with the following categories of financial instruments:

- State aid free instrument – e.g. loans at market rates, guarantees priced at market rates or at “safe harbour” rates, as defined by the EC
- Instruments with a state aid element but considered compatible with the TFEU and thus exempt from notification:
 - De minimis instruments under Reg. 1407/2013, not requiring notification – e.g. investments under the de minimis ceiling amount, or guarantees/loans where the aid element (gross grant equivalent) falls below the de minimis threshold.
 - Instruments exempt from notification under Reg. 651/2014, such as risk capital funds with at least 40% private participation and complying with all the other conditions set out in the GBER 651.
- Outside of these categories, instruments with a state aid element require a formal notification to the EC in coordination with the national state aid point of contact if considered required.

Since notified instruments may take longer to be approved, and state aid free instruments may not be interesting for market players and final recipients, the EIF’s experience in the former programming period is that the block exemption rules (GBER and de minimis) are the best option to be used for financial instruments.

For each financial instrument, a careful assessment of state aid compatibility is needed, not only at final recipient level, but also at the level of the intermediary and (in the case of equity funds) of a private investor. As with any EU projects, it is essential to make the state aid elements a part of the instruments’ design process, in tandem with the ESIF eligibility rules. This ensures that the principles are duly respected and, if required, a state aid, or a de minimis aid scheme, is proceeded with well in time for the implementation of the instruments.

1.5 Potential for additional resources to be raised by the financial instruments

1.5.1 Identification of potential sources of funding

It is understood that the FoF structures for the North East Region (both the North East LEP area FoF

and NPIF), will be seeking to attract EIB loan capital and legacy funding as matched funding. If approved and finalised this creates an immediate initial leverage factor of 2x to 2.5x as shown above. For this reason, it is important to note that the selected FoF manager needs to have the capability to attract matched funding of this kind. In addition, certain underlying financial instruments may need to attract additional independent private investment (leverage) to varying degrees at either the level of the financial intermediaries or the eligible undertakings in order to increase the available capital pool (See Table 4) and comply with any relevant regulations (for example: risk finance measures/instruments operating under the General Block Exemption Regulation 651/2014 will need to respect Article 10). This effect can bring clear benefits in terms of critical mass and impact for the region.

It is important to note that the provision of an EIB Loan at the FoF level is a key aspect of this implementation model. From previous experience with commercial banks and reflecting the current status of commercial banks lack of willingness to undertake these types of loans, the EIB loan financing is considered to bring significant added value in enabling this structure to be implementable. Should any commercial bank be willing to lend on similar terms and conditions to EIB, then the region should fully explore that possible source of funding.

Additionally, a further source of funding to be considered is the legacy returns generated from the successful implementation of previous activities. These funds can either be used to add to the regional commitment to the FoF or allocated outside of the FoF to cover management costs likely to be incurred.

1.6 Consistency of the expected results with the operational programmes

In line with the objectives of the Operational Programmes and specific Priority Axes, the following are possible result indicators in the assessment of the performance of the proposed FIs.

Table 5 (a): Potential result indicators of a notional NE LEP and TVU portfolio (Original PIS)

| Financial Instrument | Funding Source | Result indicators ¹⁵ | |
|--------------------------|--------------------------|---------------------------------|------------------|
| | | Jobs created | Jobs safeguarded |
| Innovation Fund | ESIF and Matched Funding | 799 | 238 |
| Early Stage Fund | ESIF and Matched Funding | 561 | 263 |
| Growth Capital Fund | ESIF and Matched Funding | 2,438 | 1,560 |
| Development Capital Fund | ESIF and Matched Funding | 894 | 1,100 |
| Totals | | 4,692 | 3,161 |

Source: EIB/EIF after appropriate consultation

¹⁵ It is important to understand the difficulty in estimating result indicators of this nature for financial instruments when the implementing period is spread across a number of years and potentially differing economic cycles. Therefore, all indicators should be considered as estimations only and not be considered as contractually binding on any party. These figures are offered as guidance only and subject to change through the course of actual implementation.

Table 5 (b): Potential result indicators to be monitored for the implementation of the proposed FIs (NELEP area only)

| ID | Output Indicator | Number |
|--------------------------------------|--|---------------|
| C1 | Number of enterprises receiving support | 1,200 |
| C3 | Number of enterprises receiving non-financial support (12+ hours support) | 600 |
| C4 | Number of enterprises receiving financial support | 600 |
| C5 | Number of new enterprises supported | 170 |
| C7 | Private investment matching public support to enterprises (non grants) | £60m |
| C8 | Employment increase in supported enterprises | 3,500 |
| C26 | Number of Enterprises cooperating with research institutions | 10 |
| C28 | Number of enterprises supported to introduce new to the market products | 50 |
| C29 | Number of enterprises supported to introduce new to the firm products | 120 |
| P13 | Number of enterprises receiving information, diagnostic and support (3+ hours) | 1,800 |
| Additional outputs delivered: | | |
| | EIB repayments | £67m |
| | Legacy generated | £81m |

Table 5 (c): Potential result indicators to be monitored for the implementation of the proposed FIs (Tees Valley area element of the Northern Powerhouse Investment Fund)

We are advised by DCLG that the Tees Valley ERDF contribution to the overall proposed Northern Powerhouse Fund is £19.5m (out of a total ESIF contribution of £140.360m). This equates to 13.9% of the overall proposed multi-regional FoF, including match. DCLG advise that each area will be expected to forecast from each fund in proportion (although of course, the actual will differ from this according to need/demand). Outputs are currently expected to be achieved in the same proportion. This means that Tees Valley is forecast by DCLG to achieve:

| LEP | NPIF Allocation | CI Enterprises Supported | C3 Enterprises Supported with Investment (non grants) | C4 Enterprises Supported with non financial support | C5 New enterprises supported | C7 Private leverage | C8 Employ'm't increase in supported enterprises | C28New to market products | C29 New to firm products |
|------------|-----------------|--------------------------|---|---|------------------------------|---------------------|---|---------------------------|--------------------------|
| TV | £19.5m | 353 | 195 | 158 | 69 | £56.6m | 737 | 4 | 30 |
| All | £140.36m | 2,536 | 1,391 | 1,145 | 495 | £407.5m | 5,262 | 27 | 219 |

1.7 Monitoring of the financial instrument and Revision of the Ex-Ante Assessment

1.7.1 Monitoring and controls

It is anticipated that each FoF will be a special (and single) purpose vehicle whose role will be deliver this programme of activity alone. Rigorous, effective and efficient control systems will be implemented and maintained by the FoF, which will be need to be staffed with personnel who are experienced in managing publicly funded financial instruments and the audit, control and verification environment that brings, in order to comply with Article 7 of the Delegated Regulation. These requirements include:

- 7.1.3.1 adequate capacity to implement the financial instrument, including organisational structure and governance framework providing the necessary assurance to the managing authority
- 7.1.3.2 an effective and efficient internal control system; and
- 7.1.3.3 the use of an accounting system providing accurate, complete and reliable information in a timely manner.