



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

SME Access to Finance Market Assessment  
Block Two  
Proposed Investment Strategy for the East  
and South East Midlands Regions of England

October 2016

Final Report

# Contents

<b>1</b>	<b>Proposed Investment Strategy .....</b>	<b>3</b>
1.1	<i>SME Market Analysis (2014/15) – the Summary of Findings .....</i>	3
1.1.1	A Regional Perspective.....	4
1.2	<i>Proposed Investment Strategy and Implementation Arrangements.....</i>	5
1.2.1	Options for implementation arrangements .....	5
1.2.2	Proposed financial instruments, target market and target final recipients .....	10
1.2.3	Proposed implementation structure - the case for pan-regional collaboration .....	17
1.2.4	Envisaged combination with grant support .....	19
1.3	<i>Lessons learnt.....</i>	19
1.3.1	The relevant past experience.....	19
1.3.2	Lessons Learnt.....	20
1.4	<i>Value added of the financial instruments .....</i>	23
1.4.1	Value added of the proposed financial instruments.....	23
1.4.2	Consistency of the proposed financial instruments with the OPs objectives .....	24
1.4.3	Consistency with other forms of public assistance addressing the same market.....	26
1.4.4	Possible state aid implications .....	27
1.5	<i>Potential for additional resources to be raised by the financial instruments.....</i>	28
1.5.1	Identification of potential sources of funding.....	28
1.6	<i>Consistency of the expected results with the operational programmes .....</i>	28

# 1 Proposed Investment Strategy

This Proposed Investment Strategy (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 “Proposed Investment Strategy” (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 partially based on the findings of an initial investment strategy proposal developed by Blue Sky Corporate Finance, the “Proposed Investment Strategy for the West Midlands Region” developed by the EIB. It has subsequently been updated to also reflect the proposed a multi-regional investment strategy prepared by BBB. The present PIS 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 Annex Two therein: “Area Overview for East Midlands”. Furthermore, the PIS has been developed through careful consideration of the input delivered to EIB Group from the local entities, including the findings of the autumn 2014 SME Access to Finance survey coordinated by the Local Enterprise Partnerships (LEPs) as reported in Block One, under the overall coordination by the Steering Group, comprising representatives from each LEP, DCLG and the British Business Bank (BBB). To exploit cross-regional synergies and develop a common investment approach, the East and South East Midlands (E&SEM) LEPs are working together to create, for the first time in the region, a fund of funds that will assemble a range of financial instruments to provide access to finance support for SME business creation, development and growth.

## 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 provided also a more regional perspective included in the “Area Overview” for the East Midlands Region, and it is important to use those findings to set the context for this Proposed Investment Strategy. This regional perspective provided clear further evidence of market failure and/or sub-optimal investment situations for the region. Firstly, the East Midlands Region is a significantly important economic area for England and the region is home to 313,000 SMEs, of which 298,400 (95%) are microbusinesses (less than 10 employees), 13,300 are small (10-49 employees) and 2,200 are medium sized firms (50-249 employees). Of the microbusiness stock, 170,500 are unregistered for VAT/PAYE and 59,700 are single person firms.

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 20,000 SMEs in the region looking for external finance, of which 15,000 were microbusinesses. Some of these microbusinesses will have been seeking microfinance; others will have been looking for larger amounts<sup>1</sup>.
- Of these, nearly half (45%) had difficulties of some sort in obtaining this finance.
- 6,400 (32%) of SMEs obtained none of the finance they were looking for, and 1,200 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 with micros having the most difficulties and these easing with size increases).
- 4,300 SMEs that 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 majority of these were micro businesses.

The Block One report goes further to suggest that 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 £1.2 billion in one 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 (and hence constitutes 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:

- <£5m per year for microfinance (i.e. up to £25k)
- £70m per year for microbusinesses seeking larger amounts of finance (typically less than £80,000)
- £60m per year for small and medium firms seeking larger amounts of finance.

---

<sup>1</sup> These estimations do not take into account other businesses that were not looking for external finance, but could benefit from further growth should they choose to do so.

It should be noted that this is, in effect, the gap (i.e. unmet demand) in “addition to which is already being met by the private sector and **publicly** backed initiatives.”

The European Investment Fund<sup>2</sup> (EIF) has been asked to provide its expert input based upon the aforementioned 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 its own internal reviews of the first experience of implementing JEREMIE funds, and its own knowledge of implementing similar activities across the EU and in the UK market.

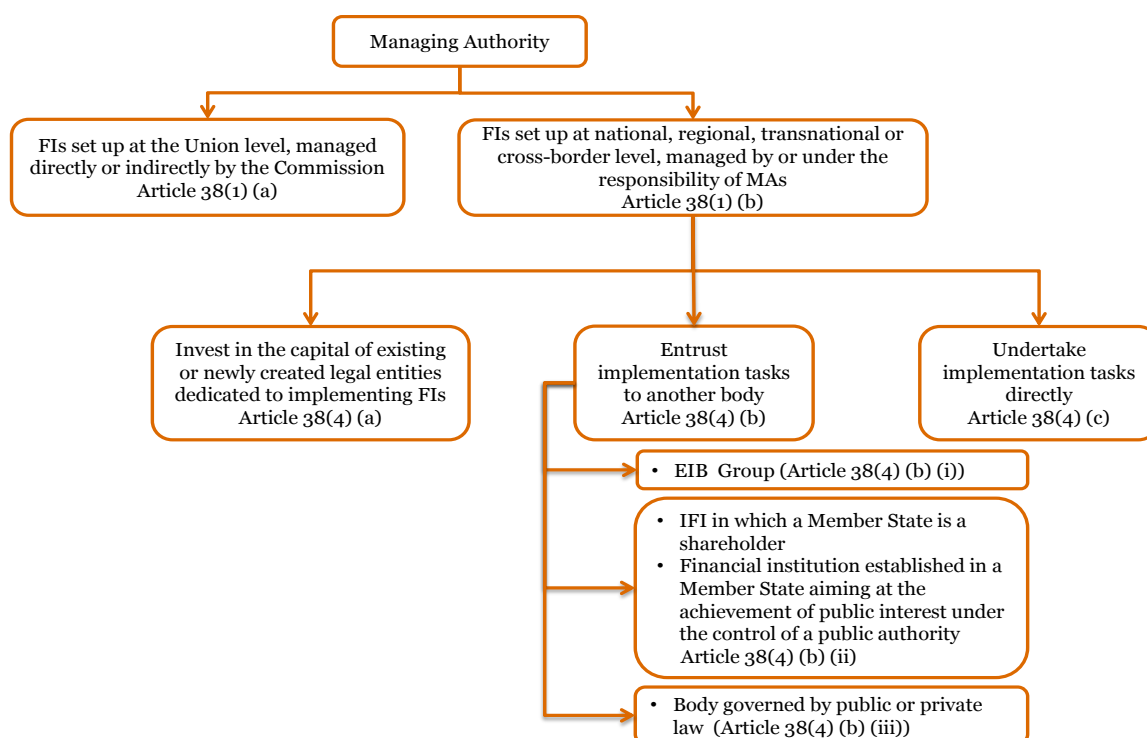
## 1.2 Proposed Investment Strategy and Implementation Arrangements

### 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 methodology<sup>3</sup>, is shown in the figure below.

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



<sup>2</sup> 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](http://www.eif.org).

<sup>3</sup> “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.

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

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 2020<sup>4</sup>, targeting financial intermediaries across the EU involved in lending, the provision of equity

4 See: [www.eif.org/what\\_we\\_do/news/2014/eu-finance-sme.htm](http://www.eif.org/what_we_do/news/2014/eu-finance-sme.htm)

(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 date the UK authorities have 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"><li>• Effectively a delegation of tasks to an entity experienced with using EU structural funds for supporting SME access to finance.</li><li>• Quicker implementation (selection of financial intermediaries, conclusion of funding agreements etc.).</li><li>• A centrally managed instrument can contain several compartments and thereby achieve greater critical mass and benefit from certain economies of scale.</li><li>• 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).</li><li>• Allows for relaxing of ESIF eligibility criteria.</li></ul>	<ul style="list-style-type: none"><li>• A certain loss of control at the level of the managing authority.</li><li>• A certain loss of targeting instruments to meet regional market failures and suboptimal investment solutions.</li><li>• 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.</li><li>• Limited synergies between the instruments.</li></ul>

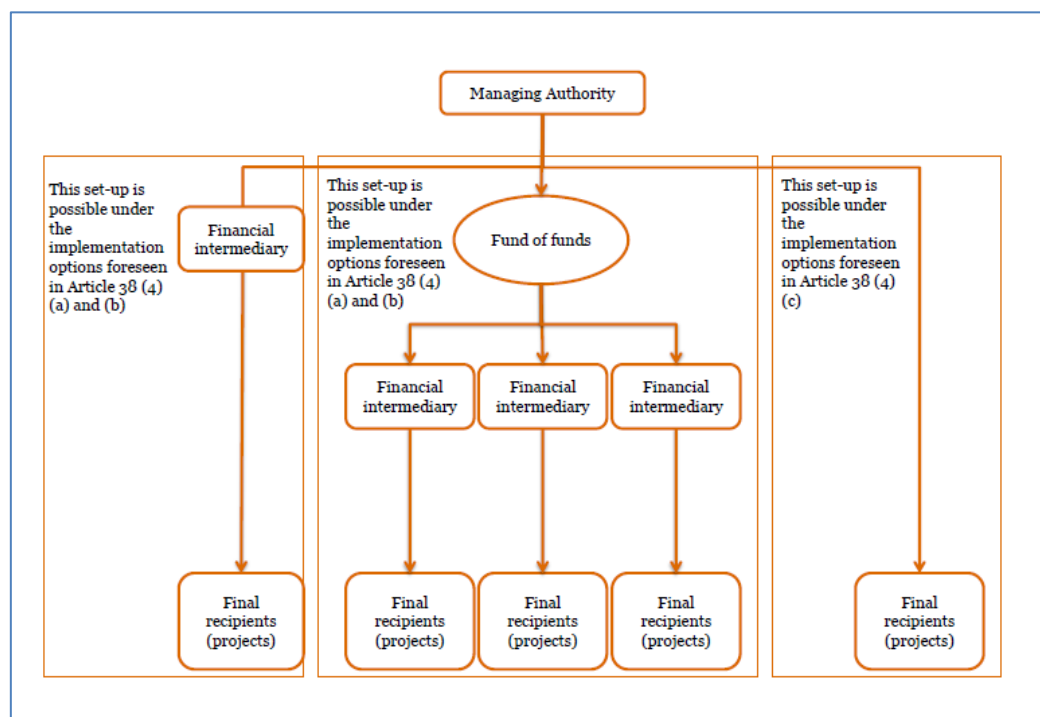
Source: EIB

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. However, it is fair to say that the previous experience of the “Fund of Funds (FoF)” implementation route in the UK has been positive and is considered to have delivered important levels of access to finance for SMEs when implemented with appropriate critical mass factors. The Managing Authority will assess this experience when finalising its implementation choice and could consider the following advantages and disadvantages.



**Table 2: Advantages and disadvantages of FIs managed via Fund of Funds**

Financial Instruments created via the Fund of Funds mechanism.	
ADVANTAGES	DISADVANTAGES
<ul style="list-style-type: none"> <li>• Closely managed control by the Managing Authority with effective delegation to an entity acting as manager of the Fund of Funds</li> <li>• Targeted instruments that meet regional market failures and suboptimal investment solutions</li> <li>• Close monitoring and controls: the managing authority still remains responsible for the operations, including payments and reporting when contributing to a centrally managed instrument.</li> <li>• Build-up of expertise and experience in management activities</li> <li>• Potential to attract additional investors at the FoF Level</li> </ul>	<ul style="list-style-type: none"> <li>• Potential lack of availability of local expertise in complex regulatory matters.</li> <li>• Speed of implementation may suffer due to learning curve aspects of implementation.</li> <li>• Potential for costs to rise above reasonable levels.</li> </ul>

Source: EIF

It is understood that the Managing Authority may also consider establishing a Fund of Funds which covers multiple regions, namely the West and East Midlands. This is on the basis that a larger multi-regional Fund of Fund could 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 Managing Authority include:

- Benefits of scale of operating one flexible overarching fund for each type of finance that reflects the two 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.

### “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 3: Advantages and disadvantages of the “Off-the-shelf instruments”**

Off-the-shelf instruments	
ADVANTAGES	DISADVANTAGES
<ul style="list-style-type: none"><li>• Benefit of defined product terms for convenience and speed of implementation;</li><li>• Oversight over implementation terms and conditions;</li><li>• These would represent clear examples of what the EC perceives as suitable financial instruments for ESI funds.</li></ul>	<ul style="list-style-type: none"><li>• Even if 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;</li><li>• 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;</li><li>• Lack of assurance on the possibility of exemption from notification requirements under State aid rules, meaning that notification cannot be excluded.</li></ul>

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).

#### 1.2.2 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 regions known as the East and South Midlands (E&SEM),

consultations with the representatives from the regions have been undertaken to consider this important subject area. These representatives have significant and valuable localised knowledge of the issues facing their regions 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 Blue Sky Corporate Finance or by Regeneris or by EIF or it is understood by BBB.

Participants in this consultation process include the E&SEM Steering Group comprising representatives of each of the participating LEPs Access to Finance Sub-Groups, local representatives of DCLG, BIS and BBB, as well local authority members.

All of the participating LEPs have independently developed economic strategies which reflect the sectoral strengths and growth ambitions of their respective areas. Many sector priorities are common to two or more of the five LEPs represented on the Steering Group, including: manufacturing, technology and innovation; creative and digital content; visitor economy, rural economy, tourism and hospitality; transport, ports and logistics; professional and financial services; construction.

The E&SEM LEPs share many of the same strategic drivers and economic priorities and they have identified access to finance as a significant inhibitor of business start-up, development and growth.

#### *1.2.2.1 Proposed financial instruments - Summary*

On the basis of the above analysis and consultation process, and with reference to the 26 November 2015 proposal for an investment strategy for FIs in the East and South East Midlands, drafted by Blue Sky Corporate Finance consultants – and pursuant to the priorities established in the relevant Partnership Agreement and the Operational Programme – the FIs described below were initially planned to be deployed in the new programming period. As indicated before, LEPs of the East and South East Midlands, decided to work together in order to gain efficiencies of scale by sharing development costs, market intelligence and the knowledge of best practice that can be brought to the table. Whilst collaborating across the East and South East Midlands on FIs deployment, the LEPs expect to maintain their ability to adopt subsequent re-allocations between financial instruments, depending on the actual implementation experience and economic circumstances.

The proposed FIs fall into two categories: debt and equity finance, with a proposed allocation of £35 million to debt and £25 million to equity. It is worth noting at this stage, the sub-optimal sizing on this activity. The instruments would constitute separate funds under the FoF structure, comprising for the debt part a business loans fund, growth mezzanine fund, and the debt element of the growth capital fund. For equity, the proposed instruments include the equity element of the growth capital fund, and a seed early-stage fund, as listed in the table below.

**Table 4: Initially proposed Financial Instruments – Programming Period 2014-2020 – East and South Midlands**

Type of financial instrument	Financial Instrument	Proposed contribution £ m and ranges	Funding Source & Other Aspects
Debt	Business Loans Fund	£15m Investment range between £15,000 and £150,000.	This fund will be focused on early-stage and established companies to provide debt support for limited growth development or working capital
	Growth Mezzanine Fund	£15m Investment range between £150,000 and £2,000,000	This fund will focus mainly but not exclusively on manufacturing and industrial companies, for which equity finance is neither desirable or viable to support their expansion, inward investments,
	Growth Capital Fund (debt component)	£5m Investment range for the entire fund between £500,000 and £2,000,000, with an average investment of ca. £1,000,000	<p>This fund will be focused on high-growth and high-performance companies, with an expected 50%-60% proportion invested in debt/mezzanine instruments to support investments focused on e.g. capital equipment, renewable technologies, or innovation. All of the form of finance will take the form of debt with two mezzanine features outlined below.</p> <p>This FI will be combined with the Growth Capital Fund to offer both equity and debt instruments and to secure fund management economies of scale.</p>
Equity	Growth Capital Fund (equity component)	£10m Investment range for the entire fund between £500,000 and £2,000,000, with an average investment of ca. £1,000,000	This fund will be focused on high-growth and high-performance companies, with an expected 50%-60% proportion invested in debt/mezzanine instruments to support investments in e.g. capital equipment, renewable technologies, or innovation. All of the form of finance will take the form of debt, with the mezzanine component taking the form of a redemption premium and an equity kicker
	Seed and Early-stage Co-investment fund	£15m Investment range between £25,000 and £1,000,000 with a cap of £25,000 on the initial investment and	This fund will be focused on pre- or early-revenue and high-risk companies with very high-growth and exit potential to support early-stage, equity investment with a focus in innovative technology and

		approx. £500,000 average total investment	knowledge-based businesses
	<b>TOTAL<sup>5</sup></b>	<b>Approximately £60m (including £30m EIB Loan)</b>	<b>The overall size of these instruments is estimated on the assumption that the implementing model will benefit from EIB Group Lending. It is recognised however that further regional co-operation may be needed to generate an overall fund size which has sufficient critical mass and scale to meet EIB lending requirements</b>

Source: EIF

The proposed six funds under the FoF would create a balanced portfolio construction to deliver sufficient diversification and retain critical mass within each fund, but the overall FoF sizing of £60m would not provide the critical mass and scale requirements of EIB lending. Hence, it was not considered to constitute a financially viable proposition when considered in isolation and wider regional consultation was recommended. Subsequent further consultation and development work has now been undertaken and a proposal to create a multi-regional Fund of Funds has emerged, which would provide greater critical mass and enable delivery efficiencies to be achieved. British Business Bank and local stakeholders have therefore proposed the following instruments for both the West and East Midlands combined.

Table 5 – Revised DCLG/BBB proposed Financial Instruments – **West and East Midlands**

Financial Instrument	Proposed contribution £ m and ranges
Proof of Concept and Early Fund	£20m Investment range usually between £25,000 and £250,000. NB. It is understood that stakeholders may wish to also increase the upper end of the range
Small Debt Fund (Small Business Loans Focus)	£30m Loans expected to range between £25k and £150,000 in size.
Equity	£80m Investments expected to range up to £2m in size.

<sup>5</sup> Management costs impact not considered in the total.

Debt	£120m Investments expected to range from £100,000 to £1.5m in size.
<b>TOTAL<sup>6</sup></b>	<b>Approximately £250m</b>

We are also advised by DCLG that the funding sources for the proposed multi-regional Fund of Funds have now broadened and are likely to now include an ESIF contribution of £78.6m, EIB potential contribution of £122.5m, a UK Government contribution of £35.6m and £20.04m allocation of legacy from single pot backed funds.

The collective view of all of the stakeholders is that the collaborative portfolio of instruments set out in the table above is best deployed under a multi-regional FoF structure which offers the significant added value of combining the contributions from the involved LEPs alongside a possible loan arrangement with the EIB Group. 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 debt financing arrangement on the same terms and conditions as EIB (especially when FoF structures involve a mixture of equity and debt activities in the underlying instruments). This type of financing brings significant advantages but requires careful and financially disciplined implementation to ensure repayment via a diversified portfolio. Even though 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 will be selected to undertake the role of manager of the FoF, working closely with the central Managing Authority (DCLG) and the EIB Group in this process. It would also be expected that any regional or multi regional FoF such as this will require appropriate governance structures to ensure implementation is completed as planned. When selecting entities for this role, the MA must consider the relevant Articles (Articles 7 (1) and (2)) in the Commission Delegated Regulation (CDR) EU No 480/2014, and further guidance via the EGESIF process, in particular, when referring to the “legal, financial, economic and organisational capacity” of the body being considered.

In the paragraphs below, there is a short form explanation of each instrument that is proposed to become a constituent part of the overall collaborative 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 instruments will 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 – Business Loans Fund GBP 15m**

The EIB Ex-Ante Assessment and local market reports have all confirmed the need for debt finance.

---

<sup>6</sup> Management costs impact not considered in the total.

Consequently, a Business Loan Fund is proposed, offering loans of £15,000 to £150,000 with the average deal assumed to be in the region of £75,000, which is in line with the findings of the ex-ante assessment. The need for such a fund is compounded by the present uncertainty relating to future funding for Community Development Finance Institutions (CDFI's) in the E&SEM region.

During the fund manager procurement stage, all options for the most efficient/effective deployment of this fund, including the potential use of one or more peer-to-peer lending platforms, will be fully explored. Whilst this type of debt fund is unlikely to offer a good financial return for the programme, this fund is nevertheless expected to yield important and helpful economic benefits and output metrics.

Loans will be offered either at above commercial rates (determined by the European Commission as reference rates over LIBOR where no market comparator exists) so that there is deemed to be no state aid, or in compliance with GBER . The Business Loans Fund will be able to invest in early-stage and more established profitable businesses that need additional debt support for limited growth/development or working capital. Pricing sensitivity will be tested at modelling stage.

In relation to the multi-regional FoF proposal, we are advised by DCLG that this instrument will be rolled out across both the West and East Midlands, with a combined allocation of £30m. EIB understands from DCLG and stakeholders that the lower range of the investment size is envisaged to now be £25,000.

#### **Instrument Two – Growth Mezzanine Fund £15m**

The relatively high proportion of manufacturing/industrial businesses in the region, for which equity finance is neither desirable nor viable, dictates that debt finance of this type is needed, and early demand for RGF-backed regional mezzanine funding in comparable neighbouring areas has been very high.

The Growth Mezzanine Fund will provide finance of between £150,000 and £2m. All of the finance provided will take the form of mezzanine debt. If there is an average investment size of £1m, this would mean a limited diversification which could create return difficulties.

The Growth Mezzanine Fund will primarily support post-revenue and post-profit viable companies with a compelling case to support the assertion that they are capable of servicing debt only.

Within the confines of state aid regulations and the framework of “off-the-shelf” instruments, the Growth Mezzanine Fund will be encouraged to support investments into expansion opportunities, and inward investments, and to work with other private sector investors at the margin of their appetite for risk (there is evidence that many investment opportunities are stalled in the region because the banks have a low appetite for risk - this prudence most often manifests itself in the form of a modest loan-to-asset ratio - to unlock the potential of these projects, the Fund will lend alongside and at the margin of the private sector lenders).

During the fund manager procurement phase, the option of (and conditions relating to) securing private sector co-investment at the sub-fund level will be explored.

In relation to the multi-regional FoF proposal, we are advised by DCLG that the debt element of this instrument will be combined with the debt element of the originally proposed Growth Capital fund in order to create a new debt fund covering both the West and East Midlands, with greater critical mass and economies of scale. The combined debt instrument will have a proposed allocation of

£120m. As a result of the combination of the original instruments, EIB understands that DCLG and stakeholders envisage that the proposed investment range will now be £100,000 to £1.5m.

### **Instrument Three – Growth Capital Fund £15m (£5m Debt Component and £10m Equity Component)**

The Growth Capital Fund will support the ambitions of the regions' high-growth firms and high-performers. This Fund will invest between £500,000 and £2m with an average investment of around £1m, pursuant to the findings of the ex-ante assessment, indicating "evidence of a continuation of a long term gap for growth capital and for equity up to £10m per annum."

This Fund will focus upon later stage post-revenue and most likely post-profit growth capital requirements. No sector specific targets have been set, but within the confines of EU/state aid regulations, the Fund will be encouraged to support investments in capital equipment, new processes, new product lines, innovation, advanced manufacturing, tooling, inward investment, renewable technologies and bio-technology.

During the fund manager procurement phase, the option of (and conditions relating to) securing private sector co-investment at the sub-fund level will be explored. If co-investment proves to be impossible/impractical, then the sub-fund manager will be contractually targeted (but not mandated) to secure leveraged co-investment on a deal-by-deal basis. It is worthy of note that the proposed fund is significantly sub-optimal in sizing when compared to normal market practices.

In relation to the multi-regional FoF proposal, we are advised by DCLG that the equity element of this originally proposed instrument will be combined to create a new equity fund covering both the West and East Midlands, with a combined allocation of £80m. EIB understands that as a result of the combination of the original instruments the proposed investment range is now expected by DCLG and stakeholders to fall below the original envisaged lower range of £500,000.

### **Instrument Four – Seed and Early-stage Co-investment Fund £15m**

Pursuant to the findings of the EIB ex-ante assessment (Block One), "there is little doubt national market failures apply in this part of the market in the East Midlands... ..exacerbated by the weak supply side in the region with a limited track record of public sector banked initiatives."

Accordingly, the proposed Seed and Early-Stage Co-Investment Fund will support early-stage, equity-based, tranching investment with a focus in innovative technology or knowledge-based businesses. Recipients are likely to be pre- or early-revenue stage and high-risk but have potential for very high growth and for good return realisation on exit.

The Fund will invest between £25,000 and up to £1m with a cap of £250,000 on the initial investment and average total investment is expected to be around £500,000.

The Fund will have no sector constraints but will actively seek to support regional university, HEI and private sector technology spin-outs.

The sub-fund managers will be free to make the investment in any combination of equity, debt or mezzanine, but they will be encouraged to make the initial investment in some form of a convertible



loan (mezzanine) or redeemable shares. This structure will provide a level of protection against unfair/undue dilution at a future equity round, and will provide an exit route for ventures that make it through to commercialisation but no further. The portfolio will be actively and closely managed. Follow-on investments will only be made against the achievement of pre-agreed milestones, with few investees securing the upper end of the investment range (and some never progressing beyond the initial minimum).

In relation to the multi-regional FoF proposal, we are advised by DCLG that this instrument will be rolled out across both the West and East Midlands, with a combined allocation of £20m. In response to further development work undertaken by DCLG and stakeholders, it is understood that the upper investment size range for this instrument is under consideration and may be increased to £750k. However, we are advised that at least 50% of investments by value will be below £250k

### 1.2.3 Proposed implementation structure - the case for pan-regional collaboration

The provision of an EIB Group loan at the FoF level is a key aspect of the proposed 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 Group 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 the EIB Group, then the regions should fully explore that possible source of funding, in which case a possible substitution of the EIB Group loan with a matching loan from another source could be viable. This, however, is considered unlikely in the current investment climate. Public sector interventions in the access to finance market require a private sector match, but the very nature of the gaps in the private sector provision of financial capital to these markets makes the challenge of securing a match self-evidently difficult.

One tried and tested model for securing private sector match operated by the EU is the Joint European Resource for Micro to Medium Enterprises (JEREMIE), which was offered in the 2007-2013 programming period. Under that programme, the EIB Group provided the match at a fund of funds level in the form of a loan. In the 2014-2020 programming perspective, the JEREMIE Initiative is no longer offered *per se*, but JEREMIE-like fund of funds structures – including the one proposed here – can still be set up. However, the minimum fund size for the operation of a JEREMIE-like fund is £100m, of which the minimum EIB Group loan is £50m.

For this reason, the most likely way that the E&SEM LEPs might benefit from the opportunity to participate in a JEREMIE-like programme would be through collaboration with a neighbouring region, such as the West Midlands or Yorkshire & Humber.

Early discussions have taken place with the six LEPs in the West Midlands, which are proposing a £125m FoF structure in their region to be applied across a range of funds designed to support debt, equity and mezzanine finance. A potential collaboration with the West Midland LEPs has the added logic of fitting within the framework of the “Midlands Engine for Growth” dialogue. It would enable the respective regions to join forces in order to create a critical mass of FoF investments, benefitting from a greater scale of the set-up contributions which would make the joint, pan-Midlands FoF structure eligible for JEREMIE-style EIB Group lending.

In-principle, agreement has been reached between the respective Steering Groups of the two regions on an ongoing dialogue concerning the potential joint development of a pan-Midlands fund. Chief among the many advantages offered by this option is the potential for the E&SEM LEPs to participate in a FoF structure with the EIB matching the £30m funding a 1:1 basis. This option would also help both regions save on establishment and management costs.

#### *1.2.3.1 Target market*

As outlined, there are clear benefits for the financial instruments to be set up at a regional or multi-regional level through a fund of funds, thereby ensuring their cohesive, effective implementation, critical mass, and efficient deployment in the targeted regions or group of regions. It is logical to assume that regional expertise, relevant expertise and local knowledge are important assets in the implementation. Additionally, the Block One report Area Overview has given some insight into the industries and sectors where the E&SEM 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 LEPs 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 the EIB Group, but also requires a greater level of cooperation. For a wider region where multiple LEPs are grouping together, the important benefits of critical mass can be undone if an un-implementable form of ring-fencing becomes a prerequisite. If a LEP 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.

#### *1.2.3.2 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 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. 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 East and South East Midlands, an FI and grant combination could consist in the creation of a supporting infrastructure for new enterprises and first-time borrowers as SMEs in terms of investment readiness (e.g. mentoring, legal advice).

Whilst in the instruments currently proposed no combination with grants is foreseen, 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.

### 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 across the European Union. Yet, given that SMEs were the main recipients of the instruments, existing implementation processes provided sufficient experience to draw some

lessons to be considered for the purpose of this document and for reflection by the MA before implementation of new activities begin.

### 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 the 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 Group 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 the EIB Group 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 these structures is required. The EIB Group estimates this to be at least GBP 100m.
- In order to ensure an appropriate level of predictable reflows from the underlying financial instruments 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. This is to ensure that costs do not erode the critical mass of funding available to the underlying funds and, hence, reduce diversification and the ability to generate repayments.
- 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, some of which have been rectified within the new regulations for the 2014-2020 period:

- 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” (MBOs) 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 businesses, thereby undermining the potential to create positive returns to investors<sup>7</sup>.

### *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**

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.

---

<sup>7</sup> Now resolved under the ESIF Regulations for the 2014-2020 period.

### **Availability of funds**

During the previous programming period, all funds were available at the beginning of the operations. This ensured that the holding fund 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 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-focused 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. 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 regionally-specific funds rarely manage to attract top talent, as far as concerns fund managers, due to their size and limited scope. 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 carried interest might make investors less interested, and so such incentives might only be possible with regard to public participation in the fund. Careful judgement on what the appropriate level of management fees/incentives and implementation costs is, remains a difficult balancing act to follow.

### 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 ex-ante analysis and outlined earlier on, 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 Group 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 the 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 Group loan, this further enhances the overall leverage and market impact aspects.

As part of the ongoing development work for the proposed multi-regional FoF, BBB and stakeholders have modelled the possible returns and leverage of the revised financial instruments. It is understood that it is now estimated that £247m of private sector investment will be levered for both the West and East Midlands. This estimate and the underlying assumptions have not been reviewed by EIB.

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).

## 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 the European Regional Development Fund will be focused 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, focused 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. It enables a high level of consistency between the overall national priorities and the more regional focus of both the PIS and the subsequent implementation.

### 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 the EIB Group with the support of Regeneris Consulting has covered this subject in depth. It explained the array of previous and current initiatives to support greater SME access to finance within England and the UK. It is therefore unnecessary to duplicate that analysis here, but 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](http://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. Therefore, it is wise that open and constructive coordination between the involved parties is continually undertaken to avoid or minimise any overlaps.

### 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. Their predecessors, CIP, FP7 RSSF and 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), amongst others, and also remain an important part of the publicly-funded SME financial instrument landscape. As before, careful consideration of the impact of these instruments is advised when finalising regional investment strategies.

### 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 EIB Group’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

The East and South East Midlands LEP economic growth strategies set out ambitious growth targets and a sizeable fund of funds programme is required on a scale that can match up to these plans. It is envisaged that the proposed FoF structure for the E&SEM would create an investment pool of not less than £60m, comprising circa £30m of ERDF contributions, with matched funding of £30m, possibly through a loan from the EIB Group. Under the proposed multi-regional FoF approach, this will be potentially supplemented by a UK Government contribution of £32.5m. If approved and finalised, this would create an immediate initial leverage factor of 2x as indicated earlier on and shown in the table below.

In addition to the initial investments in the FoF, the underlying financial instruments may need to attract additional independent private investment (leverage). This would happen, and to varying degrees, at either the level of the financial intermediaries or the eligible undertakings in order to increase the available capital pool and comply with any relevant regulations: e.g. risk finance measures/instruments operating under the General Block Exemption Regulation 651/2014 will need to respect Article 10. Additional capital could be found from the respective fund managers who pledged additional co-financed investment as part of a successful tender submission (either from their own reserves or from a third party). Overall, this effect could bring clear benefits in terms of critical mass and impact for the region.

It should be noted that whilst a £60m FoF would deliver public-sector-backed investments on a scale hitherto unknown in the E&SEM, it would still represent only an average investment of £12m per annum over the investment period and, as such, represents only a modest contribution to the £120m gap identified by the EIB Group ex-ante assessment (Block One).

## 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.

In relation to the ongoing development work for the proposed multi-regional FoF, DCLG and stakeholders have modelled the possible results the revised financial instruments.

The table overleaf reflects the estimates provided to EIB by DCLG (originally from BBB) and reflects the forecast for the combined East and West Midlands FoF.

<b>Output</b>	<b>Estimate</b>
<b>Number of enterprises receiving support</b>	2,286
<b>Number of enterprises receiving financial support other than grants</b>	1,478
<b>Number of enterprises receiving non-financial support</b>	808
<b>Number of new enterprises supported</b>	622
<b>Private investment</b>	£250m
<b>Employment increase in supported enterprises</b>	3,833
<b>Number of enterprises supported to introduce new to market products</b>	15
<b>Number of enterprises supported to introduce new to the firm products</b>	118

These estimates and the underlying assumptions have not been reviewed by EIB.

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

### 1.7.1 Monitoring and controls

It is anticipated the FoF will be a special (and single) purpose vehicle whose role will be to 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:

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