FUNDING LONDON

Offering to LEP’s in respect of Financial Instruments Strategies for European Structural Investment Funds (“ESIF”)

Dear LEP Representative

As you consider the options for an ESIF-backed Financial Instruments (“FI”) strategy, we would like to draw your attention to our offering to provide support in carrying out the required activities to produce and deliver a successful FI strategy compliant with ESIF Regulations, and in particular, the requirements for the Block 2 Ex-Ante Assessments.

The attached document seeks to provide a high level summary of our approach to the design and implementation of FI strategies to achieve specific economic development objectives – highlighting the key issues identified and how we address them. Whilst the summary is based on our learnings and experience in London, we believe that it is applicable throughout the UK.

The success of our research-led approach in the design of fund structures in London has led to SME Wholesale Finance increasingly being requested to work outside the capital. We are very interested in providing services to LEP’s outside of London to develop their investment strategies for their ERDF Financial Instrument allocations.

Our offering will be particularly relevant to those LEP’s/LEP consortia who are not planning a JEREMIE Fund (where EIB will be conducting the Block 2 Ex-Ante assessments).

We trust you will find it helpful, and we would be delighted for the opportunity to discuss this further in the context of your LEP/LEP consortium strategy and objectives.

Yours sincerely,

M Rodriguez-Piza
Chief Executive
October 2015

About SME Wholesale Finance

SME Wholesale Finance was established in 2004 by the then Mayor of London with the specific long term mandate to support the Economic Development Strategy for London through its SME funding activities. Since its founding SME Wholesale Finance continues to channel funding from Europe and the UK through appointed fund managers to sustainable and ambitious SMEs caught in the funding gap.

Funds created, governed and managed by SMEWFL have achieved the following impacts to date:

- More than £36m invested by four equity and four loan funds into over 430 SME's, with a further £20m being investment through our current funds;
- Co-investment multiple for venture funds at 4.5 times enabling a total investment of £116m into small businesses; and
- More than 2,500 jobs created or safeguarded.

We have recycled £7.1m of the returns generated from our first set of funds to establish four new funds launched since 2012:

- The MMC London Fund is investing £14m into early- stage growth businesses, typically in Series A rounds, alongside private sector co-investors.
- The London Legacy Loan Fund is reinvesting our European Social Fund legacy by making small loans to start ups in London's Objective 2 areas.
- The new London Co-investment Fund which was launched in December 2014. The fund is investing £23m into 156 London based seed stage companies in the Science, Digital and Technology sectors – which are of strategic importance to the London economy.
- We are investors in the CAN Early Intervention Fund – a fund supporting Community Interest Companies and other Social Enterprises dedicated to making an impact in the lives of young people in London.

We are experts in generating successful fund strategies:

Through the design, creation and implementation of our funds we have built unrivalled expertise in devising successful financial instrument strategies. In particular, our solutions have delivered specific economic development objectives whilst engaging with the best private sector partners available.

We have achieved this through:

- Innovative thinking bringing to bear our deep private sector experience in finance;
- Excellent working relationships with market participants and incorporating their input;
- Strong analytical skills;
- Focusing on generating returns by selecting the best managers; and
- A mission to make a difference and ensuring impacts are achieved.

Our ESIF/ERDF Experience

SME Wholesale Finance has secured grants from the previous two ERDF Programmes, 2000-2006 and 2007-2014. Furthermore, it has successfully reinvested legacy from previous funds into new funds. We have therefore built a significant level of experience and knowledge in respect of ERDF backed funds and working with private sector managers to deliver programme objectives while achieving financial returns.

Our ability to design, implement and deliver successful funds is based on our research-led approach whereby we understand the importance of incorporating feedback from market participants into the design and requirements for the funds. We believe strongly that this approach has allowed us to make significant impact with our ERDF-backed funds.

Principal Insights from our previous ERDF-backed funds

Design and objectives must be attractive to private sector partners

Historically there has been a (perhaps perceived) disconnect between the aims of ERDF funds (jobs, GVA, number of SME's) and the priorities of private sector fund managers (focus on value accretion, supporting winners in equity portfolios, limiting the size of portfolios). Whilst the two sets of priorities are not incompatible, there is an imperative for those designing ERDF FI's to take into account current market practice to ensure that the proposed FI's will be attractive to private sector managers. For example, where an ERDF manager would want to maximize the number of SME's receiving investment, it may be that from a private sector manager's point of view, the number of SME's supported by a specific FI should be limited to ensure success through several rounds of follow on investment and close involvement from the fund manager.

In conclusion there is a need to involve the private sector in developing solutions, in particular potential delivery partners; this ultimately is the basis for securing private sector best practice. Capital preservation must co-exist with public sector outcome priorities.

Focus on impact to avoid unnecessary fragmentation

The findings from the Block 1Ex-ante Assessment, outline several finance gaps within each LEP area. However, given limited pots allocated towards FI's, it is important to assess the potential impact of allocating ERDF funds towards each identified gap. This will be influenced by the local economic development priorities, the number of SME's that can benefit from each FI given a specified amount of funds, the private sector expertise that are available to deliver the FI and the economics of each FI.

A desire to focus on specific sectors may also diminish impact by leading to fragmentation and lower cost efficiencies.

Effective procurement – focus on track record not costs

In many instances the process required by the European Procurement Regulations seems onerous and over complicated from a private sector supplier's point of view; however it is paramount that the best fund managers are encouraged to apply as the success of the strategies depends on securing the best partners.

Therefore, feedback from delivery partners should be carefully considered in designing project targets which are then passed on to the delivery partners.

Furthermore, the process of selecting fund managers should never be skewed towards minimizing cost but rather towards establishing the track records of bidders and selecting those with the best capabilities.

The ESIF Requirements

The European Commission's regulations require an Ex-Ante Assessment to be undertaken by the responsible Member State (MS) / Managing Authority (MA) before committing ESIF 2014-2020 Programme resources to a FI. The Ex-Ante Assessment requires MAs to provide evidence of the adequacy of the envisaged FI against an identified market failure or sub-optimal investment situation and to ensure that the FI will contribute to the achievement of the Programme and the ESIF objectives

In order to address this requirement at a national level, the European Investment Bank (EIB) was commissioned to undertake an Ex-Ante Assessment that will meet the requirements of Article 37 (2) of the CPR, before deploying ESIF 2014-2020 Programme resources to support SME FIs in England. This Assessment consists of two parts – Block 1 and Block 2.

Block 1 of this Assessment, the Market Analysis, undertaken by Regeneris, reported at the end of February 2015 on:

1. Evidence of persistent market failure in the UK and each UK region in the areas of early-stage debt and equity finance, as well debt and equity finance for established businesses seeking to grow; and,
2. An estimate of the unmet demand for finance for each region as well as the UK as a whole. But the authors state that it is not possible to determine what proportion of these SMEs had viable business plans.

Block 2 of the Ex-Ante Assessment would not be conducted by the EIB, if the FI did not involve the EIB, and would need to be commissioned by the LEPs, either collectively or individually.

The Block 2 Assessment should then go on and develop a FI strategy, which should include:

1. An outline of the thematic and geographical coverage of the FIs;
2. Proposed financial products and the final recipients to be targeted;
3. Assessing management, delivery and procurement issues:
   - Financial and legal implications; and,
   - Options for implementation arrangements and for fund manager selection.
4. Considerations of technical assistance or equivalent;
5. Considerations of State Aid implications from proposed investment strategy; and,
6. Assessment of possible combination with grants, interest rate subsidies and guarantee fee subsidies.

On this basis, we have outlined overleaf a scope of work to produce a FI Strategy compliant with the Block 2 requirements.

Scope of Work – High Level Process Overview

1. Review of Block 1 Ex-ante and other information:

   The process of creating a Financial Instrument Strategy begins with the review of the findings from the Ex-ante Block 1 Assessments carried out in late 2014 for each LEP Region in the UK. This information then needs to be considered in the context of local market dynamics and economic development priorities.

   We consider the following activities to be key in this process:

   1.1. Detailed review of Ex- ante Block 1 for the specific LEP region(s) in question

   1.2. Review of the Common Provisions Regulations to determine the best method of delivery for Financial Instruments for the specific LEP region(s)

   1.3. Input from local entities and stakeholders including LEP representatives, fund managers and other investors

   1.4. Review of LEP economic development strategies or priorities

   1.5. Review of "lessons learnt" from previous ERDF programmes and current ERDF 2014-2020 Programme Requirements

2. Development of the Investment Strategy

   The activities listed in 1. inform the investment strategy as follows:

   Block 1 findings provide the context for the investment strategy. Along with the local economic development priorities the Block 1 findings should guide the specific components (e.g. Instruments) to be proposed for the Financial Instruments Strategy.

   For each gap identified in the Block 1 assessment, we will identify the financial instrument which best matches the needs of the particular group of SMEs (e.g. Loans, equity, mezzanine, micro - loans). This would then be compared against the economic development priorities of the LEPs to prioritize specific instruments.

   A further important consideration will be the magnitude and breadth of impact that can be achieved by each proposed instrument. In particular job creation, wealth creation and leverage. Depending on the size of the specific funding allocations, this could be paramount. The availability of funds versus the estimated size of the gap is another key input.

   The specific instruments within the strategy will also be subject to the ERDF's requirements in relation to:

   2.1. Lessons learnt : e.g. Restrictions on sectors or lack of flexibility within instruments can lead to inefficient funds

   2.2. Match funding : e.g. How will ERDF funds be matched, at the level of the fund or at the level of each investment

   2.3. Additionality in respect of other national programmes, e.g. British Business Bank products

   2.4. State Aid and GBER conditions must also be considered in the light of the proposed instruments.

3. Deliverables

3.1. Financial Instrument Strategy

The principal output of the Block 2 assessment will be a strategy that matches a financial instrument against each identified funding gap and the expected impacts for each such instrument – including outputs and outcomes, expected economic impact and leverage. A delivery strategy for each instrument would also be specified.

3.2. Fund structure

The fund structure will be determined to a large extent by the delivery strategy and funding structure of the funds. In several instances, LEPs are considering JEREMIE structures and this will necessitate a Holding Fund structure where a holding fund sits on top of each individual instrument being delivered (e.g. equity, loans, mezzanine, etc).

A cash flow model of each proposed instrument including all operational costs and fees will set out timing of outflows and expected inflows. If relevant they will be overlaid against specific requirements of the relevant Managing Authority or other investor (e.g. EIB).

3.3. Procurement strategy for delivery partners

A procurement strategy compliant with the European Procurement Regulations will be required for the delivery of each instrument. In our experience, in order to secure the best-of-breed delivery partners it is necessary to incorporate feedback from the interviews with market participants in relation to the proposed financial instruments and deliverable requirements, e.g. size of investment/SME, job creation targets, GVA targets, pace of investment targets, etc.

3.4. Other considerations

An assessment of requirements around governance, financing of the structure, and State and recommendations to ensure the FI Strategy is compliant with all Block 2 Ex-ante requirements.

Who to contact

Maggie Rodriguez-Piza
CEO, SME Wholesale Finance
020 7 043 0739
maggie@fundinglondon.co.uk

fundinglondon.co.uk