**North East LEP Area Fund of Funds – Ex-ante assessment**
**Supporting text from the Full Application**

**Article 37 (2)(b) – Consistency of the envisaged FI with other forms of public intervention**

*The following text, from s3.10 of the final Full Application for the project refers:*

Duplication in the market place has been considered within phase one of the ex-ante process and through a market consultation exercise.

The current JEREMIE1 initiative provides finance across the North East LEP area. This fund will cease investing in December 2016. Without an operational replacement fund in place shortly after this point. SMEs will fail to have access to appropriate investment capital and North East LEP considers that there will be serious collateral damage to the wider 'ecosystem' of entrepreneurship, investment, innovation and business support in the North East LEP area.

Block One of the ex-ante report suggests "It is possible to use national survey data on the amount of finance being sought by businesses of different sizes to generate indicative estimates of the scale of unmet demand. This analysis shows that total unmet demand in the region could be of the order of £560 million per year (Section 1.4.2 Theoretical Unmet Demand). Even on the basis of a highly prudent assumption on the proportion of firms that might have been both eligible and commercially viable, the numbers below illustrate the potential scale of market failure. For example, if only 10% of these were eligible and viable, this would imply unmet demand of:

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

The Northern Powerhouse Investment Fund (NPIF) will be a complementary fund, with clear geographical hypothecation. We will work closely with partners who will develop and deliver that fund to ensure clarity of messaging to SMEs. During earlier phases of development of this fund, North East LEP were invited to be part of the the British Business Bank, 'fund of funds' proposal, namely Northern Powerhouse Investment Fund which was to be based in Sheffield and would cover all of the LEP areas in the North of England.

After careful consideration, North East LEP decided not to be a part of the NPIF proposal. Unlike others, the North East LEP area was in the fortunate position that it had access to meaningful amounts of ERDF and Single Programme legacy funding which had been successfully generated from previous publicly funded investment funds. The LEP was keen to exploit the unique opportunities afforded by these legacies to lever additional private and public sector funds for the specific benefit of North East LEP area enterprises.

As a separate fund to the NPIF proposal, the North East LEP area Fund will:

- Build on proven local delivery structures which have played a key role in the innovation and investment ecosystem of the North East LEP area over a number of years both for reasons of continuity and to optimise value for money returns. The current JEREMIE1[1] programme has already re-paid over £50m to the EIB and has enjoyed a series of highly profitable exits to date;

[1] JEREMIE1 is the Finance for Business North East Programme which has been operational in the North East and Tees Valley LEP areas since 2010. It will cease making investments in 2016. The

- Have a fund design which specifically responds to the investment needs of the North East LEP area;

- Support the overwhelming preference of regional stakeholders (business organizations, local authorities and the professional services community) for a locally delivered solution with local accountability;

- Ensure that the North East LEP's proposed ERDF and legacy contributions can lever EIB investment to be used exclusively in the North East LEP area. Had the North East LEP proposal been incorporated into NPIF, there was a risk that the local investment could have been lost to other areas who had a proportionately higher share of the business base;

- By undertaking its own Fund Manager procurement process, ensure credible, local delivery arrangements are put in place which are accessible and appropriate for North East LEP area SMEs.

North East LEP believes that investment in enterprises below £3m should be delivered locally. Local delivery structures are grounded on extensive networks with local professional advisers, incubation centres, universities, mentors, angel investors and others including those evolving as part of the Growth Hub initiative. An intimate understanding of the local deal pipeline is difficult to achieve in every corner of a large geographic area – especially with a 'multi-sector' approach.

National (public sector) initiatives funding business start-ups exist do operate in the North East LEP area to a very limited extent. Due to the existence of those initiatives for example, micro finance has been excluded from our model with the small loans fund average investment being set at £30k to avoid duplication at the lowest levels. Other national initiatives also nominally operate in the North East LEP area;

- Enterprise Finance Guarantee programme offering Government-backed loan guarantee to lenders.
- Start Up Loans support to individuals looking to start a business, or who have traded for less than 12 months.
- Enterprise Capital Fund (ECFs) investing equity in viable smaller businesses with the potential for high growth.
- Venture Capital Catalyst fund, a co-investment pari passu fund operating in a similar remit to the ECF.
- Angel Co-Fund makes equity investments alongside syndicates of Business Angels.
- Co-Fund invests in smaller businesses identified as having high growth potential.

The number of investments or loans delivered by these programmes in the North East LEP area is low, as demonstrated by the quarterly surveys of deal activity published by leading business advisers, PWC, in association with the Newcastle Journal. This deficiency is mainly attributable to the distance between the North East LEP area and its SMEs and the principal offices of the fund managers and other delivery organizations typically charged with delivering these initiatives, given the very local nature of financing activity at the local level. A report into Small Business Finance Markets (2014) by the British Business Bank, for example, highlighted disparities in regional finance activity for small businesses. For example, whereas London has 151 business start-ups per 10,000 adults, the North East has only 64. The ex ante report prepared by Regeneris also noted "compelling evidence of

fund was originally worth £125m funded by the EIB, ERDF and Single Programme, but has been subject to a number of financial extensions. JEREMIE1 will cease making investments in December 2016.

demand unmet from mainstream sources" and that "the JEREMIE programme was responsible for the vast majority of deals in the region **(and no evidence of crowding out**)".

Beauhurst have reviewed investments in the North East since 2011. They comment "Notably, all of the top five investors by deal numbers were government backed funds. Together these funds were involved in 45% of fundraisings from 2011. Although this might point to an over-reliance on state money, these investments are usually small and early-stage, and we think it is positive that growing businesses are encouraged in the region. None of these investors appears on the list of top investors by total value of fundraisings, which is dominated by large private equity funds."

There is also some limited private provision in the North East LEP area but mainly at the higher end of the size spectrum. Newcastle-based Northern Venture Mangers (NVM) for example operates in the private equity space, as do others such as the Business Growth Fund (BGF). Typically these organisations prefer to make larger commitments than envisaged in this proposal (£3-5m and above) to established businesses. Crowd-funding and Peer to Peer lending have made only a limited impact in the North East LEP area and the mainstream banks (as elsewhere in the UK) tend to steer clear of start-ups, early-stage businesses and innovative, technology-based SMEs which typically lack conventional 'assets' against which lending can be secured. Finally, business angels are active in the Region (eg: BIG and Hotspur) but these syndicates have strongly endorsed the role of the JEREMIE 1 funds as 'anchor' investors, bringing sophisticated investment expertise which helps to 'de-risk' propositions for local co-investors, thus enhancing opportunities to attract private sector leverage. All available evidence confirms the view of the ex ante report that there is *no* evidence in the North East LEP area of crowding out of private sector provision.

Utilising the Investor Readiness element of the Fund Management service and by maintaining strong relationships with the Corporate Finance community, we can confirm that this proposal will not duplicate other activity and, where possible will complement and add value to other sources of funding.

**Article 37 (2) (c) – State Aid implications of the envisaged FI**

*The following text, from s10.7 and s10.8 of the final Full Application for the project refers:*

**10.7 For each potential beneficiary (including the applicant and any Delivery Partners) identify whether they meet the State Aid test. If you believe a potential beneficiary is outside the scope of State Aid, please provide the reasons.**

**Applicants may wish to refer to the European Commission's "Notion of State Aid" guidance and the Department for Communities and Local Government's European Regional Development Fund guidance on State Aid law**

…

In relation to the five separate funds (LPs) which are expected to be established, the principal state aid compliance approach to each is as set out in the following table, with the compliance-approach expected to be used most frequently listed first:

| Fund | Main Instrument(s) | State Aid Compliance |
|---|---|---|
| Innovation | Convertible loan and equity | Article 21 GBER<br><br>MEIP – in accordance with risk capital guidelines and communication on discount and reference rate.<br><br>De Minimis |
| Early Stage | Equity | Article 21 GBER<br><br>MEIP – in accordance with risk capital guidelines and communication on discount and reference rate.<br><br>De Minimis |
| Growth | Quasi-equity / convertible loans / mezzanine / equity | MEIP – in accordance with risk capital guidelines and communication on discount and reference rate.<br><br>Article 21 GBER<br><br>De Minimis |
| Development Capital | Quasi-equity / convertible loans / mezzanine / equity | MEIP – in accordance with risk capital guidelines and communication on discount and reference rate.<br><br>Article 21 GBER |
| Small loans | Loans | De Minimis |

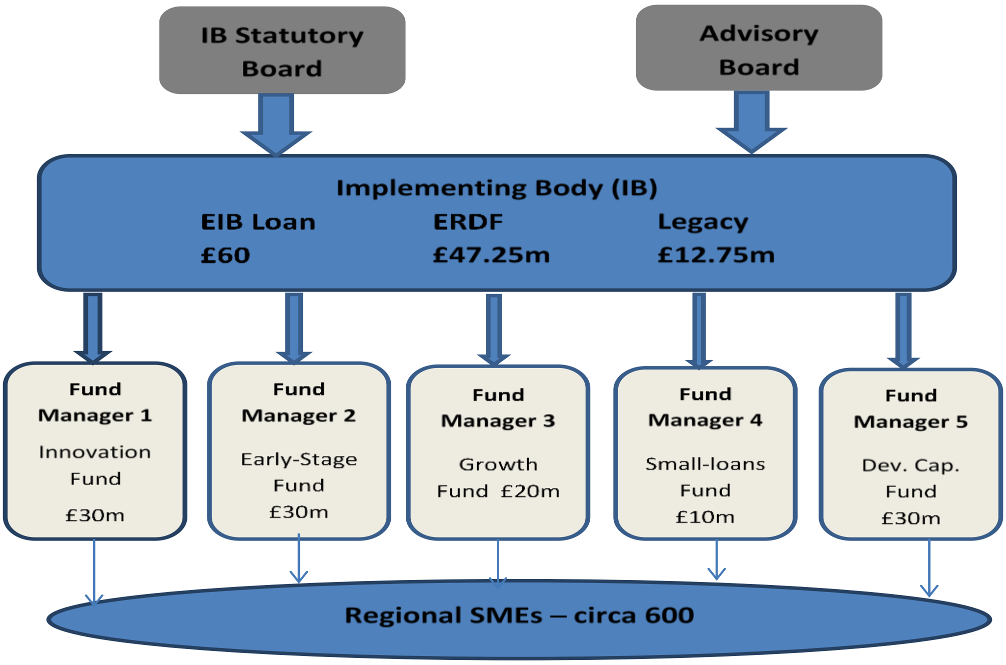
| | | |
|---|---|---|
| | | MEIP – in accordance with risk capital guidelines and communication on discount and reference rate. |

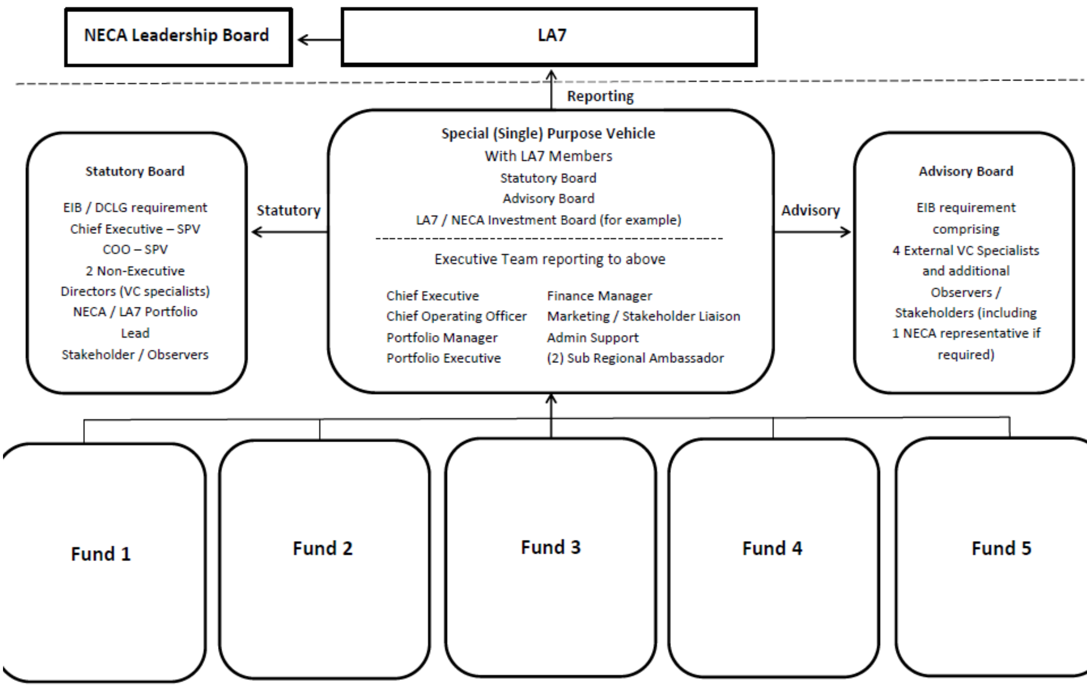
**10.8 For each beneficiary that the applicant regards as being in receipt of State Aid, identify which exemption(s) they will be using to provide the aid in accordance with State Aid law.**

| Name of beneficiary or class of beneficiaries | Name of Exemption | Scheme reference number |
|---|---|---|
| The SPV | No aid: the SPV is an intermediary vehicle to channel financing and is therefore not in receipt of State aid by, in line with Commission Guidelines on State aid to promote risk finance investments (2014/C 19/04) and the Commission's Decision in relation to the Northwest Urban Investment Fund (JESSICA) SA.32835 (2011/N). It is also an entrusted entity performing a public service as a result of cooperation between two or more contracting authorities. | |
| The LPs (in relation to all 5 Funds) | No aid/Market Economy Operator Principle | |
| The Fund Managers (in relation to all 5 Funds) | No aid/Market Economy Investor Principle | |
| Private Investors (in relation to all 5 Funds) | No aid/Market Economy Investor Principle / GBER | English Aid for Access to Finance for SMEs State Aid Scheme, SA.39065 |
| SMEs (in relation to all 5 Funds) | Market Economy Investor Principle<br>GBER – in particular Article 21<br>*De minimis* Regulation | English Aid for Access to Finance for SMEs State Aid Scheme, SA.39065 |

**Article 37 (2)(e) – Definition of the governance structure of the FI**

*The following text, from s3.3 of the final Full Application for the project refers:*




**Advisory Board:**

The Advisory Board (AB) provides specialist venture capital input as well as comfort to the stakeholders (particularly the EIB). Members have no statutory relationship (fiduciary duty) to the IB. It is intended that the AB for the North East LEP area Fund of Funds will be recruited through an open and compliant process, and particular attention will be given to measures to ensure the diversity of the Board, in order to comply with ERDF requirements regarding equal opportunities. Measures to be adopted will include advertising in appropriate media, using appropriate language to encourage applications from a cross-section of high quality applicants, and where relevant, using recruitment advisors to maximise the potential pool of applicants.

Budgets assume four paid members of the AB at a salary of £18k per annum which is a saving from the previous AB. Travel and subsistence will be charged on top of this in line with a policy agreed by stakeholders. We have concluded that payment for AB members is necessary in order to attract the required quality of personnel, most probably from outside the region. Note the AB is a key requirement of the EIB, and the bank will be keen to ensure that the necessary skills and experience is achieved.

Terms of Reference: to assist, advise and report to the board of the Company on strategic matters relating the North East LEP Area Fund as detailed:

The duties of the AB are to:

- Endorsement of the investment policy for the Fund;
- Assistance in the fund manager procurement exercise (mini competition stage);
- Endorsement of contractual arrangements with the fund managers;
- Provide strategic advice to the Board of the Company in relation to the Region's on-going participation in the North East LEP fund;
- Keep an overview of fund manager performance;
- Comment and advise upon reporting submissions from the IB to the stakeholders and express opinion on valuation methodology.
- Comment and advise upon conflicts of interest within the funds;
- Comment and advise upon changes to the fund portfolio;
- Comment and advise upon significant changes to fund manager contracts.

**Statutory Board**

The Statutory Board for the SPV / IB will be distinct from the Advisory Board in that the latter is purely advisory and its members chosen specifically for their investment expertise rather than more general 'directorial' experience.

The independent members of the Statutory Board should be selected for their experience in managing complex financial services businesses and banking skills. They (and other directors including *ex officio* stakeholder appointees) exercise the normal responsibilities set out in the relevant Companies' Acts. Appointments will be made having regard to relevant past experience in a wide range of public/private and third sector organisations. .

The responsibilities of the IB Statutory Board include *inter alia*:-

- Statutory obligations & liabilities;
- Fiduciary responsibilities in respect of EIB loan and HMG grants;
- Corporate governance;
- Remuneration of the executive team;
- Oversight of budgets and ensuring value for money;
- Audit;
- Control of operating budget;

- Exercising formal oversight of all aspects of the business

The Board of the SPV will consist of Ex- Officio appointees and independent directors. The inclusion of independent directors will not only reflect the demands of good governance but is a requirement of EIB participation, given the need to ensure the operational independence of the IB in investment matters on a day-to-day basis and to ensure that the interests of the commercial funder (EIB) are properly reflected. Two non-executive Directors will be recruited through a Nolan Compliant process. Particular attention will be given to measures to ensure the diversity of the Board, in order to comply with ERDF requirements regarding equal opportunities. Measures to be adopted will include advertising in appropriate media, using appropriate language to encourage applications from a cross-section of high quality applicants, and where relevant, using recruitment advisors to maximise the potential pool of applicants.

**Article 37 (2)(f) – definition of the monitoring system in order to effectively monitor the FI, facilitate reporting requirements and identify any improvement areas.**

*The following text, from s8.2, s8.6 and s8.7 of the final Full Application for the project refers:*

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|---|
| 8.2 Outline the project management and control systems that will be established for the project, demonstrating that the project has the appropriate capacity to meet the requirements of European Structural & Investment Funds. |
| The IB will be a special (and single) purpose vehicle whose only role will be deliver this programme. Rigorous, effective and efficient control systems will be implemented and maintained by the IB, which will be staffed with personnel who are experienced in managing publicly funded financial instruments and the audit, control and verification environment that brings.<br><br>When formed, the IB will have in place a series of operating policies. These policies will provide a project management framework. It is envisaged the following will be agreed:<br><br>Document Retention Policy<br>Idle Funds Policy<br>Performance Management Framework<br>Quality Assurance<br>Risk Management Policy<br>Internal Controls Policy<br>Environmental Policy<br>Exit Policy<br>Investment Policy<br>Publicity and Comms Policy<br>Right Sizing Policy<br>Withdrawals Policy<br>Equal Opportunity Policy<br>Fraud Policy<br><br>Management and control systems will be the responsibility of the IB Executive Team and its Statutory Board. When the Board is formed, it will be its responsibility to create and establish appropriate governance structures and to set the overall direction of the company, establishing controls, recruiting and motivating executives, overseeing the operation of the business, and accepting collective responsibility. The Board will also ensure the organisation meets its obligations to stakeholders (e.g. EIB, DCLG, BIS, NECA and North East LEP). Once the Board has set and communicated the value and standards of the business it will need to safeguard them by overseeing internal control systems such as internal audit and risk assessment procedures. The Board will be responsible for the formal monitoring and audit systems of the IB and for the identification and management of any risks to the business that might expose the company to legal or reputational damage.<br><br>It is envisaged that a system utilising declaration forms signed by investees will be introduced. This has been successfully implemented in the JEREMIE1 fund. The declaration requires the SME to confirm the level of State aid it has previously received, its location, business sector and investment proposal and sets benchmarks for output data purposes. The declaration form, together with a draw down request form completed by the Fund Manager, provides a strong audit trail as envisaged in Article 9 (e) vii-xi of the Delegated Act… |
| 8.6 Please describe how you will collate, calculate and verify deliverables to ensure that interventions are recorded and an audit trail is retained to prove their validity |
| …The precise details of the system to be adopted will be established but it is expected that they will mirror and then build on those currently in place in JEREMIE1.<br><br>Fund Managers will be responsible for collating output data. The obligation to undertake this role will be contained in the Fund Management Agreements. As set out in 10.9, a declaration form will |

be used to capture baseline data. Progress towards the commitment of fund capital and achievement of outputs would be provided in the quarterly reports which will be provided to the Statutory and Advisory Board and all funders. Fund Managers will be required to provide an update on the achievement of the results orientated outputs (for example employment increases in supported enterprises, new market products and new firm products) every six months. They would do this after contacting all investees who will be obliged to provide an evidenced update on achievements in an auditable form which is in accordance with ERDF guidance.

A recording system will be established which will allow for the collection and auditing of investor readiness support. It is envisaged that this form will incorporate a time capture and authorising mechanism. Given that the investor readiness element of the project has not been delivered in the previous fund, the IB will collaborate with BBB/NPIF to develop commonly agreed protocols for capturing this data.

8.7 How will you ensure continuous improvement in the quality of service or provision?

Quality management and performance management policies will be agreed with the Board and stakeholders. Based on those in place with North East Finance, it is expected that these policies will cover the following:

The Quality Management policy will define the manner in which the company has developed and implemented a quality management system in order to ensure that its policy, objectives and commitment to quality and stakeholder satisfaction are consistently achieved.

The scope of the quality management system is as follows:

**Quality Policy & Objectives**

- To establish and maintain a quality management system which satisfies the requirements of the Company’s stakeholders
- To provide services which comply with the quality management system and relevant statutory and regulatory requirements
- To monitor, review and report an agreed key performance indicators
- To ensure all company personnel are fully competent to carry out their assigned tasks, and train and induct new staff
- To strive continually to improve the quality of services provided and the quality management system, through the use of this quality policy, quality objectives, analysis of data, audit results, corrective and preventive actions and management review
- To maintain records as objective evidence to demonstrate compliance with the quality management system
- To review the quality management system at planned intervals to ensure that it is effective and achieving the stated quality policy.

The Chief Finance Officer, or a nominated officer of similar seniority, will be the quality representative and as such is responsible for effectively establishing, implementing and maintaining the quality management system, promoting awareness of stakeholder requirements throughout the company and reporting on the performance of the quality management system.
The Chief Executive will be responsible for the overall strategy, policies, resources and operation of the business.

A performance management framework will ensure that Fund Managers meet or exceed their mandatory outputs and make good progress against the other targets related to economic development and the generation of a sizeable Legacy Fund. This will allow the Implementing Body to deliver against its target as specified in the Funding Agreement Letters (FALs).

The IB will evaluate the performance of fund managers on the basis of key metrics, reflecting the mandatory and desired outputs and financial / investment performance against plan.

The IB will hold meetings at least on a quarterly basis with all Fund Managers to discuss their performance and address any shortcomings or explore further opportunities for improvement. The IB will identify the reasons for any under-performance both through regular contact with the Fund Managers and through independent verification in the marketplace. A variance of 10% on a cumulative basis on mandatory outputs, or other material signal of non-performance, will trigger potential corrective action by the IB.

The IB will reserve the right to adjust the amount of capital committed to each Fund, in accordance with the Right-Sizing Policy. The IB will be able to increase or decrease the capital committed to each fund, subject to an appropriate process and consultation period, which will be described in the Fund Management agreements.

It is envisaged that fund right-sizing could occur as a result of fluxes in demand in the marketplace and / or as a result of the performance of the Fund Managers.

In addition to these policies, performance-related components of fund manager's fees will be agreed as part of the Fund Manager procurement process. The negotiation procedure which has been adopted has been chosen specifically to allow fund management remuneration arrangements to be negotiated…