The story of A2F in the NE – history and timeline

Since the early 2000s the North East has benefited from a number of innovative publicly backed investment funds to address defined gaps in the provision of finance for the regions SMEs. These have been carefully designed to complement both the private sector and government interventions.

They have fallen into three principle types of funds:

- Micro Finance – loan funds targeted at small businesses typically seeking funding in the region of £5-25k,
- Mezzanine Finance – a combination of debt/equity (typically convertible loan finance) targeted at early stage businesses and businesses seeking development/growth capital (but lacking the potential returns to attract equity funding), and
- Equity Finance – development/growth capital effectively taking a stake in a business with significant growth prospects.

The most recent funding initiative, **Finance for Business North East** (FBNE) £125m super fund was launched in early 2010.

Building on its experience gained from previous funding initiatives, One North East working closely with the European Commission and European Investment Bank was the first region in England to establish a JEREMIE venture capital fund to assist hundreds of small and medium-sized businesses access valuable new finance.

Over a five year period, the fund will assist 850 businesses at various stages through development of ideas, start up and growth/expansion across a range of sectors (technology, manufacturing) and sizes from micro to medium sized enterprises. The aim is to assist businesses through provision of appropriate finance (loans and equity) helping them to create jobs (5,000) and prosperity for the region. Any returns from investments, after repaying the EIB, can be reinvested in the regions businesses in the future.

The European Investment Bank has committed £62.5m into the fund, with £44.25m coming from the European Regional Development Fund 2007-2013 and £18.25m from One North East. Finance for Business North East comprises seven separate funds and since first investment (April 2010) it has achieved the following (end September 2011):

More information about the funds can be found at:

http://www.nea2f.co.uk

or

http://www.northeastfinance.org/

The FBNE fund was built on the learning and experience gained from a number of funds introduced since 2000. The following represent the funds deployed:

Fund (links to source docs)	Description	Investment Period
North East Investment Fund 1	£6m - Mezzanine Fund	2000 – 2001
North East Investment Fund 2	£2.5m - Mezzanine Fund	2001 – 2002
North East Investment Fund 3	£18m - Mezzanine Fund	2003 – 2006
Micro Loan Fund	£2.8m – Small Loan Fund	2003 – 2005
Proof of Concept Fund	£10m – Mezzanine Fund (technology early stage)	2003 – 2008
Co-Investment Fund	£23m - Equity Fund (technology finance)	2003 – 2008
NEL Growth Fund	£5m – Equity Fund	2005 – 2008
North East Investment Fund 3b	£12m - Mezzanine Fund	2007 – 2008
Regional Enterprise Loan Fund	£3.9m – Small Loan Fund	2007 – 2010
Design & Creative Industries Fund	£2.9 m – Mezzanine Fund	2008 – 2010
Three Pillars Investment Fund	£2.7m – Mezzanine Fund	2008 – 2010
Proof of Concept Fund (extension)	£2m – Mezzanine Fund (Technology)	2009
Co-Investment Fund (extension)	£7m – Equity Fund	2009
North East Investment Fund 3c	£2.5m – Mezzanine Fund	2009
Finance for Business North East Fund	£125m – Holding Fund (combination of funds – debt, mezzanine and equity)	2010 – 2014
Creative Content Co Investment Fund	£2.4m – equity fund	2010 – 2011

These funds have assisted over 700 businesses over the last ten years but we have also learned from each one culminating in the products, structure and management arrangements of the Finance for Business Funds.

Key lessons include:

- The North East does require equity funds delivered locally (most fund managers congregate around their sources of capital (predominantly London based) and tend to invest within 2/3 hours of their base),
- Fund managers need active management by a dedicated full time executive,
- The need to establish funds of sufficient scale to allow for follow on finance (to prevent dilution in subsequent stages of company development),
- Establish clear performance targets (both financial and economic) in any fund manager contracts to help steer fund manager behaviour to deliver intended regional benefits,
- Look to use innovative products to prevent subordination to private investors (for example co-investment funds),
- Use pilot funds to test areas such as demand, fund/product structure,
- Look to develop fund management procurement solutions which allow flexibility to take into account changing circumstances,

- Carefully consider any delivery structure to consider short and long term issues (tax, legacy returns, state aids, public accounts),
- Harmonise reporting systems (inc. collection of economic data) and examine economic impact at a programme level as well as individual funds, and
- Ensure sufficient attention is paid to portfolio management by fund managers to generate maximum legacy (returns) from funds.

Over the years there have been a number of demand studies and evaluations of the funds (either individually or collectively). These are listed with links at the end of this document

In the following section we'll highlight some of the key steps to developing publicly backed investment funds.

Process for Developing a Publicly Backed Fund

Step 1 - Establish need for market adjustment

Is there a viable market for the fund?

To include checks on supply and demand, are there problems with both (if demand need to be very careful - affects viability of funds).
On supply need to be sure right target (size and type) - i.e. real location of failure and nature/scale.
What are the constraints on supply - significant or information.
Is there a real role for the public sector direct intervention or could it be done by facilitation.

Generally it is recommended that updated demand/supply studies are commissioned to cover regional issues building on work already done locally and Nationally and also taking into account relatively new national funds (e.g. Enterprise Capital Funds) and take up of newly launched funds with European support.

Timescale: Up to 6/9 months - selection of consultants, evidence gathering and consultation, reporting of conclusions/recommendations.

If Yes

STEP 2 - Establish the nature of the fund

What type, scale and design of any fund?

This will depend on the perceived gaps (equity, mezzanine, loan only), size of overall finance gap, size of investment gap for businesses (up to £2-5 million) etc.
What is the appetite of the private sector (co investment fund, pari passu, subordination)?
State Aid rules to be considered - fit with existing notifications (Risk capital guidelines) - it is always prudent to build in State Aid advice early.
Early identification of source of funds (public and if possible private)

Timescale: Can be incorporated within the previous step.

STEP3a - Implement Findings (No State Aid considerations)

For example:

No aid to fund manager (normally avoided by procurement)
No aid to investors (pari passu or procured by open process - but see below for equity funds)
Fits within current Commission thresholds - depends on status of area

Timescale: NONE - move onto to fund development and implementation.

STEP3b - Implement Findings (State Aid Exists)

If there is aid depending on materiality we would need to seek formal EC clearance.

To do so we would need to draft Notification notice and formally apply through BIS and UKREP.
EC has three months to respond but is likely to open an investigation where we step outside State Aid Risk Capital Guidelines
Note cannot start fund until Commission gives approval.

Timescale: Anywhere up to 12/18 months

Step 4 - Develop the practical Fund

What processes need to be undertaken?

Write Business plan and develop financial models (normally pre fund manager recruitment).
Secure Private sector investors (for single equity funds this generally needs to be an FSA approved body - normally Fund Manager).
Apply for and formally secure Public sector funding.
Produce legal documents (Fund manager agreements, investment criteria, offer letters etc.).
Procure Fund Manager (OJEU).
Launch Fund
Timescale: up to 12 months

Some of the above steps could be twin tracked but at a risk - for example fund managers and private sector are unlikely to be interested in applying formally in advance of EC clearance.

Step 1

In essence public sector investment funds should only operate in clearly defined gaps where the private sector is not. Where this is evident should be to consider in there a mechanism where the public sector can facilitate the private sector in engaging in the perceived gap.

It is also important that any new intervention identifies how they fit (complement) existing provision both private and public. This tends to fall into a number of areas including: stage of business (e.g. small early stage investment), debt finance where commercial sources are reluctant to provide finance (lack of track record/security), relatively low investment levels compared to downstream benefits (e.g. equity gap).

Step 2

Any fund must have clearly defined objectives and aims. Areas to consider include:

- Type of fund – debt, mezzanine, equity,
- Scale – overall size (based on demand), size of investments, period of fund,
- Private sector involvement – in fund or at point of investment (co investment) – target is to minimise or avoid preferential treatment to private sector, and
- State Aid – need to consider at four levels – fund manager, investors, fund, investee businesses.

Step 3

State aid advice – see below live example.

Step 4

Whilst this involves writing the key documents to secure funding from both the public and private sector there must have been regular contact and early stage discussions to ensure buy in from all parties.

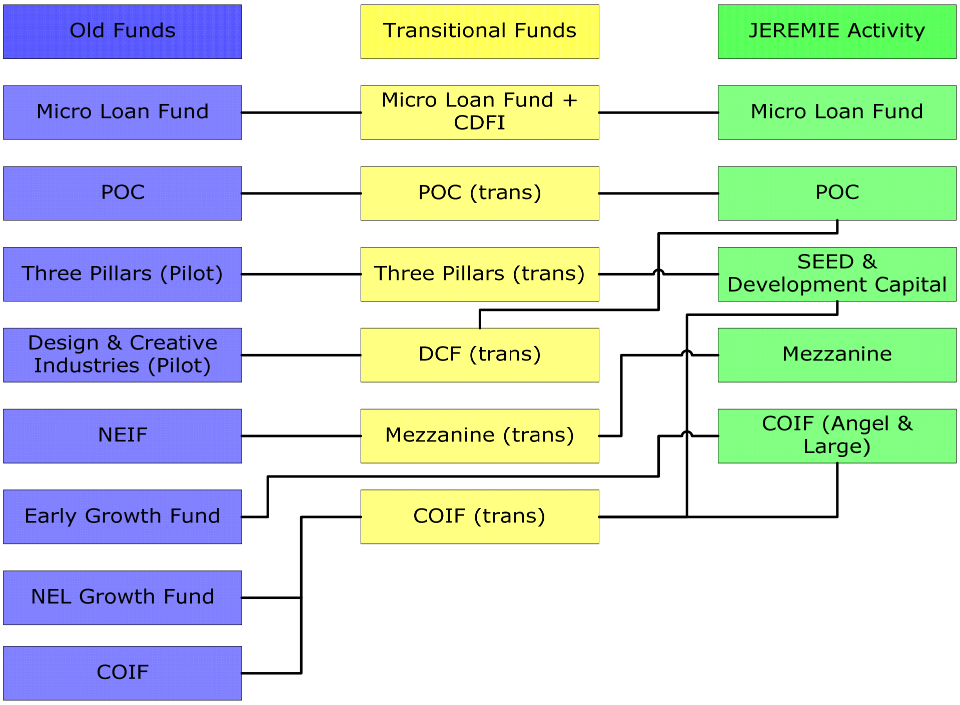
Live Example (Finance for Business North East)

The most complete example in the North East has been the development of the FBNE programme. This was established using public (ERDF/SP) funding and a loan from the European Investment Bank utilising the European JEREMIE initiative (Joint European Resources for Micro to Medium Enterprises).

This involved developing:

1. The complete product portfolio and demand analysis

This was based on the known demand and products operating over the last ten years. These were mapped onto the type of products and demand areas expected. The following shows a simple diagram including transitional funding to allow for gap between the closure of some funds and the start of the FBNE suite of funds. (JEREMIE = FBNE).



Fund Name	Fund Size	Sector / *Stage of Development of Investees* / (Average Investment per SME – inc. follow on)	Main Financial Instrument(s) Used by Fund Manager	Main Demand Areas Addressed	State Aid
POC	£15m	Tech / Innovation *Early Stage* (£103k)	Convertible loan Equity	Proof of Concept Seed Capital	***de minimis / no aid.***
Technology Fund	£25m	Tech / Innovation *Any Stage* (£417k)	Equity Quasi-Equity	Seed Capital Development Capital Mezzanine Finance	***general block exemption.***
Accelerator Fund	£20m	Generalist *Predominantly Early Stages* (£333k)	Equity Quasi-Equity	Seed Capital Development Capital	***general block exemption.***
Angel Fund	£7.5m	Generalist *Predominantly Early Stages* (£167k)	Equity Convertible Loan	Angel Match Proof of Concept	***de minimis / no aid.***
Growth Fund (500+)	£20m	Generalist *Later Stages* (£570k)	Equity Quasi-Equity	Development Capital Mezzanine Finance	***general block exemption.***
Growth Fund	£20m	Generalist *Later Stages* (£182k)	Equity Quasi-Equity	Development Capital Mezzanine Finance	***general block exemption***
Micro Finance	£5m	Generalist *Any Stage* (£17k)	Debt	Micro-Loan	***de minimis / no aid.***

As part of the design process it was also decided that there would be no specific Co Investment Fund (COIF) with the exception of Angel finance. However, where the other funds engage in larger deals there is an expectation that there will be private sector investment and that the terms of the investment from the FBNE funds match those of the private investors.

2. The Financial Model[1]

This is complex and it is recommended that professional support is engaged to help develop this. It will need to include:

Basic Fund info	Lifespan, investment period, size of fund, size of investments, number of investments, follow on info.
Financial Characteristics	Equity/loan spilt, conversion rate, failures (inc timing), returns (loan/exits) inc timing, Fees and expenses, repayment of private sector investors.
Regional Outputs	New/existing businesses, jobs etc.

This will need to be constructed for each fund and in the case of a holding fund model (FBNE) for all funds and uninvested funds (idle funds).

3. Business Case [2]

The basic document which seeks to address the requirements of the respective funders. In the case of the public funders value for money, market gap analysis, additionality etc. For the private sector in tends to be slightly simpler – how do they get a return on their investment?

4. **Company Structure**

This should consider all the issues highlighted above and management of returns. In the case of FBNE there is a balancing act between direction of public legacy funds generated by the funds and government accounting/financial principles at a time when it was not desirable to show any external private lending (EIB) on the public accounts.

This also needs to consider regional decision making in the reuse of legacy funds and there is an assumption that most legacies should be recycled in the region first.

5. **Green book appraisal** [3]

The level of appraisal is directly tied to the size of the funds being proposed. FBNE as a large project was subject to full scrutiny under the Treasurys Green Book rules.

Any approach should follow the guidelines (http://www.hm-treasury.gov.uk/data_greenbook_index.htm) but for information areas which will be tested include:

- Rationale and reasons for public intervention

[1] One North East Jeremie Financial Model w Sensitivity 090908
[2] One North East - JEREMIE - Business case signed (Board)
[3] One North East - Jeremie - Regeneris - Independent Economic Appraisal Report - NE VCLF Final Report 23-03-09

- Independent research
- Objectives, outcomes, outputs and targets
- Options - costs and benefits of options (and adjustments e.g. displacement, deadweight)
- Differences in tax between options
- Assessing and adjusting for risks
- Considering other costs and benefits

6. Procurement Route [4]

Generally given the scale of funds and potential fees it will be normal for procurement of fund managers to be through an OJEU process. This needs to be robust and it is usual for most of the key documentation to be required as part of the process (e.g. fund details, fund manager contracts etc.). Therefore sufficient time needs to be built into the development process to develop a full suite of contracting documentation.

In the case of FBNE the decision was made to establish a framework (pool) of fund managers to allow for flexibility in the event of either allocating additional capital to funds or performance/other issues which resulted in a need to swap fund managers.

7. State Aid advice

State aid in funds can be complex as there are a number of levels at which it can exist.

- Fund Manager
- Private Investors
- Fund
- Businesses receiving investment

In the design of any fund this should be considered at the outset to prevent downstream problems. There are guidelines covering this area issued by the EU.

8. Performance Reports

These need to cover both the economic and financial information required but should show both a snapshot of performance as well as a projected level of activity. The basic report should include the following elements:

- Executive Summary
- Financial Statements (both funds and holding fund)
- Investments Made

[4] PQQ Instructions and Contract Needs Lot 1 Final; 5 - Contract Notice Final & Sent to Simap

- Investment Returns
- Investments details (type, sector, location)
- Outstanding Amounts/Bad Debts
- Deal Flow
- Output Targets (numbers, jobs, leverage)
- Marketing Activity
- Fees
- Private/other investor issues (covenants, repayments etc.).

Glossary (some common terms)

Business angels - means wealthy private individuals who invest directly in young new and growing unquoted business (seed finance) and provide them with advice, usually in return for an equity stake in the business, but may also provide other long term finance.

Buyout - means the purchase of at least a controlling percentage of a company's equity from the current shareholders to take over its assets and operations through negotiation or a tender offer.

Debt investment - means loans and other funding instruments which provide the lender/investor with a predominant component of fixed minimum remuneration and are at least partly secured.

Early-stage capital - means seed and start-up capital.

Equity - means ownership interest in a company, represented by the shares issued to investors.

Exit strategy - means a strategy for the liquidation of holdings by a venture capital or private equity fund according to a plan to achieve maximum return, including trade sale, write-offs, repayment of preference shares/loans, sale to another venture capitalist, sale to a financial institution and sale by public offering (including Initial Public Offerings).

Expansion capital - means financing provided for the growth and expansion of a company, which may or may not break even or trade profitably, for the purposes of increasing production capacity, market or product development or the provision of additional working capital.

Follow-on investment - means an additional investment in a company subsequent to an initial investment.

Idle Funds - money that is not invested and, therefore, earning no income. Investopedia explains Idle Funds. If you want to increase you can manage idle funds through money markets or other interest bearing accounts. Also known as **treasury management**.

Initial Public Offering ("IPO") - means the process of launching the sale or distribution of a company's shares to the public for the first time.

Mezzanine finance – a hybrid of debt and equity financing, typically used to finance the expansion of existing companies. Mezzanine financing is typically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

Quasi-equity - means instruments whose return for the investor is predominantly based on the profits or losses of the underlying target company, are unsecured in the event of default.

Replacement capital - means the purchase of existing shares in a company from another private equity investment organisation or from another shareholder or shareholders.

Risk capital - means equity and quasi-equity financing to companies during their early-growth stages (seed, start-up and expansion phases), including informal investment by business angels, venture capital and alternative stock markets specialised in SMEs including high-growth companies.

Section 5 – Part of the Act of Parliament establishing the Regional Development Agencies under which RDAs required approval of the Secretary of State to establish companies to undertake certain activities (including investment funds).

Seed capital - means financing provided to study, assess and develop an initial concept, preceding the start-up phase.

Small and medium-sized enterprises ("SMEs") - means small enterprises and medium-sized enterprises" within the meaning of Commission Regulation (EC) No 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises Commission Regulation (EC) 364/2004 or any regulation replacing that regulation.

Start-up capital - means financing provided to companies, which have not sold their product or service commercially and are not yet generating a profit, for product development and initial marketing.

Venture capital - means investment in unquoted companies by investment funds (venture capital funds) that, acting as principals, manage individual, institutional or in-house money and includes early-stage and expansion financing, but not replacement finance and buy-outs.

Treasury definition of market failure

"Anything that may prevent products or factor markets from operating freely, adjusting quickly, or that restricts the information available to producers, consumers, or suppliers or resources"

References

1.	One North East Jeremie Financial Model w Sensitivity 090908
2.	One North East - JEREMIE - Business case signed (Board)
3.	One North East - Jeremie - Regeneris - Independent Economic Appraisal Report - NE VCLF Final Report 23-03-09
4.	PQQ Instructions and Contract Needs
5.	070507-JEREMIE- EIF Report for ENGLAND
6.	Deloitte Touche Final Report
7.	ONE Access to Finance report v2 0
8.	PN135R_micro finance_draft_report_230604
9.	Qi3 Demand Study Report v1.01
10.	Regeneris VCLF Evaluation Final Report June 2007_1
11.	VCLF Study Final Report - Main Report (Sept 2007)
12.	UK SME Finance Report – 2007
13.	Venture Capital Report – sbs