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The background of the entire page is a blue fabric-like texture with a grid of light blue squares and yellow stars, resembling the European Union flag. The text is overlaid on this background.

# Wales Ex-ante Evaluation of European Programmes 2014-20 - Financial Instruments

Stage Two Final Report by  
Regeneris Consulting and  
Oldbell3

Wales European Funding Office

**Wales Ex-ante Evaluation  
of European Programmes  
2014-20 - Financial  
Instruments**

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**Regeneris Consulting Ltd**

**&**

**Oldbell3**

[www.regeneris.co.uk](http://www.regeneris.co.uk)

# Contents

<b>1. Introduction</b>	<b>1</b>
<b>2. ERDF SME Competitiveness</b>	<b>6</b>
<b>3. ERDF Research and Innovation</b>	<b>13</b>
<b>4. ERDF Energy Efficiency &amp; Renewable Energy</b>	<b>16</b>
<b>5. ERDF Infrastructure</b>	<b>23</b>
<b>6. European Social Fund</b>	<b>32</b>
<b>7. Rural Development Programme</b>	<b>38</b>
<b>Organisations Consulted</b>	<b>44</b>



# 1. Introduction

- 1.1 This report presents the emerging findings from the on-going review of the scope for the use of Financial Instruments (FIs) in the new European programmes 2014-20 in Wales. It is intended to provide an evidence base to inform the discussion within Welsh Government of the suitability and appropriateness for the use of FIs in these new programmes.
- 1.2 The review builds on the Stage One screening assessment which provided a high level assessment of the suitability and appropriateness of FIs for the range of proposed interventions outlined in the draft 2014-2020 programme documents. This scoped in or out the use of FIs across the range of possible interventions within each investment programme. A range of comments were provided by Welsh Government and our approach has taken account of these.
- 1.3 The purpose of Stage Two is twofold:
- The conduct of market assessments for the interventions that were scoped in as suitable for the use of FIs;
  - More detailed consideration of the suitability of FIs in a number of cases where the case, one way or other, is not yet clear.

## Rationale for the Use of FIs

- 1.4 Historically, the public sector has supported economic development through direct funding and grant assistance. Increasingly, however, there is a policy desire - both within Wales and at the UK and European level - to develop alternative (non-grant funding) models of intervention. In Wales, this has been reflected by the implementation of a number of FIs under the 2007-2013 programmes, including an SME finance instrument aimed at providing finance for SMEs and an Urban Development finance instrument.
- 1.5 There are a number of advantages associated with the use of FIs in relation to SME, infrastructure and wider regeneration interventions. These advantages are summarised below:
- **Return on Investment** – Perhaps the most significant advantage of the use of FIs is the opportunity to recycle public sector investment and hence the opportunity to achieve a far greater return on investment and long term momentum than would be the case under more traditional grant funding mechanism.
  - **Levering Additional Private Sector Investment** – the use of FIs is likely to lever in significantly higher levels of private sector funding than might be the case under grant funding models, by encouraging venture capitalists to invest or encouraging investees to make a supplementary contribution themselves for example. This sharing of risk can create the potential for much larger scale investment funds than might otherwise be the case.
  - **Ensuring Long Term Commitment** – the nature of FIs means that the private sector is likely to be engaged over a longer time period than might otherwise be the case. This in turn is likely to build stronger commitment and relationships between the public and

private sector.

- **Tapping into Wider Pools of Expertise** – FIs which operate on a much larger scale can often access both a wider and higher quality pool of private sector expertise, both in terms of the management of the fund and in terms of fund delivery. This has positive implications in terms of the levels of expertise and experience that can be drawn upon to achieve shared objectives as well as in terms of decreasing and sharing project risk among a wider set of stakeholders.
- **Move away from grant funding culture** – As discussed above, grant funding models have in the past dominated intervention at the European and Welsh levels. FIs are seen as an ideological move away from the provision and reliance of start-ups and growing SMEs on grant aid, in favour of a more collaborative and holistic approach which sees the public and private sectors working more closely together to achieve shared objectives.

1.6 However, in the author's experience the use of FIs also present a number of challenges which need to be taken into account when considering their potential use:

- **Cost of Setup and Delivery** – reflecting a range of factors, including the complexities of delivery and in some cases the lack of existing models and expertise, FIs can be more expensive to setup and deliver than grant based approaches.
- **Complex Models of Delivery** – FIs often involve more complex rules than traditional grant based models, which in turn have implications for the delivery models which are adopted. These complexities present a number of challenges – in terms of the cost of set up and delivery (as discussed above) and in terms of the additional expertise required from policy makers, those delivering the support and also potential investors. This can potentially push up delivery costs and reduce value for money.
- **Step Change in Approach** – if FIs are to prove successful, they must be attractive both to potential private sector investors and recipients. Given the long track record in Wales – as elsewhere – in grant funding models, some dependency on grant investment remains. Steps have been taken to address this already, through commitments made in the Welsh Government's 2010 Economic Renewal Programme for example. However, further change is required from the perspective of both policy makers and the market.

## Scope of the Assessment

1.7 The scope of the assessments and the associated research tasks are set out below. We have categorised these into what we consider to be sensible groups of activity.

### SME Competitiveness Priority - Finance for SMEs

1.8 The focus here has been upon the use of FIs as a delivery mechanism for the provision of finance to start-up enterprises and growing SMEs. The general principle is that finance is provided on a commercial basis, namely that it is provided at market rates or with investment terms attached which depend upon the precise nature of the finance.

1.9 The assessment covers a wide range of businesses types, in particular:

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- Start-up businesses, distinguishing between start-ups with different motivations and prospects (e.g. high and non-high growth, profit-making and social enterprises, start-ups established by the unemployed, etc.);
- Micro-enterprises, typically requiring small amounts of debt finance;
- Early growth businesses, requiring a range of different types of finance;
- Larger expanding SMEs, seeking a range of finance types to enable longer term investment and growth;
- Social and community enterprises;
- The finance needs of high technology businesses.

1.10 There has been no particular presumption about the suitability of particular types of finance, although there is the expectation on the part of the European Commission that the main forms of finance targeted at SMEs will be debt, risk capital (and mixes of these) and guarantees.

### Research and Innovation - Finance for R&D

1.11 The Stage One assessment concluded that a range of possible FIs could be adopted in support of R&D activity, mainly proof of concept and commercialisation of University and SME R&D. The assessment concluded that there was not a pressing case for specific FIs in relation to higher volume SME innovation demand stimulation activities<sup>1</sup> within this priority. However, there is an important role for finance to support the set-up, early growth and expansion of high-tech firms which could be addressed through FIs either in this priority or the SME Competitiveness priority discussed above.

1.12 The focus of the assessment was therefore:

- The need for commercial finance to enable the commercialisation of University based R&D through establishing proof of concept, the spin-out of companies and the licensing of IP;
- The finance requirements of SMEs involved in proving and commercialising R&D, including proof of concept, seed funding and early stage growth.

### Renewable Energy and Energy Efficiency

1.13 The Stage One Screening Assessment concluded that there are various opportunities for FIs in the Renewable Energy and Energy Efficiency priority. These include:

- Energy efficiency activities focused on residential communities and SMEs (with the latter also including micro-generation);

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<sup>1</sup> This includes, for example, grant based projects such as Innovation Vouchers, which provide small grants to SMEs to encourage them to undertake specific clearly defined research and innovation activities. The intention is to encourage them to progress towards more extensive and intensive forms of research and innovation.

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- R&D and infrastructure investment to support the realisation of economic opportunities associated with the marine energy sector;
- The exploitation of renewable energy and low carbon infrastructure in major economic development schemes (e.g. business parks);
- Community renewable schemes.

1.14 However, the proposed analysis in Stage Two has stopped short of a full market assessment in many of these possible areas. Rather, the intention is to further investigate the types of investments which are proposed, the scale of activity and potential amounts of ERDF funding required, the indicative demand and supply, and the suitability of FIs.

### Infrastructure

1.15 There is a case for the use of FIs in the Infrastructure priority, with the possibility of building on the lessons from JESSICA<sup>2</sup> in the current programme to achieve investment in urban development. There is also the potential to use FIs to fund aspects of transport, ICT and energy related infrastructure within the priority.

1.16 However, as with the Renewable Energy and Energy Efficiency priority, this requires further investigation of the suitability of FIs. There are a number of key considerations which contextualise this, including:

- In the case of a FI to support investment in urban development (land and property primarily), the performance of the current JESSICA scheme and the delivery challenges it has faced;
- The potential merit of FIs for funding the other aspect of this particular priority, including transport, ICT and energy related infrastructure, where investment in individual projects can be large but few in number.

### ESF

1.17 The Stage One Screening exercise concluded that there was limited value and scope to use FIs in the future ESF programme. However, it noted the merit in exploring the links with access to finance support for start-up and micro businesses to ensure the support needs of start-up and growing micro businesses are being adequately addressed between the two programmes. This was approached in the following way:

- Integration of the assessment of finance (including demand for potential ESF funded FI interventions) for start-ups into the ERDF assessment of finance needs for SMEs outlined above;
- Exploring ways of clearly demarcating the roles of ESF and ERDF support so that they can meet the needs of potential entrepreneurs in an integrated and coherent manner.

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<sup>2</sup> Joint European Support for Sustainable Investment in City Areas.

### Rural Development Plan

- 1.18 As with the ERDF programme, the RDP has identified activities for which there could be a role for FIs in delivery. However, the Stage One Scoping Exercise found that the limited scale of the activity in these cases is likely to make the adoption of FIs unviable in many instances.
- 1.19 There may however, be merit in exploring the scope to achieve the necessary scale and viability through coordination or aggregation of activity with FIs under the ERDF programmes. This could apply to, for example:
- Provision of finance to support the diversification and modernisation of the farming sector;
  - Finance for start-ups and micro-loans for small established businesses in rural areas;
  - Finance for community renewable schemes;
  - Finance to support community hubs, community transport schemes and other forms of infrastructure.

### Report Structure

- 1.20 The remainder of the report presents the findings of the Stage Two analysis grouped by each of the European Funds and the corresponding priorities and interventions areas which were identified for investigation.
- 1.21 In the case of the ERDF SME Competitiveness and Research and Innovation priorities, the detailed market assessment is presented in a separate report.



## 2. ERDF SME Competitiveness

### Introduction

- 2.1 This section summarises the key findings of the Stage Two assessment of the potential to use FIs to support SMEs in Wales in the 2014-2020 Structural Fund programmes.
- 2.2 The conclusion of the Stage One assessment was that the provision of various types of finance for SMEs (including microfinance) is a key priority for the new ERDF programmes in Wales and should be subject to an initial market assessment. The Stage Two assessment therefore provides a detailed assessment of the market for finance for SMEs. We cover the following finance types in particular:
- Microloans;
  - Finance for Social Enterprises;
  - Loans;
  - Risk capital (targeted at business expansion).
- 2.3 The use of finance targeted at early stage businesses is relevant here, although it is also covered in the following section which focuses on finance in support of the research and innovation priority.
- 2.4 For each market segment we review the evidence on supply and demand, and market failure. In undertaking this assessment we have drawn upon a wide range of sources, including:
- Publicly available data on the supply of loan and equity finance, both in the UK and where available, for Wales;
  - Contextual data on the SME business base in Wales, covering the stock of businesses and rates of new business formation;
  - Data from recent surveys of SMEs in Wales and the UK, covering demand for finance and the extent to which SMEs have been able to source this finance;
  - Data supplied by Finance Wales on the performance of its various Funds, covering the supply of finance and the returns being secured from these investments;
  - Recently published research and evaluation reports on access to finance, mainly at the UK level.
- 2.5 We have supplemented this data analysis with a programme of consultations with business intermediaries, SME advisors, banks and Finance Wales. A list of consultees is provided at the end of this report.
- 2.6 It should be noted that whilst we have drawn upon a wide range of sources throughout, estimating unmet demand for viable investment propositions in different market segments is inherently problematic, both given the constraints on available data and more fundamental

theoretical difficulties. In the detailed appendix we provide a summary of the theoretical underpinnings of market failure in the provision of finance to SMEs. Despite these challenges, publicly available survey data provide an indication of demand and data on supply. Financial returns from Finance Wales have also enabled us to make a reasonable assessment of future capacity for publicly backed funds.

## Analysis and Findings

### Microloans

- 2.7 There are currently around 92,000 microbusinesses<sup>3</sup> in Wales, representing 82.4% of the total business base. Typically microbusinesses make use of overdrafts, credit cards and informal loans from friends and family members to finance early stages of their activity. When seeking £5k or more they then tend to seek small amounts of debt finance from external sources.
- 2.8 A little less than a quarter (23%) of Welsh microbusinesses sought external finance in the last 12 months, equivalent to 21,000 businesses in 2012. The majority of microbusinesses were seeking bank finance. Microbusinesses reported greater challenges than larger SMEs in gaining finance: only 53% of those seeking finance obtained all that they needed (compared to 57% of all SMEs). A further 11% obtained some but not all of the finance they needed.
- 2.9 This survey data alone cannot tell us how many viable propositions are failing to obtain finance at a reasonable market price, but it suggests a potentially significant level of unmet demand for microfinance. Based on a recent survey of Welsh SMEs by BIS<sup>4</sup> and published business data from ONS we estimate that there are around 6-7,000 microbusinesses in Wales failing to obtain any of the finance they sought. At an mean level of investment sought of £61,000<sup>5</sup>, this would suggest an unmet demand for finance of over **£360-420 million**.<sup>6</sup> However, it should be borne in mind that many of these will not be reasonable propositions for lenders, given the nature of the businesses and the lenders' assessment of risk and returns.
- 2.10 It is generally accepted that high street banks and other commercial lenders are often reluctant to lend to micro-businesses and finance from these sources is not always appropriate. This is due to the small amounts of finance sought, the higher default rates amongst these types of businesses and the relatively high costs. Finance Wales has run the £5m microloan fund in Wales as part of the JEREMIE initiative. Data on the performance of this fund in terms of investments made, expected returns and economic development outputs provide us with a pointer on the size of the market for viable microfinance propositions in Wales. Whilst some issues were encountered initially in sourcing viable propositions in this area, these appear to have been resolved and investment levels are recovering. Finance Wales expects to have made over £800k of microloans per annum on average by the end of the six year investment period. In

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<sup>3</sup> Defined as those having fewer than 10 employees. ONS UK Business Activity, Size and Location, 2012; data is taken from VAT or PAYE records and so excludes a significant number of those very small businesses operating below the current VAT threshold

<sup>4</sup> BIS (2012) Small Business Survey: SME Employers in Wales. BMG Research

<sup>5</sup> *ibid*

<sup>6</sup> Clearly this is subject to significant margins of error and is only useful as an indicative order of magnitude. However, it serves to illustrate the potential scale of unmet demand for microfinance in Wales.

addition, in response to a Welsh Government report<sup>7</sup>, a £6m microbusiness fund has been established, which is able to invest in sectors that are ineligible for EU support.

- 2.11 Overall the evidence suggests that there are a significant number of viable investment propositions in this area of the market in Wales. Finance Wales is projecting a modest positive return in gross terms on the investments made. However, it should be noted that these investments are not likely to yield a net positive financial return, given the typical default rates and once administrative costs are accounted for. There is some evidence that positive economic outputs are being achieved, although the longevity of these is unclear.<sup>8</sup>

### Finance for Social Enterprises

- 2.12 In 2009 Welsh Government undertook a mapping exercise in order to survey the scale and type of social enterprises in Wales and to better understand the sectors' needs. Just over 3,000 organisations representing 2.6% of all business turnover (£2.2 billion) were identified as undertaking social enterprise activity in Wales in 2009<sup>9</sup>.
- 2.13 Two-thirds of social enterprises have described access to finance as one of the main factors that would help in their organisation's future success, with smaller social enterprises generating less than £500,000 in revenue identifying this as their number one concern. Furthermore, when asked which areas of support and advice they would like to see expanded, 44% of social enterprises highlighted access to finance, far higher than any other area (including business and strategic planning (18% of organisations), volunteers (15%), diversification of income streams and partnership development (14%) and financial management and premises (13%)<sup>10</sup>.
- 2.14 All of the social enterprises surveyed stated that grant funding would be preferable over other forms of finance while demand for loan finance stood at 15% of organisations, compared to 39% among private SMEs at the time. While social enterprises are not typically the prime targets for equity investment, a significant 8% of social enterprises saw it as having a place in the future funding of their business. However a lack of understanding and awareness of how to access risk finance and of the relative benefits of doing so often acts as a barrier to take-up.
- 2.15 Data on the level of supply of finance to social enterprises is hard to come by where the source of finance is not specifically aimed at the social enterprise sector (for instance it is not possible to ascertain what proportion of commercial bank lending has been directed to social enterprises).
- 2.16 The 22 local authorities provide the greatest scale of support to the social enterprise sector in Wales and finance from the authorities predominantly comes in the form of grants. However, it is clear that there is a strong network of other organisations working to support the sector as well.

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<sup>7</sup> Welsh Microbusiness Task and Finish Group Report, January 2012

<sup>8</sup> It should also be noted that there have been some difficulties in monitoring these outputs through surveying investees. See Chapter 3 from the accompanying Appendix Report highlighting the creation of jobs through the Welsh JEREMIE Microloan Fund (p. 20) and UK Enterprise Finance Guarantee (p. 33) and for example.

<sup>9</sup> Welsh Government (2009). 'Mapping Social Enterprise Activity in Wales: Understanding in order to Influence'.

<sup>10</sup> *ibid*

- 2.17 There remains a fundamental mismatch between a requirement for loan finance and the types of loan products available commercially which are rarely shaped by the requirements of many social enterprises. However, the Unity Trust Bank which dispensed £19 million across the UK in social lending in 2012 and the Charity Bank which has lent £177 million to more than 1,000 charities across the UK between 2002 and 2012 provide a model through which loan finance to social enterprises could be expanded.
- 2.18 £2.3 million in ERDF has been channelled to the £4.7 million **Communities Investment Fund (CIF)** managed by the Welsh Council for Voluntary Action (WCVA). From January 2012 to June 2013 it received applications from 83 organisations for £5.5 million (an average of £66,000). Eighteen of these applications (22%) were approved at an average value of £89,000, a total amount loaned of £1.59 million and an average term of 10 years<sup>11</sup>.
- 2.19 In addition, more innovative means of delivering finance to social enterprises such as those provided by credit unions, or through community share schemes and community asset transfer have expanded and offer another way of expanding finance to the sector.

### Loans

- 2.20 There are no definitive sources of data on demand for debt finance from SMEs within Wales, but bringing together contextual data helps to provide a rough indication. In 2011 there were 8,225 new business starts in Wales, 33% below the business birth rate in the UK as a whole and 21% versus the UK excluding London and the South East. If the birth rate in Wales was to close this 21% gap, there would need to be 2,140 additional start-ups per annum (an increase of 49.9%). Assuming the current business birth rate continues, simple analysis of survey data suggests a need for finance of around **£700m per annum** to support this. Survey evidence on non-micro SMEs suggests that 18% of those that sought finance failed to obtain any finance.<sup>12</sup> Applying data on the average amount of finance sought, this would suggest **over £370m of unmet demand amongst established SMEs excluding micros SMEs (although again a proportion of this would not have been seen as being commercially viable to most lenders)**.
- 2.21 Since the 2007/8 credit crisis the supply of debt finance from mainstream sources has contracted very sharply, with banks focussing on lower risk propositions and demanding more security. This is reflected in data on overall net lending and has also had a significant impact on the demand for debt finance from Finance Wales, both through the JEREMIE Fund and through the recently launched SME Fund. Consultees suggested that the impact of Central Government initiatives (e.g. Funding for Lending) has largely been felt in a reduction in interest rates for existing customers rather than an opening up in lending to SMEs previously unable to source finance.
- 2.22 Finance Wales has been able to make a significant volume of loans through JEREMIE and the latest expectations on returns are healthy. The retreat of the banks has led to Finance Wales playing the role of prime lender rather than a gap funder. There has been a significant flow of viable propositions that are unable to source debt finance from elsewhere. The JEREMIE loan fund has been supplemented with a further £20m in loans offered through the SME Fund. It is

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<sup>11</sup> All figures received from the Welsh Council for Voluntary Action (WCVA), July 2012

<sup>12</sup> 90% of these businesses failing to obtain finance were small businesses (with 10-49 employees).

too early to make judgements on the performance of this particular Fund.

- 2.23 Looking ahead, should macroeconomic conditions become more benign in coming years, demand for loans to finance business growth, reinvestment in capital and business start-up can be expected to increase. Our consultations and analysis suggest that on the balance of probabilities, banks' lending practices are unlikely to become more liberal in coming years, given the pressure to repair balance sheets and continuing regulatory pressures on capital ratios. Banks are unlikely to return to their lending behaviour in the pre credit crisis period in the short or medium term. Should UK economic growth pick up, there is therefore the likelihood for the gap in debt finance in Wales to increase. There is the potential for other parts of the private sector to come into the market but there is much uncertainty about this, leaving a very important role for public sector backed lenders.

### Risk Capital for Expansion

- 2.24 Equity finance tends to be suitable for a small minority of firms that have high growth potential but a high level of risk associated with their business plans. Again, there is very little direct evidence on the level of demand for equity finance in Wales. Indeed estimating demand for risk capital investment from SMEs is difficult given that equity investment is only suitable for a relatively small number of SMEs. Moreover, even once a fund is established it is extremely difficult to predict at the outset, likely rates of return, given the inherently risky nature of investments. As for debt finance, demand can be expected to be higher in more benign macroeconomic conditions, but there is nevertheless significant uncertainty.
- 2.25 Overall, according to the 2012 Small Business Survey<sup>13</sup> in Wales, 24% of SMEs in Wales sought finance of some sort. Data from the UK-wide 2010 ONS Access to Finance Survey found that just 1% of SMEs seeking finance were looking for equity finance in 2010. Applying this to the Welsh SME base would equate to around 450 firms in Wales seeking equity finance. There is no reliable data on the extent to which these firms are successful in securing this finance, or whether they represent viable propositions. Given the relative paucity of evidence on demand, it is more illuminating to look at trends in the supply of equity finance and returns being secured from these investments.
- 2.26 The value of total equity investment in Wales has been lower than in the comparator areas of the UK and Scotland (relative to the size of the economy) and has fallen sharply since the credit crunch. Our analysis and consultations confirm that the mainstream venture capital market in Wales is very thin, and that the equity gap in Wales is at least as pronounced in Wales as in elsewhere in the UK. The credit crunch has served to reinforce this.
- 2.27 As a consequence, Finance Wales acts as a major provider of risk capital to SMEs in Wales. Analysis of the performance of the existing JEREMIE Fund helps to provide an indication of the equity gap in Wales. Finance Wales expects to have been able to make around £10m of risk capital investments per annum through JEREMIE. This is less than expected, in part reflecting the performance of the Welsh economy in general which has dampened demand for risk capital, allowing £7m to be vired into early stage portfolios<sup>14</sup>. Current expectations are for a

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<sup>13</sup> 'Small Business Survey 2012: SME Employers', BMG Research for BIS (2013).

<sup>14</sup> The Early Stage portfolio makes equity investments in young companies which are usually technology and science orientated, often commercialising R&D.



healthy positive return overall on the risk capital portfolio (although these are still subject to judgements on the likely realisations from these investments).

## Conclusions

- 2.28 There is a strong case for the ERDF programme to provide an integrated and coordinated approach to the provision of finance for SMEs, with the current JEREMIE fund providing a good basis upon which to build in the next programming period. This has the advantage of providing the scale necessary to be attractive to a major co-investor (such as the EIB), the ability to mix funding types in a fully integrated manner and to act as a credible partner to the range of SMEs in Wales seeking finance.
- 2.29 An overall fund which channels finance to a set of sub-funds (a so called 'fund of funds') could have an overall capital value of between £120-160 million (including seed and early stage growth which is examined in the next section). A case could be made for increasing this in response a number of factors including the need for greater amounts of debt finance and the potential for early stage support.

## Micro-loans

- 2.30 Given the typical default rates and operating costs, the market is highly unlikely to operate in this area for the foreseeable future. However, the evidence on the volume of viable microloan propositions in Wales provides a case for continued public sector backed microfinance. The experience of the JEREMIE Microloan Fund and the Microbusiness Fund suggests that there is capacity **of the order of £0.8-£1m per annum if offered on similar terms to that provided by the existing JEREMIE Fund. This would equate to a total Fund of £4-£5 million over five years (of which ERDF would provide part)**. This could be operated alongside other forms of business support for these businesses.

## Finance for Social Enterprises

- 2.31 Through the 2007-13 structural funding period, there has been less than £3 million directed specifically towards channelling non-grant finance to social enterprises, through the Community Investment Fund. Given the greater policy focus on social enterprises and fundamental mismatch between supply and demand set out above, we suggest that the scale of future funding be set to allow for organisations like the WCVA and Wales Co-operative Centre to expand upon the non-grant offer already provided within the next round of structural funds. However, this is in the absence of any evaluation evidence of the effectiveness and value for money provided by the existing ERDF backed schemes in Wales – these are very important considerations in assessing the scale of finance which is both needed and justified.

## Loans

- 2.32 The scale of the gap in the market is subject to uncertainty, given the challenges of predicting economic prospects and nature of demand and supply drivers. However, our analysis suggests a strong continuing need for publicly backed provision of debt finance in the period 2014-2020. Given the experience of JEREMIE, we would expect there to be capacity for at least the level of debt finance as that invested within the current JEREMIE Fund, if not more.
- 2.33 This suggests in the order of **at least £10-12m per annum of loans in Wales over a five year period, equating to a £50-£60m Fund, if offered on similar terms to those offered at present**

by JEREMIE<sup>15</sup> (of which ERDF would be around 50%).

### Risk Capital

- 2.34 Given the continued persistence of the equity gap and the relative lack of provision in Wales, our analysis suggests a continuing need for publicly backed provision of risk capital in the next Programme period. Given the experience of JEREMIE, we would expect there to be capacity for **in the order of £9-11 million of risk capital investments in Wales per annum, if offered on similar terms to those offered at present by JEREMIE.**<sup>16</sup> This would equate to a total fund of **£45-55 million over a five year period (of which ERDF would be roughly 50%).**

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<sup>15</sup> It should be noted that if any future JEREMIE Fund's successor is to be part funded by the European Investment Bank (EIB) or other senior debt funder as match funding for EU Structural Funds, then a loan fund of sufficient scale will be needed in order to service the debt repayments to the EIB.

<sup>16</sup> *ibid*

## 3. ERDF Research and Innovation

### Introduction

3.1 The Stage One assessment concluded that a range of possible FIs could be adopted in support of Research and innovation, mainly proof of concept and commercialisation of University and SME based R&D. The assessment concluded that there was not a pressing case for specific FIs in relation to higher volume SME innovation demand stimulation activities within this priority. However, there is an important role for finance to support the set-up, early growth and expansion of high-tech firms which could be addressed through FIs either in this priority theme or the SME Competitiveness priority discussed above.

3.2 The agreed focus of the assessment was therefore upon:

- The need for commercial finance to enable the commercialisation of University based R&D through establishing proof of concept, the spin-out of companies and the licensing of IP;
- The finance requirements of SMEs involved in proving and commercialising R&D, including proof of concept, seed funding and early stage growth.

3.3 The approach has consisted of:

- Consideration of the sector priorities and the associated policies of Welsh Government. These are important in shaping the focus of R&D activity within Wales.
- Using the available data sets, analysis of R&D activity occurring in Wales' universities and SMEs and the extent to which these lead to commercialisation and the establishment and growth of businesses. However, it should be noted that the extent and quality of the data available on R&D activity and its commercialisation is limited, as well as the demand and supply of commercial finance linked to this.
- Consultations with a range of organisations, in particular: universities; commercialisation partners active in Wales such as Fusion IP; private sector and public sector backed VCs active in Wales; Welsh Government officials dealing with policy, funding and delivery support for innovation and more specifically commercialisation of R&D.

### Analysis and Findings

3.4 Overall, there are low levels of business and academic investment in R&D. This is explained by various factors such as:

- Economic change and a sector mix which has resulted in a poor representation in some particular high R&D areas such as pharmaceuticals;
- A lack of PLCs headquartered in Wales, as well as company R&D centres;
- An under-representation in STEM subjects in Welsh HEIs and difficulty attracting top

level researchers and poor graduate retention<sup>17</sup>;

- A lack of government R&D institutions.

- 3.5 However, there are pockets of world class expertise in academia in areas with commercial potential, although they are commonly lacking in global scale. There are also a number of key multi-national ‘anchor’ companies, such as EADS and Tata, and clusters of smaller companies in niche areas such as optoelectronics and medical instrumentation. Wales has also benefited from previous public sector investments in major infrastructure projects/R&D facilities (e.g. Institute of Life Sciences) and more recently a positive engagement between government and business through nine sector panels<sup>18</sup>.
- 3.6 These factors have contributed to a situation in Wales where there has been a limited flow of good investment propositions for the commercialisation of R&D from both the academic and business sectors. This in turn has resulted in a lack of venture capitalists and business angels who are willing and able to invest in the commercialisation of R&D through proof of concept, seed funding and risk capital for early stage growth.
- 3.7 The emerging evaluation evidence for the JEREMIE fund suggests that it has played an important role through the Co-investment and Tech Transfer funds, both in stimulating demand and in filling this gap in finance provision.
- 3.8 The average level of investment expected across the five year investment period is around £5m per annum, although it should be noted that an increasing proportion of this has been focused in inward investing companies and whilst the forecast outturns are optimistic (11-14% respectively across the two funds) the ability to secure a positive Internal Rate of Return (IRR) still needs to be demonstrated in what is a challenging investment area.

## Conclusions

- 3.9 There is clearly a strong case for publicly backed finance in Wales to support the commercialisation of R&D. The actions of Welsh Government and Finance Wales have played an important role in addressing the issue of market failure in the provision of finance, but also helping to stimulate R&D activity and the demand for finance to commercialise this.
- 3.10 However, the demand for this type of finance from spin-outs and early starts in Wales remains thin. Consequently, Finance Wales has had to look outside of Wales for suitable investment opportunities, with these spin-outs and early starts receiving finance where they inward invest in Wales. Given the experience of JEREMIE, we would expect there to be capacity for in the **order of £4-8 million of early stage technology focused investments in Wales per annum**. This wide range reflects the difference between the geographical focus of the fund, with the higher amount accounted for by the additional investment associated with inward investing early starts. **This would equate to a total fund of £20-40 million over a five year period (of which ERDF would be roughly 50%).**

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<sup>17</sup> See ‘Innovation Wales: Evidence and Analysis Paper’, Wales Government (2012) for evidence.

<sup>18</sup> See the Welsh Government Department for Business, Enterprise, Technology and Science ‘Sectors Delivery Plan’ (2012).

3.11 Based on the assessment and our experience, we set out below our thoughts on the potential scale and range of investments with early stage companies:

- There are good reasons for continuing to support proof of concept activities with a grant rather than repayable finance, primarily linked to the risks of these activities and the ability to cost-effectively recoup investments<sup>19</sup>
- At seed investments are best delivered between the range of **£20,000 and £50,000** to start with follow-on investments reaching up to **£100,000**
- Early stage investments should be within the range **£50,000 to £1 million** overall (including follow-on).

3.12 While there is also a case for supplying debt, this should be delivered on a typically smaller scale where suitable for particular investments and generally supplemented by equity.

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<sup>19</sup> See Mouqué (2012). 'What are Counterfactual Impact Evaluations Teaching us About Enterprise and Innovation Support?'. DG Regional and Urban Policy. European Commission.



## 4. ERDF Energy Efficiency & Renewable Energy

### Introduction

- 4.1 The Stage One Screening Assessment concluded that there are various opportunities for the use of FIs in the Renewable Energy and Energy Efficiency priority. These include:
- Energy efficiency and micro-generation activities focused on residential communities and SMEs;
  - R&D and Infrastructure investment to support the realisation of economic opportunities associated with the marine energy sector;
  - The exploitation of renewable energy and low carbon infrastructure in major economic development schemes (e.g. business parks);
  - Community renewable schemes.
- 4.2 The analysis in this chapter stops short of a full market assessment. Rather, the intention is to further investigate the types of investments which are proposed, the scale of intervention required, the indicative demand and supply, and the suitability of FIs.
- 4.3 The methodology for this analysis has included:
- Desk based research relating to Wales, UK and European policy, guidance and project information and evaluations;
  - Review of the experience of relevant projects from the 2007-13 programmes in Wales and other UK regions;
  - Consultations with relevant staff in Welsh Government, partner bodies and case study projects. Energy Efficiency Related to Residential Communities and SMEs.
- 4.4 Grants have been provided for energy efficiency improvements in social and private housing through the *Arbed* scheme over the period of the 2007-13 ERDF programme and there is potential to incorporate a loan mechanism into some or all of this activity in the future.
- 4.5 Similarly, loans to SMEs to improve energy efficiency or install micro-renewables can generate annual cost savings and improve business efficiency, (as well as reduce carbon emissions), and are an area identified to be pursued under this priority.

### Case for Using Financial Engineering Instruments

- 4.6 The national Green Deal programme offers an opportunity for individual households and businesses to invest in energy efficiency or small-scale renewable energy generation, with loans paid back from energy cost savings. Consideration is being given by Welsh Government to piloting a similar 'invest to save' programme, however it would be sensible for this to complement and add value, rather than duplicate, the finance offering provided by the Green Deal. The Green Deal scheme is available across the UK, meaning there is a limited case to be made for replicating this financial support scheme in Wales for individual houses or businesses.

- 4.7 While the Green Deal offers the opportunity to individual households and businesses, there remains scope for funding wider programmes of intervention, under the ERDF programme. This activity has been taken forward under the Arbed programme in Wales in recent years, with objectives to reduce carbon emissions, reduce energy costs and fuel poverty, and support the local supply chain development. Larger programmes of intervention could continue to be supported eg working with social housing landlords (RSLs) or private landlords with multiple properties. It might also be extended to include schemes supporting energy efficiency in public and voluntary sector buildings.
- 4.8 There are likely to be challenges to using loan finance instead of grants for Arbed-type interventions. For RSLs, one challenge will be that although the RSL would make the investment in energy efficiency improvements, it would be tenants, rather than the RSL accruing the cost savings from reduced energy use, making the repayment model more complex. Another challenge, experienced by the London Energy Efficiency Fund (see below) was that several RSLs already had substantial bank loans and were unable to take on any further loans.
- 4.9 In addition, one of the key objectives of Arbed is to reduce fuel poverty, thus there may be a case to retain grant funded interventions for the most disadvantaged households (because if loan funded then the loan repayments made might negate any energy cost savings for these households).
- 4.10 The Green Deal mechanism (whereby energy efficiency measures are implemented and paid back through energy efficiency savings) is nevertheless a model which could be adopted in at least some cases to replace grant funded activities supported under Arbed, albeit with a number of complexities that would need to be resolved.
- 4.11 This approach has been tried and tested through the JESSICA London Energy Efficiency Fund in the 2007-13 ERDF Programme period. It has made £100m available to invest in refurbishment projects for London-located social housing and other public / voluntary sector buildings (eg university, museum, hospital, school, local authority buildings). Funding of £1m or more is available, but the target is for grants between £3-20m for programmes of intervention. The scheme has found that the FI was well suited to this type of investment, given the situation where returns are only likely to emerge over the longer term (up to ten years) and do not meet the short-term return hurdle rates required by conventional lenders (based on information provided by the scheme manager).

### Conclusions

- 4.12 **There is a very strong case for at least some of the Arbed programme activity to be taken forward through a FI in the future.** The large scale of activity under Arbed, the move nationally to fund these improvements through a loan approach (ie the Green Deal) and the successful model for this type of intervention witnessed in the London Energy Efficiency Fund all point to an FI approach being appropriate and suitable for this intervention area.
- 4.13 We anticipate however that part of the Arbed activity may need to continue to be funded through a subsidised approach for the most disadvantaged households facing significant fuel poverty challenges.
- 4.14 **Funding for SMEs to invest in energy efficiency / microgeneration through the ERDF programme is less likely to be needed** as individual firms can already access finance for this

through the national Green Deal fund.

## Marine Energy Related R&D and Infrastructure

- 4.15 Investment in prototypes / demonstrators and supporting infrastructure for the marine energy sector (primarily wave and tidal technologies) is a priority for Welsh Government given the potential economic benefits this may secure. However, the sector is still at an early stage, and there is a need for the public sector to pump-prime pre-commercialisation R&D activity and deliver supporting actions. In the 2007-13 ERDF programme similar activities have been supported through grant funding.
- 4.16 Infrastructure investments could also be supported, which seek to improve the attractiveness of Wales and Welsh territorial waters to the marine energy sector.

## Case for Using Financial Engineering Instruments

- 4.17 Investment in supporting testing and commercialisation of wave and tidal demonstrator projects has been supported through grant funding in the 2007-13 programme, including a total of £7m ERDF invested in the DeltaStream demonstrator. The recent Marine Energy Infrastructure Study (Welsh Government, 2012) highlighted that support should be given to the first multi-device arrays to ensure that these are successful and act to stimulate investor confidence.
- 4.18 Whilst it might be desirable to use ERDF to support the deployment and testing of multi-device arrays in Welsh waters, traditional grant funding may be the best approach. Alternative forms of financing may not be particularly attractive or practical at this stage, either to the public sector or developers, given the significant financial risks involved in relatively untested technology.
- 4.19 As the technology is tested, proved and deployed on a larger scale, this may become an attractive route for publicly backed venture capital funds. However, it is difficult to predict whether the sector could reach this stage during the investment period of the next ERDF programmes. But if it does, this could form one strand of early stage investment picked up by a future SME finance instrument scheme, rather than a stand-alone scheme.
- 4.20 Other options are being explored by the Welsh Government, including:
- Opportunities to match ERDF funding with funding from major renewable sector firms operating in Wales as part of larger research programmes. However it is not yet clear what the focus of this research might be, whether there is any interest / commitment from firms to this, or whether grants / equity investments might be best suited to this type of activity.
  - Opportunities to match ERDF funding with national Technology Strategy Board (TSB) funding channelled through the Offshore Renewables Catapult Centre, to deliver in Wales parts of their programme of activity researching areas to develop and reduce the cost of offshore renewable technologies, including wind, wave and tidal. Again, however, it is not yet clear who might be involved in Wales, whether there are research strands that Welsh bodies could lead on, whether the Catapult Centre would be open to this form of collaboration, or whether grants / equity investments might be best suited to this type of activity.

- 4.21 There could also be a strong case for the public sector to back other forms of investment which could support the development of the marine energy hubs in one or two particular locations in Wales. These investments could reinforce the efforts to secure the deployment and full commercialisation of devices in Welsh waters, including various aspects of R&D, testing and demonstration, and possibly some aspects of operations and maintenance.
- 4.22 One particular infrastructure aspect where there may be potential for FIs is around grid upgrades. Establishing onshore cabling to enable ease of access to the grid could significantly enhance the attractiveness of landfall sites for marine / tidal demonstrators. Upfront investment in this could be undertaken through a joint venture between the local authority / Welsh Government with a private sector partner, using equity investment from ERDF funding.

### Conclusions

- 4.23 Whilst there is a strong case for supporting the marine energy sector in Wales, there is limited potential to use non-grant forms of support at this stage.
- 4.24 The possible exceptions to this are:
- the potential for a publicly backed early stage technology fund to invest in commercial arrays which emerge in the lifetime of the next programme. However, there is a lot of uncertainty concerning the timing of this. This could be one strand of early stage investment picked up by a future SME finance instrument scheme.
  - the potential for equity investments in grid infrastructure upgrades to enhance the attractiveness of key landfall sites.

### Renewable Energy and Low Carbon Infrastructure

- 4.25 Financial support under this category could include loans or loan guarantees to de-risk investments and leverage private sector investment in low carbon / renewable energy infrastructure as part of larger economic development and regeneration projects. Examples might be renewable energy infrastructure or district heating schemes built into the fabric of Enterprise Zones or other regeneration sites that improve the competitiveness of these areas.

### Case for Using Financial Engineering Instruments

- 4.26 There is currently little indication of exactly what type of infrastructure is needed and of any specific sites where this activity could take place (although the Enterprise Zones have been highlighted as one potential area). It is likely that a scoping exercise would need to be undertaken initially to identify potential sites and gauge interest in this across Wales.
- 4.27 District energy schemes have been explored in the past in Cardiff and Swansea. However, feedback from WAG consultees suggests that they have lacked the volume of potential users in order to make the schemes commercially viable in their own right. To fill the commercial funding gap in order to make such schemes viable is likely to require grant funding rather than FIs in this case.
- 4.28 One example of a business park scheme that has taken place in South Wales is a two wind turbine scheme at Oakdale Business Park. This was led by Partnership for Renewables, a firm

set up under the Carbon Trust. The firm will fund and deliver the scheme on land owned by Caerphilly County Borough Council, which will be paid for by the revenues generated, as well as offering the opportunity to provide discounted electricity to business park users. As this is externally funded, there is no financial risk borne by the local authority.

- 4.29 While this looks to be a funding model with potential to be replicated, we are not aware that there is any significant demand at this stage for similar types of projects. It appears likely that to deliver this type of intervention would involve demand stimulation, working closely with public and private business park owners and developers.
- 4.30 One of the key challenges to funding this type of intervention using ERDF funding is likely to be delivery within given timescales. The timescales for scoping out potential projects, generating interest, securing planning consents, constructing infrastructure and then gradually paying back a loan through annual revenues will make this a long development and payback process. Defraying investment within the programme period and then securing payback in the limited timescales of a fund may be challenging, and may limit the number of schemes that could be delivered.

### Conclusions

- 4.31 While **there could be potential for a finance package to support this type of intervention**, the timescales for project identification, then consenting, development and recouping investment are likely to limit the viability of a significant number of these schemes.

### Community Renewable Schemes

- 4.32 Investment in community renewable energy schemes was a priority area under the 2007-13 programme, with objectives to reduce carbon emissions, create income streams for community bodies, and encourage a culture of local ownership of the renewable energy agenda.
- 4.33 The main support project funded under the 2007-13 programme is the £15m Ynni'r Fro project (£7m ERDF funding), set up to support the establishment of 22 new community renewable energy projects across Wales (primarily wind and hydro projects). The scheme provides advice and support to community groups as well as grants and loans up to £300,000.

### Case for Using Financial Engineering Instruments

- 4.34 The Ynni'r Fro project has three main components:
- 1) A team of Technical Development Officers providing in-depth advice and support to community groups throughout the development process;
  - 2) A grant of up to £30,000 to fund early stage activities to help projects get off the ground, such as environmental surveys, planning applications and community engagement activity. Awarding of this grant does not interfere with Feed-in Tariff payments;
  - 3) A grant of up to £300,000 (or from 2013 a loan of up to £250,000) towards the capital cost of schemes. This began as grant funding only, however due to non-compatibility with Feed-in Tariffs, was widened to offer loans as well (WCVA are currently operating the loan scheme).



- 4.35 To date the project has had around 200 expressions of interest, of which around 70-80 are viable schemes. Around 25-30 are expected to be achievable within the ERDF programme period (schemes must be generating electricity by March 2015).
- 4.36 The findings of the scheme to date actually suggest that the third element of the scheme – the large capital grant/loan finance is the least critical support strand. While securing planning consent has been highly challenging for projects, securing finance has been less of a challenge. Loan finance for schemes has been available from a number of other providers, including Triodos and the Co-operative.
- 4.37 Finance Wales consultees suggested that, based on their experience, there is a relatively crowded (albeit fairly fragmented) market for finance for social enterprise projects. They have allocated £1m of funding from Welsh Government to social enterprise activity over a five year period, which in conversations with a wide range of stakeholders was felt to be sufficient. Having been launched in January 2013, none of this funding has yet been drawn down.
- 4.38 The other element of the scheme where there could be potential for FIs is the second strand – the £30,000 early stage grant could be delivered through a loan scheme instead. However, in this case it is likely that this move would significantly reduce take up of the support, and affect the ability of the project to achieve its target of establishing new community energy projects. One alternative to this could be to make these grants repayable, in the event that the scheme comes to fruition (at which stage repayment of the grant should be easily affordable by the scheme). Setting up in this way would also avoid the additional investment required in setting up and running a new FI.
- 4.39 A final opportunity currently being explored by Community Energy Wales is to deliver a project whereby a team within CEW would develop, secure consent and build schemes, which they would then sell on as a package to community groups. In this case, there could be an opportunity for a loan fund to support community groups with raising the finance to buy out such projects. However, given that finance for the higher-risk investments in building and operating schemes is not proving a great challenge for community groups, it is anticipated that securing finance for lower risk investment of this nature will be even less challenging.

### Conclusions

- 4.40 Findings to date from the Ynni'r Fro project suggest that major finance for construction and operation of schemes has not been a major challenge for community groups, as the market is already providing for this.
- 4.41 There could be an opportunity for a FI relating to the earlier stage activity (currently provided for by grants of up to £30,000), however establishing this as a loan scheme is likely to significantly reduce demand, and affect the number of projects that eventually come to fruition. One alternative would be to set up a grant scheme for this which would be repayable if projects are successfully developed and generate sufficient revenues to do so. **It is therefore not anticipated that a FI would be appropriate in this activity area.**

### Overall Conclusions

- 4.42 It is anticipated that the main opportunities for use of financial engineering instruments in this priority area are as follows:

● Wales Ex-ante Evaluation of European Programmes 2014-20 - Financial Instruments ●

- **Marine Energy R&D Funding.** There are a number of opportunities in this area at relatively early stages of exploration within Welsh Government. At this stage the area most likely to come forward is early stage technology funding to invest in commercial multiple device arrays. This could be one strand of early stage investment picked up by a future SME finance instrument scheme.
- **Capital Funding for Infrastructure.** There are several strands of activity that could be supported through an urban development finance instrument fund, including energy efficiency in housing, infrastructure to support marine energy investments, renewable energy investments at business parks, and potentially district energy / community renewable investments. These would be likely to require a mix of loan and equity investments. There is a case for bringing these activities together in a single funding structure in order to secure the necessary critical mass. The experience of the ERDF-funded London Energy Efficiency Fund (JESSICA scheme) is that offering a broad range of investment opportunities through the fund is beneficial as the fall-off rate from initial applications to the fund is high (around 5-10 applications for every 1 eventually funded), thus keeping investment options open is beneficial.

4.43 A number of other studies currently in process or starting up, including the Marine Energy Economic Study and the evaluation of the Ynni'r Fro project are likely to provide further intelligence that may help to inform this work going forward.

## 5. ERDF Infrastructure

### Introduction

5.1 A high level assessment of the suitability and appropriateness of FIs for the proposed Infrastructure interventions was undertaken as part of the Stage One screening exercise. The assessment concluded that the potential for the use of FIs should be explored further for two groups of interventions, each of which are outlined below.

5.2 These have not been subject to an initial market assessment, however. The Stage One report concluded that this would be premature at this stage, given the uncertainties which remain about the suitability and appropriateness of FIs as part of the infrastructure priority in the future ERDF programmes.

5.3 **Land and Property Interventions.** The intervention areas under consideration here include :

- Economically important investments in Wales' physical infrastructure (built and natural/green). In particular those that are key parts of integrated regeneration and economic development schemes
- Targeted investment in education and training infrastructure with clear economic focus
- Strategically important business sites and premises
- Local infrastructure (e.g. training or childcare facilities) supporting broader economic development investments

5.4 The Stage One screening exercise concluded that whilst there is clear potential for the use of FIs in relation to these intervention areas, further analysis was required to understand the nature and complexities of possible delivery models, particularly in terms of understanding the performance of Wales's current JESSICA<sup>20</sup> fund.

5.5 **Wider Infrastructure Interventions.** The interventions under consideration here include:

- Intermodal and sustainable transport facilities that improve access to employment and education (e.g. transport hub)
- ICT networks and mobile communications networks
- Port infrastructure and access to ports by rail and/or road (in particular where they enable the exploitation of renewable energy)

5.6 The Stage One Screening exercise concluded that whilst there are likely to be benefits in using FIs for these interventions, the relative market size of each intervention area may mean that it is not possible to deliver FIs cost effectively. As such, further analysis was required to understand the advantages and disadvantages of the FIs, possible models for delivery and any lessons from existing models.

5.7 In this context, this section provides a more detailed assessment of the appropriateness of the use of FIs for these two groups of interventions, ultimately presenting conclusions regarding whether or not it is necessary to proceed to full market assessment.

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<sup>20</sup> Joint European Support for Sustainable Investment in City Areas

## Potential Use of Financial Instruments

- 5.8 There are a range of non-grant finance models which can be utilised to support infrastructure related interventions – including prudential borrowing, tax increment financing and Urban Development Funds (UDF). Of most relevant to European funding is the Urban Development Fund model. A UDF is defined by the EIB as “*a fund investing in public-private partnerships and other projects included in an integrated plan for sustainable urban development*”<sup>21</sup>.
- 5.9 UDF type funds are currently in operation in various guises throughout Wales and the UK, including the Welsh Industrial Partnership, the British Waterways Public Private Partnership and Local Asset Backed Vehicles such as Croydon Urban Regeneration Vehicle. However, the UDF model currently of most relevance to the European Funding context is the JESSICA model – a policy initiative of the European Commission set up with the aim of helping Managing Authorities to implement financial engineering mechanisms to support sustainable urban development and regeneration.
- 5.10 This JESSICA Model is considered in detail below, with reference to the advantages and disadvantages of the use of this type of FI, and with reference to experiences and performance of existing JESSICA funds, both in Wales and elsewhere.

### Overview of Existing JESSICA Model

- 5.11 JESSICA is a policy initiative of the European Commission, developed in collaboration with the European Investment Bank (EIB) and the Council of Europe Development Bank (CEB). It provides a mechanism for Managing Authorities to use a financial engineering mechanism to deliver ERDF structural funds to support sustainable urban development and regeneration.
- 5.12 There are two broad models of delivery:
- Under the first model, ERDF contributions are allocated to local UDFs which then invest them in public-private partnerships or other projects included in an integrated plan for sustainable urban development;
  - Alternatively, managing authorities can decide to channel funds to UDFs using Holding Funds which are set up to invest in several UDFs.
- 5.13 Investments can take the form of equity, loans and/or guarantees. Under the 2007-2013 programme, JESSICA regulations stipulate that investments can only be made in projects which are set out within an ‘Integrated Plan for Sustainable Urban Development’ and which focus upon the following areas:

- Urban infrastructure – including transport, water/waste water, energy
- Heritage or cultural sites – for tourism or other sustainable uses
- Redevelopment of brownfield sites – including site clearance and decontamination
- Creation of new commercial floor space for SMEs, IT and/or R&D sectors
- University buildings – medical, biotech and other specialised facilities
- Energy efficiency improvements

<sup>21</sup> Source: European Investment Bank (EIB) at <http://www.eib.europa.eu/products/jessica/funds/index.htm>

5.14 There are a number of advantages and disadvantages of the JESSICA Model. These relate largely to those set out above for FIs more generally and include:

Advantages	<ul style="list-style-type: none"> <li>• Sustainability – The revolving nature of the fund generates returns for investors. This offers a more sustainable alternative to grant finance.</li> <li>• Leverage – by combining structural funds with other sources of funding, JESSICA boosts resources making it easier to provide support to a larger number of projects</li> <li>• Flexibility – JESSICA offers flexibility, both in terms of structure, and in the use of funds by way of either equity, debt or guarantee investment, which can be tailored to the specific needs of particular countries and regions</li> <li>• Expertise – JESSICA enables managing authorities to engage with the private sector. Aside from leverage, this provides technical and financial capacity in project design and delivery</li> <li>• Partnerships – Reflecting the above, the JESSICA model can help to establish new partnerships between public and private sector stakeholders in pursuit of shared objectives</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>• Complex Models – JESSICA is no different to other Financial Instruments in terms of the relative complexity of the delivery model. This has implications in terms of the cost effectiveness of model for certain intervention areas and in terms of the expertise required for setup and delivery.</li> <li>• Risk – the emphasis in the delivery model on partnership and collaboration means that there is a greater degree of risk relating to partner / relationship breakdown than might be the case with grant funding</li> </ul>

Source: European Commission, accessed at [http://ec.europa.eu/regional\\_policy/thefunds/instruments/jessica\\_en.cfm#4](http://ec.europa.eu/regional_policy/thefunds/instruments/jessica_en.cfm#4)

5.15 A number of JESSICA UDFs have been set up under the 2007-13 programme, including the Regeneration Investment Fund for Wales. The experience to date of this fund is considered in detail below.

### Regeneration Investment Fund for Wales

5.16 The Wales JESSICA Fund – the Regeneration Investment Fund for Wales – was established in 2010. It was the second European UDF to be set up in the UK and only the third across Europe.

#### Fund Overview

5.17 The UDF is worth £55 million in total, of which £40 million is the European Funded element. The Fund comprises £25 million ERDF Convergence funding, match funded with £15 million in cash and assets from the Welsh Government. WG also provided an additional £15 million in cash and assets, not tied to European Funding and hence providing flexibility to make investments which would not necessarily be eligible under ERDF. Whilst the European Funding is due to be spent by 2015, the Fund itself has a minimum anticipated life of 12 years.

#### Fund Rationale

5.18 The Scoping Study<sup>22</sup> for the Wales JESSICA Fund set out a clear rationale for the setup of the Fund. The study argued that there is a strong case for public sector investment in regeneration

<sup>22</sup> Jessica Preliminary Study For Wales Final Report (2008), King Sturge

and infrastructure in Wales as a result of inefficiencies in the property market which has “regularly deterred the private sector from investing in areas outside of the major conurbations”, a situation which has exacerbated during the economic downturn.

- 5.19 The result of these market inefficiencies have been decades worth of public sector intervention in regeneration. Traditionally, this has taken the form of gap funding assistance. However, the Scoping Study notes it has become a necessity to explore new approaches to intervention which ensure that “a legacy of future funds is created for investment purposes after 2013 and the current round of funding from Europe”. The study identified that the JESSICA model could help this to be achieved, increasing the overall pool of resources available for regeneration and allowing for a more cohesive programme of regeneration which is sustainable and perpetuating in the long run.
- 5.20 The study concluded that there was evidence that a JESSICA initiative could make “a significant contribution to enabling regeneration projects where private sector intervention on its own was not realistic, and where grant funding would not represent the optimum value for money for the public sector”.

### Fund Setup and Focus

- 5.21 The UDF has been established as a limited liability partnership known as the Regeneration Investment Fund for Wales (RIFW). Unlike many other JESSICA Funds in Europe, the UDF was not set up via a Holding Fund. The Fund and Investment Managers are Amber Infrastructure as Fund Manager and Lambert Smith Hampton (LSH) as the Investment Manager.
- 5.22 Reflecting the relative inexperience in delivering this model (both in Wales and across Europe), a phased approach to delivery was adopted:
- Under the first phase (still ongoing), the fund structure is wholly public, with ERDF and WG resources utilised alone. This intention behind this approach was to enable the fund to establish itself and gain credibility in the first instance. Under this Phase, the Fund is offering loans to potential developers.
  - Under the Second phase it is intended that the UDF will extend its reach, seeking to increase funding levels by leveraging in private sector finance. Under this Phase, it is intended that the range of products offered will broaden to include Equity and Loan Guarantees.
- 5.23 Reflecting the Convergence Funding, the initial focus of the Fund is on urban areas within the Convergence area of Wales. Suitable projects include medium to large scale development opportunities where there is a mix of commercial uses. Projects can also include investment opportunities in other areas including renewable energy generation, waste and infrastructure. The Regeneration Fund for Wales sets out a broad criteria that projects should match:
- Initially to be located in an urban area within the Convergence Area, although schemes outside this area will be considered for investment in the medium term
  - Commercial development with proven regeneration credentials
  - The site must be included in an Integrated Plan for Sustainable Urban Development (IPSUD)
  - Projects that include the provision of renewable energy
  - It is envisaged that funding support will range between £3m and £10m per project



## Progress to Date

5.24 The Fund has now been operational for around two years. There are a number of overarching headlines regarding the progress of the Fund:

- To date, the Fund has made one investment, a £13 million loan investment in the mixed use redevelopment of Neath Town Centre, announced in October 2012;
- The Fund is currently suspended from making investments pending the results of two investigations by the Welsh Audit Office. These were announced in February 2013 and are “a peer review of the process by which the fund disposed of the land assets vested in the fund by the Welsh government” and “an internal review of its activities and the government's "oversight" of it during the period which included the land disposal”<sup>23</sup>

## Fund Constraints

5.25 Consultation with WEFO has suggested that there have been a number of constraints to the delivery of the Regeneration Fund for Wales to date. These include:

- **Nature of WG Funding** – as discussed previously, the Welsh Government provided funding in the form of cash and assets. The latter has proved problematic – the packaging together and sale of assets has led to a number of procurement concerns which have resulted in the suspension of the Fund. It must be noted, however, that this constraint relates to the existing set up of the Regeneration Investment Fund for Wales rather than to the viability of the UDF model overall.
- **Economic Context** – It was also anticipated that the economic downturn might influence the ability of the Fund to generate sufficient interest. Whilst this may be true, this has been overtaken by the suspension of the Fund, subject to further investigation of issues related to sources of matched funding. The manner and extent to which this will impact upon the investment and financial performance of the fund is not yet clear.
- **Lack of clarity in JESSICA Regulations** – one of the main constraints has been a perceived lack of clarity from the European Commission on the regulations surrounding JESSICA. The current EC guidance currently places limits on what UDF can and cannot invest in; in particular, the stipulation that potential projects must be included within an ‘Integrated Plan for Sustainable Urban Development’. Given that these do not exist in that format with Wales, this has led to confusion and caution on some part. The definition of what is classified as ‘urban’ has also led to some confusion around what is and isn’t eligible.
- **Complexities of Delivery** – whilst the Regeneration Fund for Wales has drawn upon considerable expertise within WG and the Fund Manager, this still represents an innovative approach to delivery, both at the Wales and European levels. As was expected therefore, there has been an element of learning within the early stages of delivery.

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<sup>23</sup> <http://www.insidermedia.com/insider/wales/84735-regeneration-investment-fund-suspended>

- **Inertia and Nervousness from Policy Makers and the Private Sector** – as discussed previously, the use of FIs represents a step change away from more traditional funding mechanisms. Anecdotally, this step change may be one reason for the relatively slow start made by the Fund in terms of actual investment – especially in the context of the economic downturn.

### Fund Strengths

5.26 Despite the above, consultation with WEFO has also highlighted a number of potential strengths, which could provide a useful platform on which to build in the next programming period (although these would need to be verified through an independent review or evaluation in due course):

- Whilst only one investment has been made to date, there is a strong pipeline of potential projects, of between 40 and 50 in total, which between them would require around £170 million worth of investment. Not all of these projects are likely to be viable or eligible for investment. However, the Fund Manager has identified 10 projects which are seen to be most viable and these alone require more investment than the total value of the Fund (i.e. £55 million).
- To date, the business model for the fund has largely been seen as a strength. Many other areas in Europe opted to place European funding within a Holding Fund, which has resulted in delays in the setup of UDFs and actual project delivery. In Wales, the delivery of funding straight to the UDF allowed the Managing Authority to retain more control and has enabled faster setup. However, given the issues noted above, this conclusion will need to be revisited in due course to ensure that it holds true.
- The fund has succeeded in leveraging more WG funding than would might be the case with grant finance (i.e. the funding provided over and above the ERDF Match). There is potential for even greater leverage forwarding the future as it moves into phase two. Whilst the Fund has been supported entirely by public money to date, once it has become established there is potential to seek private sector investment and pursue equity finance, which is where potential returns are likely to be maximised

### JESSICA Funds Elsewhere

5.27 The JESSICA model has been adopted in various guises across Europe in recent years. The last overarching update on the progress of the JESSICA model across Europe was provided in late 2011. At this stage around €1.89 billion has been committed to 22 JESSICA operations across 10 Member States. The majority of these UDF's were set up using holding fund agreements, with only three set up without a holding fund (Brandenburg, East Midlands and Wales)<sup>24</sup>.

5.28 The scope of supported projects at that stage was relatively broad, including brownfield regeneration, the development of sustainable urban infrastructure, waste and energy efficiency interventions in the existing housing stock.

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<sup>24</sup> JESSICA State of Play (2011), EC, accessed at [http://ec.europa.eu/regional\\_policy/thefunds/doc/instruments/jessica/20111019\\_jessica%20state\\_of\\_play.pdf](http://ec.europa.eu/regional_policy/thefunds/doc/instruments/jessica/20111019_jessica%20state_of_play.pdf)

- 5.29 There has been no overarching review to date on the progress of the JESSICA model across Europe – this partly reflects the fact that the model is still relatively new and in the early stages of delivery. However, the JESSICA Networking Platform was set up by the European Commission to help with the implementation of JESSICA and within this the ‘JESSICA Lessons Learnt Working Group’ has provided an update from across Europe on emerging lessons. Key findings of relevance for future delivery include<sup>25</sup>:
- There is a need to ensure greater flexibility in OPs where FIs are implemented;
  - There is a lack of clear state aid rules related to revolving mechanism in the present programming period;
  - Co-operation of private and public sector representatives should be strengthened;
  - Funds for information and promotional actions supporting project promoters should be made available.

### Implications for Future Delivery

- 5.30 Clearly, the Regeneration Investment Fund for Wales is still in its early days of delivery. As a relatively innovative model of delivery, it was always anticipated that it would take time for the Fund to gather momentum and to overcome initial constraints.
- 5.31 However, whilst the Fund has made only one investment to date, the model has succeeded in generating significant interest from the public sector, as evidenced by the pipeline of potential projects.
- 5.32 Aside from this, there are a number of learning points regarding potential future delivery, the most important of which include the need for greater clarity in overall project objectives and project eligibility (which partly comes at the EC level), and the need to think carefully about the types of funding provided.

### Anticipated Changes to JESSICA Model 2014-2020

- 5.33 The European Council has published a consultation document<sup>26</sup> regarding the delivery of FIs under the 2014-2020 programme. It is currently intended that the JESSICA model will be retained going forward, but with a number of changes in rules and regulations.
- 5.34 Perhaps the most significant change proposed relates to project eligibility. It is currently proposed that all projects eligible for ERDF Funding will be eligible for investment from JESSICA UDFs. This is a move away from the current regulations which state that projects must be included within an “Integrated Plan for Sustainable Urban Development”. Reflecting this, there will also be greater flexibility to move away from solely ‘urban’ interventions.

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<sup>25</sup> JESSICA Lessons Learnt Working Group (2012), Conclusions and Recommendations, accessed at [http://ec.europa.eu/regional\\_policy/thefunds/instruments/doc/jessica/02\\_lessons\\_learned\\_wg.pdf](http://ec.europa.eu/regional_policy/thefunds/instruments/doc/jessica/02_lessons_learned_wg.pdf)

<sup>26</sup> Cohesion Policy legislative package - Presidency compromise on financial instruments (2012), Council of the European Union, <http://register.consilium.europa.eu/pdf/en/12/st11/st11027-ad02re01.en12.pdf>

- 5.35 *It is important to note that these are draft regulations – whilst they have been agreed by the European Council they are still to be agreed by the Parliament and the European Commission.*
- 5.36 The implications of the above are that 2014-20 JESSICA models are likely to have a greater amount of freedom regarding the investments that they make. This should help to ensure that greater clarity is achieved going forward in Fund design and delivery, which will ultimately be important in helping to engage more strongly with the private market.

## Overall Conclusions

### Land and Property Interventions

- 5.37 The Stage One assessment found FIs to be a relevant and suitable approach to funding some forms of land and property interventions. FIs such as Urban Development Funds can be used to accelerate and bring forward development activity which otherwise might not happen – interventions around brownfield sites and the creation of new floor space.
- 5.38 Whilst the performance to date of the JESSICA fund in Wales has been well below expectation and future returns are highly uncertain, there remains a long term need for this type of investment vehicle in Wales as the economy comes out of recession. The lessons learnt from existing delivery could provide a good platform on which to develop an effective UDF mechanism under the 2014-20 Programme. The Stage Two assessment therefore confirms that the relevance and suitability of this mechanism remains, in principle at least, high.

### Transport Related Infrastructure

- 5.39 The proposed ERDF programmes allow for a limited range of transport related infrastructure projects, in particular for the West Wales and the Valleys Programme. These include, for example, transport interchanges and access to employment sites.
- 5.40 The rationale for providing financial support to the private sector for site access is broadly the same for land and property investment covered by a future urban development fund. There are strong market failure and viability arguments in some locations, with the potential for them to be integrated into wider property proposals in some cases.
- 5.41 There could also be a case for supporting other types of transport infrastructure projects which are not site access related. However, the potential number of investments could be limited in practice and would certainly not justify the setting up of a specific ERDF backed investment vehicle. In addition, these types of investments are often public sector led, which could reduce the attractiveness of commercial debt and equity funding over the use of existing public sector monies or municipal borrowing. Whilst this does not rule out the case for integrating this type of investment into an all encompassing JESSICA type fund, it does suggest the opportunity may be limited.

### Port Infrastructure

- 5.42 The Stage One Assessment found that FIs might be relevant where the private sector requires loan finance to bring forward port related infrastructure improvements:
- Given the large scale commercial interests in port activity, there could be clear

advantages in pursuing FIs over grant finance given the ability to generate positive financial returns. Also, accessing grant finance for public related investments can be challenging given State Aid rules, often discouraging potential bidders from pursuing this route.

- The existence of a market failure in the provision of commercial finance to port operators is not clear, with many of the larger operators able to access corporate finance for profitable investment propositions even in the current economic conditions.
- However, there could be market failure affecting some potential port investments, in particular where there are abnormal development costs. The likelihood is that the numbers of investments which fall into this category are few in number.

5.43 The analysis above has highlighted that proposed EC changes in the regulations attached to JESSICA have the potential to allow future FIs to incorporate a more inclusive range of interventions. Whilst the demand for public sector backed repayable finance for potential port infrastructure projects might be limited in practice, these types of investment could be covered by an all-encompassing urban development fund, which covers all proposed ERDF land, property and infrastructure interventions including port infrastructure.

5.44 A future JESSICA type fund could provide an FI platform to build upon generally, although there is no track record of specific investments in port infrastructure interventions in the current fund and the practicality and relative merits of doing this would need to be investigated further in due course.

### ICT and Mobile Communication Networks

5.45 The focus of the review has been upon the areas of Wales in which the private sector will not invest in broadband due to market failure. However, these areas are steadily shrinking, as the private sector enables more exchanges across Wales. Even where the private sector has been in discussion with the public sector about accessing public monies to close funding gaps, the focus has been on grant rather than any form of repayable finance. The challenge for these schemes is typically their viability given the nature of the market and capitals costs, rather than a failure in finance markets.

5.46 There is the potential for some form of debt or risk finance to support community led rural broadband schemes. However, the long term nature of debt or risk capital and the availability of other grant finance options (e.g. Rural Community Broadband Fund) may make these forms of finance a less attractive option, affecting take up levels. Grant finance may well remain the preferred approach in this instance.

5.47 The proposed EC changes in the regulations attached to JESSICA have the potential to allow future FIs to be designed to incorporate a more inclusive range of infrastructure related interventions. However, for the reasons stated above, the need to do this in support of ICT and Mobile Communications investment in the new ERDF programmes may be limited and on balance not worth pursuing further.

## 6. European Social Fund

### Introduction

6.1 The Stage One FI screening assessment for the European Social Fund 2014-20 concluded that the potential for the use of FIs was limited but that a number of the proposed interventions should be explored further:

- Interventions Relating to Self-Employment and Enterprise;
- Interventions Relating to Higher Level Skills.

6.2 This section provides a more detailed assessment of the appropriateness of the use of FIs for these types of interventions, presenting conclusions on the relative merits.

### Self-Employment and Enterprise Interventions

#### Overview of Proposed Interventions

6.3 The interventions under consideration here are included within the Brighter Futures and Helping People into Work ESF Priority areas. Possible interventions include those targeted at helping people to move into self-employment and enterprise, including *“Actions to ensure that young people gain the skills, competencies and experience required to access sustainable employment, including self-employment, and to compete in a competitive work environment”*.

6.4 These intervention areas also have strong linkages to interventions set out within the SME Competitiveness Priority of the proposed ERDF programme 2014-20, in particular the focus on entrepreneurship (encouraging new start-ups and supporting their growth) and access to finance (for start-ups, micro businesses and established SMEs).

#### Previous Interventions and Delivery Mechanisms

6.5 Across Europe, there is a relatively limited track record in the use of FI to deliver ESF interventions, particularly for the types of intervention under consideration here. All interventions under the Wales 2007-2013 ESF programme have been delivered via grant funding mechanisms and there is no track record in Wales of the use of FIs for the delivery of ESF.

6.6 Despite this, there is a track record of using FIs to deliver other aspects of the Structural Fund programmes in particular ERDF support for enterprise and SMEs. Whilst this focuses on established businesses, it points to the technical expertise in FIs within Wales which would be an important consideration in setting up any future mechanism.

6.7 Across Europe, the number of FIs set up under the ESF Operational Programme is relatively modest. In December 2011 (the last EU level update provided<sup>27</sup>) of 484 financial funds, only 18

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<sup>27</sup> Summary report on the progress made in financing and implementing financial engineering instruments co-financed by Structural Funds (2011), European Commission



were set up using ESF spread across 6 countries (Denmark, Germany, Italy, Estonia, Latvia and Lithuania).

6.8 The majority of these funds have focused on micro-credit and micro finance. Whilst there is very limited evaluation evidence to date on achievements / successes, interventions of relevance include:

- In Latvia<sup>28</sup> the “Support to Self-employment and Business Start-ups” programme was set up in 2009 with ESF and government resources totalling €32.7 million. The purpose of the programme is to boost economic activity in the country by developing the knowledge and skills of business start-ups and providing them with the financial support they require. By 2011, the project had achieved the following results (exceeding initial targets):

- 1,938 signed agreements with applicants regarding participation in the programme (target: 1,200 persons)
- 1,033 persons trained (target: 1,200 persons)
- 537 loan agreements totalling €9.31 million signed (target: 800 entrepreneurs)
- Grants totalling more than €1.68 million issued. The average loan amount disbursed is €18,000, indicating that the entrepreneurs actually need lower amounts than was initially thought

- In Germany<sup>28</sup> the federal guarantee fund “Mikrokreditfonds Deutschland” was set up in January 2010 with the sum of €100m, with the aim of improving access to loans up to €20,000 for start-ups and microbusinesses. The goal of the fund is to disburse 15,000 loans by 31 December 2015. Serving clients with a migrant background, female entrepreneurs and companies offering apprenticeships is of special importance. Since the start of the fund in 2010, the number of disbursed loans is more than 250% above what was initially planned. By December 2011 6,600 microloans totalling €39m had been given out, with a default rate of only 3%.
- In Poland, in the region of Slaskie, a micro loan fund was set up aiming to support unemployed people who wish to establish micro-enterprises. The project is in its early stages of delivery, but early evidence suggests that demand has not been high and that a preference for grant aid for startups has been noted<sup>29</sup>.

### Future Delivery

6.9 This section examines possible models for the use of FIs for these intervention areas, and assesses the suitability of this type of mechanism.

6.10 It would be important that any FI for ESF interventions relating to Enterprise and Self Employment was linked closely to ERDF interventions relating to SME Competitiveness (examined separately elsewhere). Ensuring complementarity in approach between the two would be vital in ensuring that both programmes are able to pursue their objectives with

<sup>28</sup> Designing microfinance operations in the EU A manual on how to build and implement microfinance support programmes using the ESF

<sup>29</sup> Between Scylla and Charybdis: Navigating Financial Engineering Instruments Through Structural Fund and State Aid Requirements (2012), European Policies Research Centre

maximum efficiency and effectiveness.

6.11 With this in mind, the ways in which FIs could be implemented include:

- A FI which uses ESF Funds to help people move from unemployment into self-employment / micro-enterprise. Repayment would need to be based upon future business turnover / earnings;
- A broader model which integrates ESF and ERDF funding. The former would help to get particular target groups to the stage where they are ready to set up their business or become self-employed, with interventions including advice, training and possibly non-repayable allowances. ERDF would fund micro-loans, larger loans and equity investments, providing a funding continuum as described in an earlier section of this report. This approach would maximise complementarity between the two programmes and we believe prove more cost effective than a less integrated approach between the two programmes.

6.12 Perhaps the key distinguishing factor in the use of FIs compared with grant finance is the need for an effective repayment mechanism. However, there are a number of significant challenges in using repayable finance with the ESF target groups:

- **High Degree of Risk** – there is always an element of risk in the provision of loan finance; the perceived level of risk will be at the core of decisions made by lenders. It is likely that the provision of loans to support unemployed people moving into employment would be a particularly high risk area. The difficulties in setting up and developing new businesses are well researched<sup>30</sup>; the level of difficulty is likely to be even greater for the groups targeted (young people and unemployment groups) and particularly in the context of the current economic climate. As such, it is likely that the level of risk (of default) attached to the provision of loan finance for these intervention areas would be higher than acceptable.
- **Appropriateness of Loans** – the growing burden of loan finance on UK households has been well documented in recent years. Recent years have seen large scale growth in levels of personal debt and easy access to loan finance has been identified as an important contributing factor<sup>31</sup>. As such, the provision of loan finance to help the target groups move into employment is unlikely to be seen as an appropriate response, with potential negative impacts including increased levels of debt and further embedding the ‘loan’ culture.
- **Impacts on business sustainability** – again, there are multiple financial challenges associated with setting up a business. Whilst the provision of loan finance could help

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<sup>30</sup> BIS (2011), Research to understand the barriers to take up and use of business support, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/32250/11-1288-research-barriers-to-use-of-business-support.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32250/11-1288-research-barriers-to-use-of-business-support.pdf)

<sup>31</sup> The Financial Inclusion Centre (2011), Debt and the Family, [http://www.stepchange.org/Portals/0/Documents/media/reports/additionalreports/Report\\_Debt\\_and\\_household\\_incomes.pdf](http://www.stepchange.org/Portals/0/Documents/media/reports/additionalreports/Report_Debt_and_household_incomes.pdf)

individuals to set up new businesses, they could also provide an additional burden (both financial and administrative) in terms of loan repayment.

- **Levels of Take-up** – the above factors (both on the demand and supply sides), along with wider concerns amongst the target group around taking on debt may ultimately impact upon levels of take-up. In turn, this would have implications for the scale and certainty of the ESF spend rate and hence the extent to which policy objectives are ultimately achieved.

6.13 Based upon the above, we conclude that due to the many challenges and risks associated with the use of repayable finance to deliver particular aspects of the support focused on self-employment and enterprise, a loan-based approach is unlikely to prove an appropriate or cost-effective delivery mechanism for the ESF programme.

## Access to Higher Level Skills Interventions

### Overview of Proposed Interventions

6.14 The intervention areas under consideration here are included within the 'Skills for Research and Innovation' theme of the 'Skills for All' priority area of the proposed ESF programme. Potential areas for intervention which have been identified by WEFO include:

- Higher skills and research based activity responding to the needs of, and embedded within, the private sector
- Increasing the supply of individuals with higher skills in research and innovation through collaboration between the private sector and learning providers

6.15 These intervention areas also have strong linkages to interventions set out within the Research and Innovation Priority of the proposed ERDF programme, including strengthening the research and development base, supporting commercialising innovation and stimulating the demand for innovation and knowledge from businesses.

### Past Interventions and Delivery Mechanisms

6.16 As discussed in the previous section, across Europe, there is a relatively limited track record in the use of FI to deliver ESF Funding. There is currently no track record in Wales regarding the use of FIs to deliver ESF higher skills support, nor across the EU in this area.

### Future Delivery – Financial Instrument Scoping

6.17 This section examines possible models for the use of FIs for higher skills intervention areas, and assesses the overall suitability of this type of mechanism.

6.18 As discussed above, it would be important that any FI for ESF interventions relating to Higher Level Skills was linked closely to ERDF interventions relating to Innovation and Research and Development (examined separately elsewhere). Complementarity in approach between these priority areas will be vital in ensuring that both the ESF and ERDF programmes are able to pursue their objectives as effectively as possible.

6.19 With this in mind, a number of models for FI could be pursued:

● Wales Ex-ante Evaluation of European Programmes 2014-20 - Financial Instruments ●

- An FI funded by ESF and delivered in collaboration with HEIs, which provides loan finance for individuals, employees or businesses which are seeking to achieve higher level skills. A focus on those areas where there are identified skills shortages and where there is complementarity with ERDF R&D priority areas;
  - The ESF Funded element above could also be incorporated into a broader FI which also includes ERDF Funded Research and Development interventions. This approach would help to maximise complementarity between the work of the two programmes and would also help to deliver efficiencies.
- 6.20 As suggested above, loan finance could be used to support a number of groups to achieve higher level skills – individuals, employees, and businesses. For each of these groups there are a number of considerations regarding the suitability of the use of FI.
- 6.21 **Businesses** – there is scope to provide loan finance to businesses who wish to achieve higher skills levels within their workforce. Loans could be provided to support either internal or external training, which could then be repaid via increases in business turnover or earnings. However, there are a number of points of caution here:
- The first relates to market failure – businesses are unlikely to invest in skills training unless there is a clear link to future improvements in business performance – either via access to new markets / expertise or via increased productivity. If such causality is not a given, businesses may be unwilling to invest, given that the benefits are likely to reside with the employee as opposed to the business;
  - Secondly, research conducted by UKCES<sup>32</sup> has highlighted a trend of decreasing levels of business investment in training over the past decade. This trend, along with the wider context of the economic downturn (with many businesses seeking to make efficiency savings) are likely to constrain the size of the market for loan finance.
- 6.22 As such, demonstrating to businesses the linkages between workforce skills and business performance is likely to be an important factor in developing a strong demand market for loan finance. It is worth noting that grant schemes which have been based on 50% funding rates, such as ELMS, have struggled to generate sufficient levels of take up.
- 6.23 **Employees** – it is difficult to conceive of a suitable mechanism for supporting employees to achieve higher level skills in the absence of the involvement of their employers. If employers are not involved, then the approach outlined below is more appropriate.
- 6.24 **Individuals** – For individuals, loan finance could be used to support either full time or part time study, with repayment through future salaries. Both the need and demand from individuals is likely to be greatest for post-graduate study and there could be a case where this might support specific sector development priorities. The delivery of repayable finance might not prove cost-effective<sup>33</sup>, unless it operated on a scale which is difficult to conceive within the proposed ESF

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<sup>32</sup> The impact of the 2008-9 recession on training at work : Second interim report (2012), UKCES

<sup>33</sup> As referenced throughout this paper, FI mechanisms are often more expensive to set up and deliver than grant based approaches. This reflects a range of factors, including the complexities of delivery and in some cases the lack of existing models and expertise

programme or it could piggy-back on another suitable financial body in order to minimise overhead costs and achieve cost effectiveness.

- 6.25 The use of repayable finance to encourage the take-up of higher skills provision is challenging in terms of the sustainability and cost-effectiveness of the delivery models. However, it is likely to be most effective where it is targeted at individuals, achieves a measure of scale in terms of the volume of training and individuals involved, and is able to piggy-back on existing delivery structures in order to minimise overhead costs.

## Conclusions

- 6.26 In summary, there is limited opportunity for the effective use of FIs in the ESF programme. The suggested approach therefore is:
- **Enterprise and start-up support.** Ensure that there is close integration between ESF and ERDF provision, with the former providing pre-start up advice, training and possibly small amounts of grant based allowances. Participants receiving this assistance would be advised about the various sources of loan and equity funding targeted at start-up businesses, both ERDF and non-ERDF backed sources.
  - **Higher Level Skills.** A targeting of repayable finance for higher level skills provision in priority sectors and skills on individuals in particular. However, this is subject to being able to deliver this provision in an effective and cost efficient way, which will depend on various factors including the volumes involved and possibly the scope to piggy-back on existing delivery structures.

## 7. Rural Development Programme

### Introduction

- 7.1 The Stage One Screening Assessment concluded that there are various opportunities for FIs in the RDP. These include:
- Provision of finance to support the diversification and modernisation of the farming sector;
  - Finance for start-ups and micro-loans for small established businesses in rural areas;
  - Finance to support community hubs, community transport schemes and other forms of infrastructure.
- 7.2 Finance for community renewable schemes was also discussed in the Stage One Screening Assessment, however this has been discussed in further detail under the ERDF programme – Renewable Energy and Energy Efficiency.
- 7.3 The analysis in this chapter will stop short of a full market assessment; rather, the intention is to further investigate the types of investments which are proposed, the scale of intervention required, the indicative demand and supply, and the suitability of FIs.
- 7.4 The methodology for this analysis has included:
- Desk based research relating to Wales, UK and European policy, guidance and project information and evaluations;
  - Review of the experience of relevant projects from the 2007-13 programme.
- 7.5 Consultations with relevant staff in Welsh Government, partner bodies and case study projects. The findings of this screening study are set out in the sections below.

### Diversification and Modernisation of the Farming Sector

- 7.6 This activity forms a core part of RDP activity, and whilst this has more commonly been delivered through grant support in current and past programmes, there is scope to replace / complement grant support with alternative loan support options. Activity during 2014-20 (as set out in RDP 2014-20: Next Steps, Welsh Government, January 2013), could include financial support for:
- On-farm / forest improvements eg welfare and environment standards, genetics and breeding, cost reduction, energy efficiency, distribution, renewable energy, health and safety;
  - Diversification away from agriculture, forestry and food processing eg test-trading and marketing support, low value business grants (under £5k), start-up premises, community based retail support.



### Case for Using Financial Engineering Instruments

- 7.7 There are no large grant schemes for the farming sector in the current RDP programme, although there are grants for processing and marketing activity (PMG fund), further along the supply chain. In the previous Objective 1 programme, grants were available for the farming sector, however there was a common concern that they had not been sufficiently focused and as a result did not achieve as much as they might have.
- 7.8 In the current programme, the PMG fund received around 200 applications in total, with intervention rates ranging from 20-50%. With around 500 businesses in the food processing sector in Wales, 200 applications represents a fairly large proportion. It is anticipated by the Welsh Government however, that if this programme had only been able to provide loan funding rather than grant funding, then fewer than 20 of the 200 schemes would have gone ahead.
- 7.9 There are around 18,000 businesses in Wales in receipt of farming subsidies and closer to 30,000 businesses in the wider definition of the farming sector. Around 15,000 beneficiaries have accessed the support available from Farming Connect in the current programme, and under Objective 1, around 4-5,000 businesses accessed the capital grant support that was available.
- 7.10 It is clear that the £43m PMG fund would need to be far greater if this type of support was also opened up to the wider farming sector.
- 7.11 While there is a desire within Welsh Government to offer greater capital investment support through RDP to the farming sector, there is not a clear consensus on the best financing option. While grant funding would allow for more focused policy goals to be realised, recyclable loans would allow the funding to go further.
- 7.12 Whether grant or loan schemes are pursued, there is likely to be a continued need for a substantial advice and support service to the sector, which could be delivered as part of grant / loan schemes, or could be decoupled and delivered separately.
- 7.13 Although the evidence is limited, farming businesses appear to be experiencing significant challenges in accessing finance. Finance Wales highlights that high street banks have moved away from the sector, in most cases no longer having dedicated agricultural managers in place, and hence lacking expertise in a sector which can be risky to invest in. Finance is likely to be most difficult to secure for non-owner-occupied farming businesses, having no asset base to secure loans against.
- 7.14 If a loan finance scheme to the farming sector and its supply chain was taken forward (as the full approach or part of the approach to delivering this strand), it might most sensibly be taken forward as an SME finance instrument. Although the current JEREMIE fund has not included funding from the RDP, Finance Wales does not see any fundamental reasons why its successor could not be in the future.
- 7.15 This would allow direct match funding from EIB, and would build on the expertise built up around delivery of the SME finance instrument. In all likelihood this would need to be supported by a wider support programme for the sector, and demand stimulation for the fund.

## Conclusions

- 7.16 The scale of investment in this area and identified market gap for finance to the sector suggests that **this activity area could be an appropriate area for the use of repayable finance and a FI.** For the ability to deliver finance in a cost effective way, utilising the match funding potential and existing expertise, linking this into a future ERDF backed SME finance instrument project might be a sensible way to take this forward.

## Enterprise in Rural Areas

- 7.17 Building on experience in the current RDP programme, there are opportunities for FIs to be set up to support local enterprise development, for example through local venture capital and loan schemes.

## Case for Using Financial Engineering Instruments

- 7.18 Support for credit unions was highlighted as a potential area for investment in the first phase of this analysis work. However support from RDP in the current programme has primarily gone to supporting the management of credit unions (with the finance for loan support being raised through local individual investments). Furthermore this activity has been supporting individuals primarily, rather than businesses. This activity is therefore not seen to be an area which would be appropriate for an FI approach. However, since 2012 credit unions have been able to lend to businesses and other bodies and therefore could play a greater role in providing repayable finance in the future.
- 7.19 Finance Wales currently has a £5m micro-business loan fund which operates across all of Wales, so there is a risk that further activity providing micro-finance for rural businesses at a pan-Wales level would simply duplicate this. Further information on micro-finance for business is provided under the market assessment for ERDF SME Competitiveness Priority.
- 7.20 At a more local level there can be a case for grass-roots schemes, whereby FIs are more geographically focused and financially limited, aiming to promote bottom-up economic development in rural areas, based on mobilising local resources which are intended to be predominantly kept in the target area and used for the benefit of the local population. However, again, there are a series of more localised investment funds already set up across Wales delivering this – the Local Investment Funds (LIFs), funded under ERDF.
- 7.21 By setting up additional FIs under RDP that effectively duplicate micro-finance activity funded under ERDF, there is a risk of creating confusion and not making best use of the resources available.

## Conclusions

- 7.22 Due to micro finance activity supported across Wales under the ERDF programmes (see market assessment information on micro-finance for business under ERDF SME Competitiveness Priority), **it is not expected that an FI approach would be necessary under this activity area.** However, RDP resources could be aligned with ERDF funds to increase the availability and targeting of both micro and larger loans upon small and expanding rural SMEs.

## Community Hubs and Infrastructure

7.23 Investment to purchase and/or develop assets to become sustainable rural hubs or new services is a recognised aspiration in many rural areas to support community cohesion and rural settlement vitality and viability. Accessing finance can be an obstacle to this.

### Case for Using Financial Engineering Instruments

7.24 In the current RDP programme around £13m has been allocated to 'Basic services for the economy & rural population', including grants most commonly used for community transport and village hall projects. In total this funding has supported around 40 projects.

7.25 Given relatively high investment costs per project, there is an aspiration for some or all of this activity to be financed through loan rather than grant support in the future.

7.26 There are good examples of community projects in Wales being run commercially, allowing not only for sustainable delivery, but also repayment of loans used to set the enterprises up:

- The Plunkett Foundation works with community groups across the UK to set up community enterprises, in particular for community shop and pub schemes. There are currently around 15 such enterprises operating in Wales. Given the current economic climate and reduction in grant support, the financing mechanism for these schemes has moved towards loan financing in recent years. The main demand for support for such schemes has been where a local facility is closing, and so a community facility scheme emerges from the response to this. Typical costs are around £120,000 on average for a community shop project and between £150-500,000 for a community pub project. These costings typically factor in purchase and renovation, initial stock and first year's staffing.
- There are unlikely to be any more than around 5 projects per year seeking support of this nature, based on current demand, thus c.25-30 over a six year programme. The experience of the Plunkett Foundation working with a local authority in Lincolnshire which sought to proactively generate additional demand for this type of intervention was that demand stimulation was difficult without a strong community desire to progress a scheme.

7.27 Based on the take-up rate of grants for this type of activity in the current RDP programme, it would be reasonable to assume that demand for community transport schemes might be of a similar order. Thus, of the order of c.50 community enterprise schemes might be a sensible target across the 2014-20 RDP.

7.28 The Plunkett Foundation have found that for community shop and pub schemes, the success over recent years of these projects has helped to prove their viability, and meant that there is no longer a shortage of funders. In particular Triodos and Co-operative and Community Finance (CCF) have a strong track record of financial support in this area, and provide advice and support to groups as part of the process. However, there are some gaps, as Triodos tend to only finance projects requiring around £50,000 upwards, and although CCF provide finance from £20,000 upwards, they are generally less enthusiastic about funding at this lower end. While this generally meets the needs of community pub schemes, a community shop scheme would rarely want a loan greater than c.£20-30,000.

- 7.29 Similarly for a commercial community transport scheme, the loan amount required would likely often be less than £20,000, in order for the enterprise to be viable.
- 7.30 Finance Wales currently see the funding market for social enterprises as relatively crowded (although quite fragmented). They have allocated £1m of funding from Welsh Government to social enterprise activity over a five year period, which in conversations with a wide range of stakeholders was felt to be sufficient, and having been launched in January 2013, none of this funding has yet been drawn down.
- 7.31 However, demand for finance is likely to increase if grant funding for key types of support reduces. It is therefore anticipated that a market gap could arise at the lower end of support needs for social enterprise creation linked to community hubs / community services.
- 7.32 In some cases a community hub / service scheme may not be fully commercially viable as an enterprise, but still be a priority for support. In such cases, a combination of grant and loan support may be appropriate.
- 7.33 If a FI was set up for this intervention area, it is likely that it would need to be as part of a wider project incorporating loan as well as grant support, and to be provided alongside a strong support package to work with groups interested in setting up a social enterprise. Organisations such as WCVA, who are running the £1m social enterprise fund for Finance Wales, are likely to be able to provide the expertise needed to administer such schemes, potentially alongside other partners (eg the Plunkett Foundation).

### Conclusions

- 7.34 Whilst this would require further research and consultation with other potential financial providers (such as Triodos and CCF), there may be a market gap around lower level funding for setting up social enterprises, which could be met by a FI under RDP. The overall level of finance required is expected to be of the order of £1m across five years (based on 50 schemes accessing c.£20,000).
- 7.35 **This activity area may be an appropriate and suitable area for establishing a FI under the RDP, although achieving cost-effective delivery at this scale of operation would be challenging.**

### Conclusions

- 7.36 It is anticipated that the main opportunities for use of financial engineering instruments under the RDP are as follows:
- **Loan finance to the Farming Sector.** Although evidence is limited, there appear to be access to finance challenges for the farming sector in commercial provision which may be constraining growth and diversification. This is a specialist sector and any finance scheme would require a lead body with significant expertise to run this. It is likely that the optimal position would be a mixed grant and loan scheme, with clearly defined parameters, linked closely to a wider business support offer to the sector. For the ability to deliver finance in a cost effective way, to utilise the match funding potential and existing expertise, linking this into a future ERDF backed SME finance instrument project might be a sensible way to take this forward (whether by Finance Wales bringing specific sector expertise in-house, or contracting this element out to another

specialist delivery body).

- **Finance for Rural Community Enterprises.** Although finance for much of the work of community enterprises is well catered for by commercial providers (including Triodos and Co-operative & Community Finance), consultees believe that gaps remain in this overall offer. Further analysis would be needed to better understand the nature of these gaps and scale of unmet demand, however there could be a case for RDP investment in a FI to support community investment activities. This could possibly be linked in to a wider social enterprise fund supported under the ERDF SME Competitiveness priority, along the lines of the current ERDF supported Communities Investment Fund.

## Organisations Consulted

### ERDF SME Competitiveness and R&I Priorities:

- Nick Bourne, Cardiff University
- Josh Miles, The Federation of Small Businesses
- Rhydian Ayres and Janet Owen Jones, Welsh Government
- David Baynes, Fusion IP
- Geraint Rowe, Gambit Corporate Finance
- Kevin Fernquest, The Institute of Life Sciences, Swansea
- Matthew Frohn Oxford Technology
- Richard Coppock, RCA Corporate Finance
- Tim Pezzack, Santander, Cardiff
- Tracey Mayes, The Welsh European Funding Office (WEFO)

### ERDF Infrastructure Priority:

- Ken Cook, Head of Regeneration and Spatial Support, WEFO

### ERDF Renewable Energy and Energy Efficiency:

- Dafydd Munro, Tom Smithson and Ken Cook, Welsh European Funding Office
- David Clubb, Renewable UK Cymru
- David Eccles, Ynni'r Fro Project, Welsh Government
- Jenny Curtis, London Energy Efficiency Fund, Amber Infrastructure
- John Bradshaw, Energy & Environment Exploitation Project Manager, Welsh Government
- Phil Fiander, Director of Programmes, Wales Council for Voluntary Action
- Sian Price and Peter Wright, Finance Wales.

### ESF

- Policy Lead – Catherine Jenkins

### RDP

- Nia Griffiths, Head of RDP Reform, Welsh Government



● **Wales Ex-ante Evaluation of European Programmes 2014-20 - Financial Instruments** ●

- Joanne Amesbury, Sustainable Futures, Welsh Government
- Gary Douch, Head of Farming Connect, Welsh Government
- Neil Howard, Supply Chain Development Scheme, Welsh Government
- Steve Mallinson, General Manager, Neath Port Talbot Credit Union
- Phil Fiander, Director of Programmes, Wales Council for Voluntary Action
- Derek Walker, Wales Co-operative Centre
- James Alcock, Plunkett Foundation
- Sian Price and Peter Wright, Finance Wales
- Graham Pearce, ERDF Priority 3 Manager (Sustainable Communities), Yorkshire & Humber Region, DCLG.



**Regeneris Consulting Ltd**

Manchester Office  
4<sup>th</sup> Floor Faulkner House  
Faulkner Street, Manchester M14DY  
Tel: 0161 234 9910  
Email: manchester@regeneris.co.uk

London Office  
70 Cowcross Street  
London, EC1M 6EJ  
Tel: 0207 608 7200  
Email: london@regeneris.co.uk

[www.regeneris.co.uk](http://www.regeneris.co.uk)