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**Report to:** Business, Innovation and Growth Panel

**Date:** 26 February 2019

**Subject:** **Growing Places Fund & Business Investment**

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## **1. Purpose of this report**

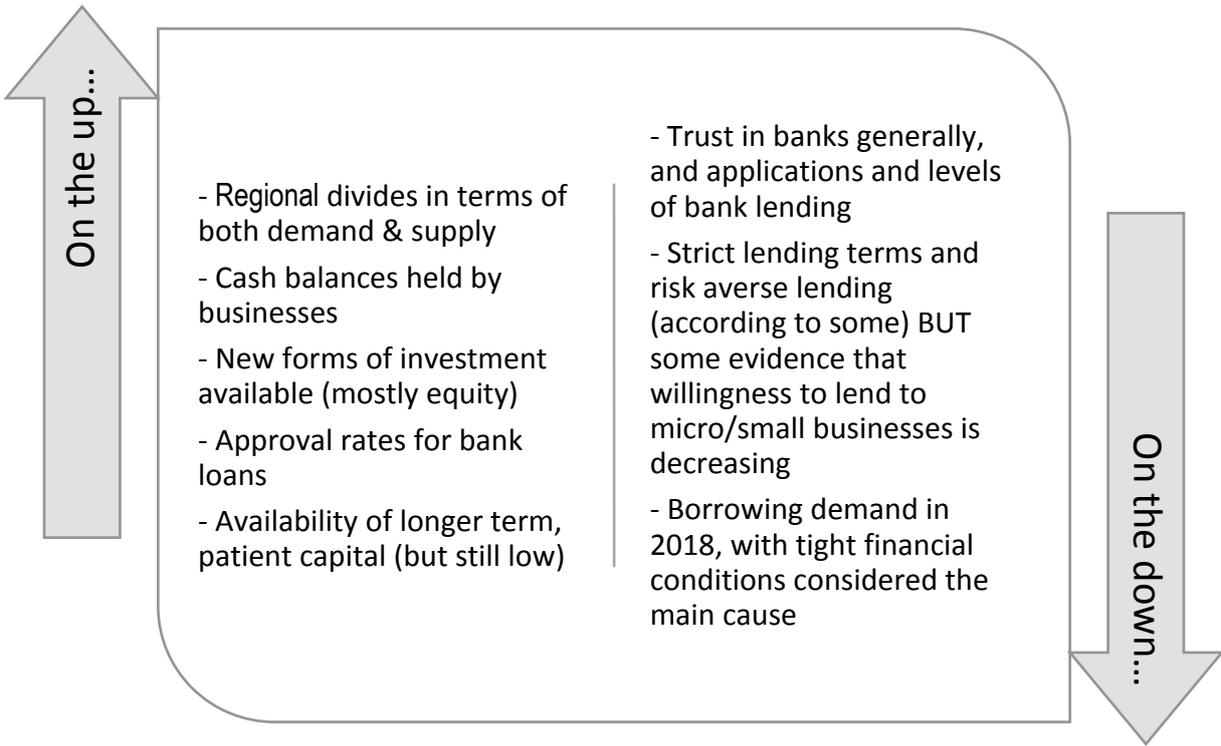
- 1.1 To update the Panel on developing Leeds City Region Enterprise Partnership (LEP) policy on issues of business finance, in particular on the role of the LEP in making business investments and the future use of returned funds from the Growing Places Fund, and seek the Panel's view on how this work should be further developed; including through external support.

## **2. Information**

### Background and context

- 2.1 The role of public intervention in business finance is usually focussed on achieving broader policy priorities as well as helping overcome the asymmetric / imperfect information, or imperfect competition / coordination problems, between business finance supply and demand that cause market failure.
- 2.2 In recent history this market failure has been driven particularly by a lack of liquidity in the market following the financial crisis. In those circumstances the LEP played an important role in providing financial support to encourage investment that was not being provided through private market sources, helping stimulate business growth. However, evidence suggests that this has now changed, with an increasing number of actors in the business finance landscape offering a larger and more varied product offer, meaning the issue for accessing business finance is less about liquidity in the market and more about risk appetite and investment readiness (a summary of analysed trends is outlined in diagram 1 below).
- 2.3 In order to ensure that the LEP continues to fulfil a role that is not met by the existing business finance market, whilst aligning to new policy priorities around productivity and inclusive growth, work has been undertaken to understand current business finance trends and to begin to map where the LEP's investment role in the future should be.

Diagram 1: Analysis of trends in business finance<sup>1</sup>



Aligning business finance policy to city region priorities

2.4 In developing the LEP’s role in business investment going forward, one of the guiding principles should be the City Region’s priorities. Table 1 below maps how business finance can contribute to these priorities, indicating where some existing LEP products are already doing so.

| Priority                   | Potential impact of business finance (existing programmes)  |
|----------------------------|---|
| 1. Boost productivity      | <ul style="list-style-type: none"> <li>• Supports investment in business processes or projects that deliver greater firm level productivity (productivity pilot, strategic business growth programme, investment readiness project)</li> <li>• Providing the financial support required to drive research &amp; innovation (access innovation / connecting innovation ESIF bid)</li> <li>• Target productivity enhancing behaviour particularly in low productivity sectors (business basics fund project)</li> </ul> |
| 2. Enable inclusive growth | <ul style="list-style-type: none"> <li>• Make finance conditional on improving inclusive growth outcomes (criteria being rolled out across programmes)</li> <li>• Stimulate regeneration in more economically disadvantaged places through supporting businesses in specific locations and stimulating demand</li> </ul>  |

<sup>1</sup> The table summarises evidence from a number of sources: British Business Bank, Treasury Committee, Bank of England, Patient Capital Review, Grant Thornton

|  |   |
|--|---|
| 3. Deliver a connected transport system                      | <ul style="list-style-type: none"> <li>• Unlock investment in infrastructure or businesses on key route networks</li> </ul>   |
| 4. Support transition to a low carbon / clean growth economy | <ul style="list-style-type: none"> <li>• Supporting firms that particularly look to operate in a low carbon / clean growth approach (<a href="#">resource efficiency fund</a>)</li> <li>• Speeding up the diffusion of new, cleaner businesses practices across all sectors by enabling business investment; including air quality</li> </ul> |

### A future business investment model for the LEP

2.5 Historically the LEP has worked on the basis of individual business finance products, ring-fenced to deal with specific locations (e.g. Enterprise Zones) or offer a single product (e.g. Growing Places Fund loans). Whilst this model has worked well and unlocked significant investment, specific location or product approaches do limit the potential investment in other projects or businesses that could generate significant growth for the City Region and contribute to wider policy aims. It has also functioned well in a market where there was a strong rationale for public investment to unlock investments that otherwise would not be fulfilled by the private market. However, as described above the business finance market has since changed significantly with increased liquidity available and broader range of finance options. Taking on board this learning, and based on the emerging policy work and analysis of business finance trends, it is proposed that the LEP look to a future business investment model based on two more broad, yet distinct, products:

1. A returnable investment, structured income fund supporting regional growth whilst delivering sustainable returns to the LEP
2. A flexible growth fund that can be used to invest in targeted investments to respond to changes in business needs, where there is clear evidence of market failure and therefore additional levels of risk.

### Structured Income fund

2.6 Whilst the market may be providing greater levels of liquidity for business investment, there remains significant room for further investment in the City Region. At a national level, business investment has hardly grown since 2016<sup>2</sup>, and current forecasts suggest the impact of the UK leaving the European Union will affect this further, at least in the short term.

2.7 Within this context, and with a desire for the LEP to generate a returnable income stream from lower risk opportunities that can be used to support the City Region's priorities, it is proposed that further exploratory work is undertaken to understand how a LEP structured income fund could operate.

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<sup>2</sup> <https://www.ft.com/content/cf51e840-7147-11e7-93ff-99f383b09ff9>

This will include exploring the types of opportunities that would deliver a sustainable returned income, and how it would enable further investment in the City Region.

#### Flexible growth fund

- 2.8 The second product would be a more flexible funding pot that had as its primary objective the addressing of market failures in the business finance market. Here the focus would also be on making investments that deliver productivity and inclusive growth in the City Region, however it would look to operate where those investments were not being adequately supported by the private market, and, therefore, in an area where there is a higher level of risk.
- 2.9 The primary source for this investment pot would be the returned capital from the current Growing Places Fund (GPF), with the capability to increase in size as wider funds become available. GPF was one of the first funding streams for LEPs, with the Leeds City Region LEP receiving £35.5 million of capital funding in 2011/12 to use for loans and grants to unlock stalled developments that had been particularly affected by the tightening of credit. With significant capital receipts returned and more forecast to arrive by 2019/20, and the changes to the external economic environment and business finance landscape as outlined above, it was proposed at the LEP Board meeting of 20 September 2018 that there is now the opportunity to consider future use of these returned funds. This has been reinforced by an external evaluation report of the programme, which reported at the end of 2018.
- 2.10 It is proposed that the flexible fund pot would be established in line with the recommendations agreed by the LEP Board in September 2018. In particular, in line with the guiding principles, 80% of the returned funds would be used to continue providing investment capital on a returnable basis. Work on how the further 20% would be utilised to directly (grant) fund projects that support inclusive growth is also being progressed separately.
- 2.11 In terms of how the flexible funding pot would operate, it is intended to take on board the recommendations of the evaluation report of the GPF programme in terms of administration, appraisal and approval and risk management. Also reflecting the findings of the report, in terms of the current business finance conditions, it is suggested that it be deployed across a number of potential investment options to ensure the fund addresses the challenges for business investment, particularly around risk appetite. Current options being considered include:
- Capital finance loans - similar to the existing GPF but with new criteria and a defined target market that reflects current priorities of the City Region.
  - Supporting businesses with additional finance above a mainstream loan - partnering with an existing or multiple existing financial institution to provide additional finance that is required for a project to be viable, but not supported by the main lender
  - Open market opportunities to finance SMEs e.g. peer to peer lending platforms that allow regional and sectoral targeting

## Next steps

- 2.12 Subject to the views of the Panel, in order to develop these two products further, it is proposed that the LEP take the following three steps:
1. Engage with external advice on the approach and design of the two products
  2. Work to develop the internal capacity required within the LEP to service our commercial grant and loan activity, with the ambition to establish a centre of excellence
  3. Further scoping of the two products and soft market testing of the opportunities in the existing market.
- 2.13 The final design of the two products will be directed by a number of key questions for the LEP to agree on:
- the balance of risk and return desired in investments, and the extent to which investment operate in an area of clear market failure or just a market gap
  - how far LEP finance products should contribute to the City Region's four policy priorities, in particular inclusive growth.
  - whether the LEP is comfortable with, or actively wishes to pursue, new approaches such as peer to peer lending (as opposed to a loan funding approach)
  - if strategic partnering with private sector business finance providers (such as banks) is desirable and the extent to which the LEP could rely on their due diligence processes
- 2.14 In support of this proposed action, it is also recommended that a working group is established with representation from businesses. It is proposed that the group reports to the BIG Panel on development of the two products, and that Panel members consider their potential involvement in the group.

## **3. Financial Implications**

- 3.1 There are no direct financial implications as a result of this report. However, the LEP Board's decision about the future design of business investment products will have financial implications, and a further report will be required that describes the potential costs and income from the proposed products including interest, technical support, resource and potentially balancing a portfolio of risk.

## **4. Legal Implications**

- 4.1 There are no direct legal implications as a result of this report.

## **5. Staffing Implications**

- 5.1 There are no direction staffing implications arising from this report. However, the operationalisation of the proposed products would have staffing

implications. For this reason the report recommends further work be undertaken to develop the internal capacity required within the LEP to service commercial grant and loan activity.

## **6. External Consultees**

6.1 The LEP board and Business Investment Panel have received the expert report on the future of the GPF and the current programme risks, and will continue to be involved in the development of the new products. As well as the expert report, some informal conversations have taken place with market lenders on the current business finance landscape.

## **7. Recommendations**

7.1 The panel are asked to note the progress of work to date on business finance, and to provide feedback in particular on the suggested approach to business investment based on two products:

1. A returnable investment, structured income fund supporting regional growth whilst delivering maximum returns to the LEP
2. A flexible growth fund that can be used to invest in targeted investments to respond to changes in business needs, where there is clear evidence of market failure and therefore additional levels of risk

7.2 They are also asked to consider the three proposed actions to take this work forward:

1. Engage with external advice on the approach and design of the two products
2. Work to develop the internal capacity required within the LEP to service our commercial grant and loan activity, with the ambition to establish a centre of excellence
3. Further scoping of the two products and soft market testing of the opportunities in the existing market.

7.3 In support of this proposed action, it is also recommended that a working group is established with representation from businesses. It is proposed that the group reports progress to the BIG Panel on the development of the two products, and that Panel members consider their potential involvement in the group.

## **8. Background Documents**

8.1 None

## **9. Appendices**

9.1 None