LEEDS CITY REGION ENTERPRISE PARTNERSHIP

Report to:	LEP Board
Date:	26 March 2019
Subject:	**Reinvestment of grants and loans; and Enterprise Zones**
Director:	Alan Reiss, Director, Policy, Strategy and Communications
Author(s):	Alex Clarke and Seamus McDonnell

1 Purpose of this report

1.1 To update the Leeds City Region Enterprise Partnership (LEP) on issues of business finance. Particularly the role of the LEP in making business investments and the future use of returned funds from the Growing Places Fund. This paper seeks the Board's view on how this work should be further developed; including through external support.

1.2 To detail an approach to funding the development of the Leeds City Region Enterprise Zones. Whilst this maintains the 'loan first' principle it also recognises that under certain circumstances sites will require grant funding where there is evidence of market failure if they are to be developed.

1.3 This paper will initially consider the approach to grants/returnable investments before looking at the particular issues and circumstances that will shape the approach required to ensure the successful development of the Enterprise Zones.

2 Information

Background and context – Business Finance

2.1 Elements of the reinvestment of grants and loans work have been discussed by the LEP's Business Innovation and Growth Panel at their meeting in February 2019, and comments from that session have been incorporated into this report.

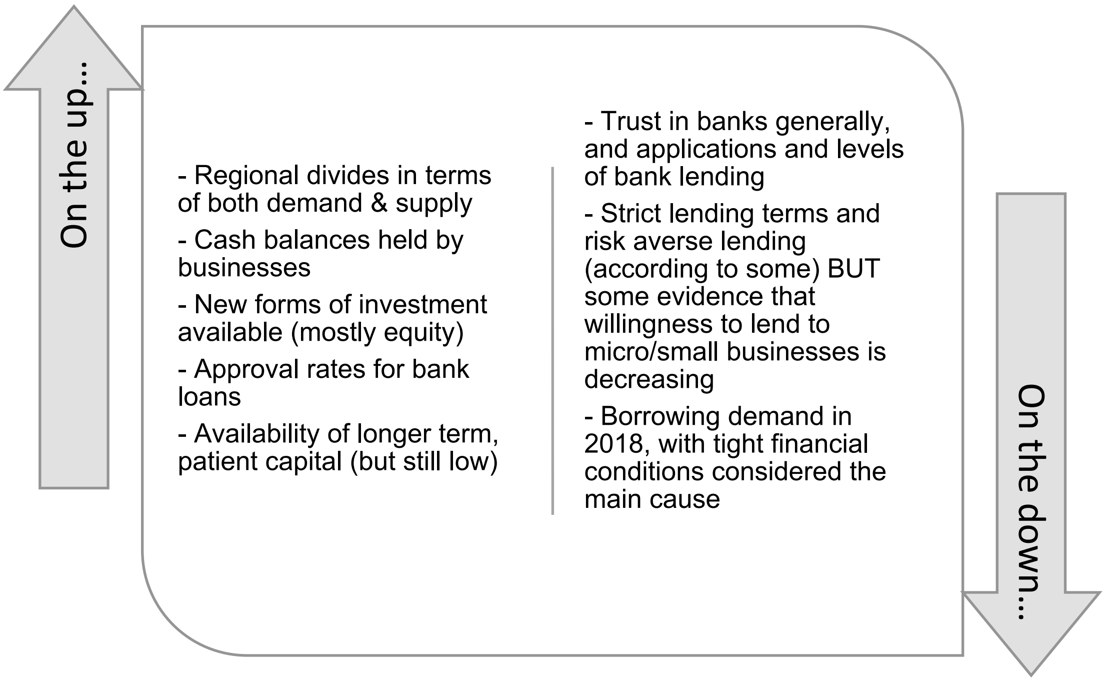
2.2 The role of public intervention in business finance is usually focussed on achieving broader policy priorities as well as helping overcome the asymmetric / imperfect information, or imperfect competition / coordination problems, between business finance supply and demand that cause market failure. In line with HM Treasury's Green Book, it is required that public funds only be used to support projects where there is either clear evidence of market failure or redistribution impacts, where additionality is evident and where any financial support can be shown to represent value for money.

2.3 In recent history the rationale for public investment in this way has been driven particularly by a lack of liquidity in the market following the financial crisis. As a result of this market failure, the LEP played an important role in providing financial support to encourage investment and stimulate business growth.

2.4 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).

2.5 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[1]



Aligning business finance policy to city region priorities

2.6 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.

[1] The table summarises evidence from a number of sources: British Business Bank, Treasury Committee, Bank of England, Patient Capital Review, Grant Thornton

Priority	Potential impact of business finance (existing programmes)
1. Boost productivity	• Supports investment in business processes or projects that deliver greater firm level productivity (productivity pilot, strategic business growth programme, investment readiness project) • Providing the financial support required to drive research & innovation (access innovation / connecting innovation ESIF bid) • Target productivity enhancing behaviour particularly in low productivity sectors (business basics fund project)
2. Enable inclusive growth	• Make finance conditional on improving inclusive growth outcomes (criteria being rolled out across programmes) • Stimulate regeneration in more economically disadvantaged places through supporting businesses in specific locations and stimulating demand (including through Enterprise Zones)
3. Deliver a connected transport system	• Unlock investment in infrastructure or businesses on key route networks
4. Support transition to a low carbon / clean growth economy	• Supporting firms that particularly look to operate in a low carbon / clean growth approach (resource efficiency fund) • Speeding up the diffusion of new, cleaner businesses practices across all sectors by enabling business investment; including air quality

A future business investment model for the LEP

2.7 Historically the LEP has worked on the basis of individual business finance products, ring-fenced to deal with specific locations or projects (e.g. Enterprise Zones) or offer a single product (e.g. Growing Places Fund loans). Whilst this model has worked well and in some circumstances continues to unlock 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 a 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 looks to develop a future business investment model, which will require exploring a different set of skills and structures.

2.8 As well as a different set of skills and structures, a new model would also need to deliver a different set of investment products, and provide reinforced approaches to existing programmes such as for Enterprise Zones (further details of how this might work is included in paras 2.17 – 2.37 below). Based on trend and market analysis to date, this might be based on two broader, yet distinct, products:

- A returnable investment, structured income fund supporting regional growth whilst delivering sustainable returns to the LEP;
- 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

2.9 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, and current forecasts suggest the impact of the UK leaving the European Union will affect this further, at least in the short term.

2.10 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. 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. At this stage there is no specific budget which could provide the finances for this fund, and therefore implementation would be dependent on the outcome of future funding decisions from central government.

Flexible growth fund

2.11 The second product would be a more flexible funding pot that has 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.

2.12 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.

2.13 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 through the Inclusive Growth and Public Policy Panel.

2.14 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. As suggested by BIG Panel, this could also look at specific deployment to sectors, subject to alignment with British Business Bank and Northern Powerhouse Investment Fund offers. 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.

<u>Next steps</u>

2.15 Subject to the views of the Board, in order to develop this new model for business investment, it is proposed that the LEP take the following three steps:

- Engage with external advice on the approach to developing the new model
- Work to develop the internal capacity required to enable the LEP to service our commercial grant and loan activity, with the ambition to establish a centre of excellence
- Further scoping of the two products and soft market testing of the opportunities in the existing market.

2.16 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.

2.17 In support of this proposed action, it is also recommended that a working group is established with representation from businesses. In their meeting of 26 February the Business, Innovation and Growth Panel agreed that the group would report to the BIG Panel on development of the two products, and that Panel members would consider nominating themselves to join the group.

Enterprise Zones (EZs)

Background and context

2.18 The Leeds City Region EZ programme supports the Leeds City Region Strategic Economic Plan (SEP) and the principle of 'good growth' by supporting delivery of innovation, good jobs/incomes and improving the quality of places. The EZs are also identified as Spatial Priority Areas (SPAs) within the SEP.

2.19 The accelerated development of the EZs formed a crucial part of the ambition contained within the SEP to deliver over 35,000 jobs and £3.7bn of additional GVA by 2036. It is anticipated that the programme could have a significant catalytic impact in terms of future development further driving jobs growth and additional GVA impacts.

2.20 The principal aim of the EZ programme is to achieve accelerated delivery of sites and high quality employment floor space. Phase 2 of the EZ programme consists of nine specific sites that have been put forward by partner councils and approved by Government - if the EZs are to be developed then they will therefore have to proceed on these sites.

2.21 Currently the EZ programme has an indicative capital funding approval of £45.044m to be invested in accelerating delivery on the phase 2 sites as well as enhancing power supply on phase 1. The funding comprises £20m Local Growth Fund (LGF) and £24.939m from over-programming against LGF. Due to the time window set by central Government for delivery and spend of Growth Deal objectives, this funding is only available for draw down until 31 March 2021. In addition the occupier incentives that come with EZ designation are only applicable for new businesses entering the phase 2 EZ sites by 31 March 2022.

2.22 A number of outline business cases have recently been received for evaluation through the Assurance Framework, including requests for funding support from the private sector. One of the central considerations for the LEP in assessing these business cases is whether to support financially through grant or loan facilities and the LEP Board has previously had an informal discussion on these matters in January 2019.

Barriers to development

2.23 The development of a number of the EZ sites is constrained by a range of physical and/or market challenges. Physical constraints across the programme include topography, access, utilities, drainage and remediation. Addressing these issues increases the cost of development and in some circumstances means that the level of return to the developer would not justify the investment.

2.24 The market challenges faced by the sites largely relate to the presence of market failures. The failures effectively mean that there are distortions within the operation of the market that prevent it from operating efficiently. This provides the rationale for the public sector to intervene in order to correct or alleviate these 'failures'.

2.25 These barriers to development combine to increase the costs of development whilst potentially creating wider benefits for society (e.g. employment, enabling further development, attracting supply-chain companies) rather than just for the developer.

Due diligence and controls

2.26 In assessing business cases as they come forward, the viability assessment – amongst other due diligence tests - will be key and would need to confirm that there was both an outright market failure and validate the claimed wider benefits and costs attributable to the developer, in order to justify any grant contribution from the public sector. The due diligence tests would be commissioned and overseen by the Combined Authority as accountable body for the LEP.

2.27 Where grants are approved then it would be appropriate to insert an overage agreement into the grant approval to ensure that the public purse benefits from any positive changes in the market as the development progresses, such that a rate of return greater than that originally anticipated may trigger repayment of some of the grant awarded, i.e. returnable investment.

2.28 Adequate investment security arrangements will need to be in the funding agreement to ensure that any overage conditions can be both monitored robustly (e.g. through appointment of a monitoring surveyor) and relied upon in the event of overage conditions being triggered requiring repayment of all/part of the grant, as well as in the event of default in delivery conditions.

2.29 Currently the EZ programme team commission external technical advice to undertake due diligence on business cases as they come forward. It is envisaged that the commercial due diligence arrangements for the EZ programme moving forward will follow the same pathway and be overseen by the same technical team as those put forward to manage the broader business finance portfolio outlined in paras 2.1 – 2.16 above once this funding stream is operational.

Loans and grants

2.30 In essence the ability of a project or programme to be supported through a loan rather than a grant will effectively be determined by consideration of the nature of the market failures present. Absolute market failure will mean that costs of delivering the project are greater than the market returns that can be generated. In these circumstances it would require non-market benefits to be present (e.g. positive externalities) to justify the provision of a grant.

2.31 Loans remain a useful tool to assist the development of sites in certain circumstances, e.g. where access to finance is limited or to support cash-flow.

Principles and parameters

2.32 Whilst the overall aim is to ensure that the EZs will be developed, this will be done on the basis that the approach maximises value for money and benefits realised, identifying the minimum funding needed to take the proposition forward.

2.33 Schemes will be funded on a loans first principle. Where a scheme can support a loan then this would be the primary route for funding. Some projects may warrant a blend of both grant and loan intervention.

2.34 The nature of market failure and independent cost and viability assessments, including a red book valuation, will determine whether a project should be able to proceed on the basis of a loan. If grant is required then the assessment will inform the maximum of grant that could be awarded.

2.35 A thorough due diligence process will be undertaken in the assessment of grant requests, including but not limited to: evaluation of delivery options; financial due diligence and Know Your Customer checks; evidence of compliance with State Aid rules and other statutory approvals; evidence of a tendering exercise having been undertaken.

2.36 All grant funding agreements will be subject to an overage clause that will trigger repayment depending on the returns/values generated. Adequate security arrangements to protect the LEP’s investment will be put in place.

2.37 All interventions would be required to consider how best they can commit to the inclusive growth conditions applicable to other LEP grants.

2.38 Grant payments to be made against evidenced defrayed expenditure

3 Financial Implications

3.1 There are no direct financial implications as a result of the proposals relating to the reinvestment of returned capital from GPF as contained in 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.

3.2 The decision to approve the policy on grant support to the private sector to further the development of the Enterprise Zones will also have implications to future decisions through the Investment Committee on assistance to developers of these sites, whether that be through loan or grant funds.

3.3 Approval of the proposed approach to the EZs will also help to ensure that the maximum number of schemes can be developed at pace and within funding timescales. Without this support, some schemes may not proceed, grant funding could be at risk of being returned to central Government and there would be a subsequent loss of business rates to the LEP for reinvestment into future economic activity.

4 Legal Implications

4.1 There are no direct legal implications as a result of this report in respect of EZs, however the decision will inform future decisions on investment into the EZ programme as individual projects/sites progress through the Assurance Framework, whether that be through loan or grant funds. One of the most significant considerations is State Aid. The Combined Authority as accountable body for the LEP is a public body subject to the State aid rules, which require it to ensure that providing grant funding pursuant to the EZ programme will not breach the rules.

4.2 In summary, state aid can occur whenever state resources are used to provide support to “undertakings” which distorts or threatens to distort competition and affects trade between Member States. Guidance on state aid states that the financing of infrastructure by a public body should be treated as economic activity if it will be commercially exploited from completion or at a later date. Therefore the Combined Authority must consider what state aid exemptions may be relied on and what conditions must be met to avoid creating a risk of breach. Bespoke State Aid advice will need to be sought on a project by project basis.

5 Staffing Implications

5.1 There are no direct staffing implications arising from this report. However, the operationalisation of the proposed business finance products would have staffing implications in the future. For this reason the report recommends further work be undertaken to develop the internal capacity required to enable the LEP to service commercial grant and loan activity as part of the EZ programme together with the proposed broader business finance portfolio.

6 External Consultees

6.1 The LEP Board, Business, Innovation and Growth 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 LEP Board 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 and endorse the following three actions:

1. Engage external advice on the approach and design of the two products;

2. Work to develop the internal capacity required to enable the LEP to service our future 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.

7.2 The LEP Board are also asked to provide feedback on the two business investment products to test further through this work, namely:

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

7.3 The LEP Board are asked to approve the policy guidance outlines in paras 2.17 – 2.37 above for provision of grant support to the private sector on projects with a demonstrable viability gap as a funding option for the Leeds City Region Enterprise Zone (EZ), to assist with accelerated delivery of the programme.

8 Background Documents

8.1 None

9 Appendices

9.1 None