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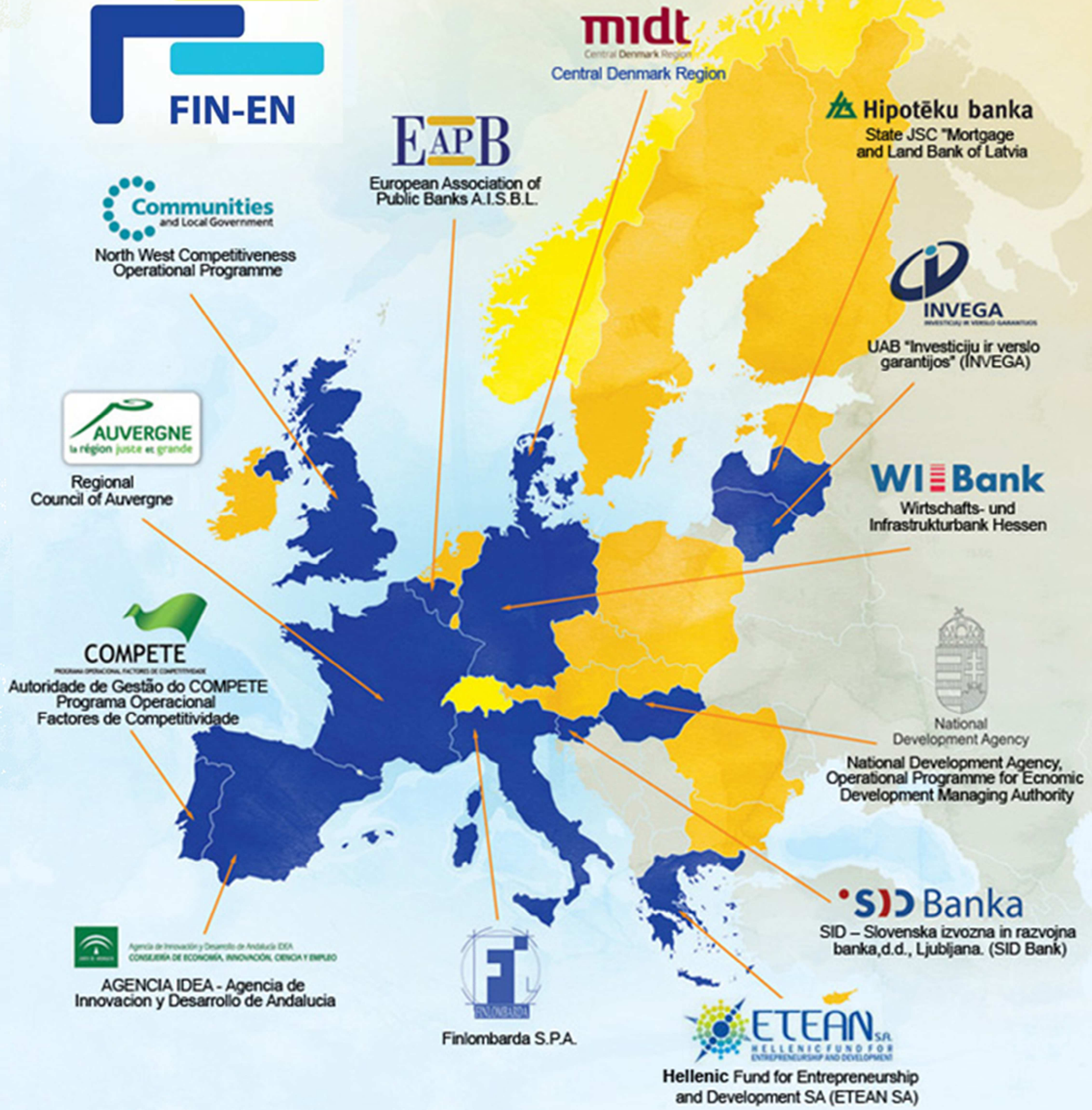
FIN-EN

sharing methodologies on FINancial ENgineering for enterprises



European Union
European Regional Development Fund

INTERREG IVC
INNOVATION & ENVIRONMENT
REGIONS OF EUROPE SHARING SOLUTIONS

FIN-EN Thematic Working Group 1

"Programming" Report

GLOSSARY

Business Angels: wealthy private individuals who invest directly in young new and growing unquoted business (seed finance) and provide them with advice, usually in return for an equity stake in the business, but may also provide other long-term finance.
References: Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises (2006/C 194/02).

Equity: ownership interest in a company, represented by the shares issued to investors.
References: (2006/C 194/02)

Expansion capital: financing provided for the growth and expansion of a company, which may or may not break even or trade profitably, for the purposes of increasing production capacity, market or product development or the provision of additional working capital.
References: (2006/C 194/02)

Financial intermediary: entity acting as an intermediary between sources of capital supply and demand (e.g. bank, holding fund, fund).
References: European Court of Auditors, Special report n.2

Fund: segregated portfolio of financial engineering instruments managed by one or several fund managers following defined investment policies and targets. A fund can be legally constituted or constituted as a separate block of finance within a financial institution.
References: European Court of Auditors, Special report n.2

Grant: non-reimbursable budgetary contribution from the EU or any Member State public institution. Also referred to as 'public subsidy'.
References: European Court of Auditors, Special report n.2

Guarantee: undertaking by a party (the guarantee fund) to bear at a predefined guarantee rate principal and interest due in case of default of a loan extended by a financial intermediary (a bank) to an SME.
References: European Court of Auditors, Special report n.2

Holding fund: fund set up to invest in several venture capital funds, guarantee funds, loan funds, urban development funds, funds or other incentive schemes providing loans, guarantees for repayable investments, or equivalent instruments, for energy efficiency and use of renewable energy in buildings, including in existing housing.
References: COCOF_10-0014-05-EN REVISED VERSION 08/02/2012

Holding fund manager / fund holder: is the subject entitled to manage the fund set up to invest in several venture capital funds, guarantee funds, loan funds, urban development funds, funds or other incentive schemes providing loans, guarantees for repayable investments, or equivalent instruments, for energy efficiency and use of renewable energy in buildings, including in existing housing.

Intermediate body: any public or private body or service which acts under the responsibility of a managing or certifying authority, or which carries out duties on behalf of such an authority vis-à-vis beneficiaries implementing operations.
References: Regulation 1083/2006 art.2

Leverage effect: how many euro of funding (public and private) have been paid for each euro of public funding paid.
References: COCOF_10-0014-05-EN REVISED VERSION 08/02/2012

Management costs: management costs are all costs in relation to the cost of managing financial instruments.
References: European Court of Auditors, Special report n.2

Managing Authority: national, regional or local public authority or a public or private body designated by the Member State to manage the operational programme.
References: Regulation 1083/2006 art.59

Mezzanine: type of high-yielding debt finance often seen in leveraged buy-out transactions and often featuring an option or right to acquire shares in a firm at a preferential rate. Mezzanine finance often takes the form of subordinated convertible loans.
References: European Court of Auditors, Special report n.2

Microcredit: small loans (usually up to 25 000 euro) granted to micro-enterprises (as defined by the EU). Usually, these micro-enterprises obtain free business advisory and mentoring as well.
References: European Court of Auditors, Special report n.2

Operational Programme: document submitted by a Member State and adopted by the Commission setting out a development strategy with a coherent set of priorities to be carried out with the aid of a Fund.
References: Regulation 1083/2006 art.2

***Pari passu* treatment:** legal term used to describe the fact that two or more financial instruments have the same class in terms of repayment rights. The opposite of *pari passu* treatment is preferential investor/private sector treatment.
References: European Court of Auditors, Special report n.2

"Prêts d'honneur": medium term credit granted to a person without personal or real guarantees and interest-free.

Revolving: when a contribution to financial instruments, after a first utilization or cycle, get recycled/reutilized.
References: COCOF_10-0014-05-EN REVISED VERSION 08/02/2012

Seed capital: financing provided to study, assess and develop an initial concept, preceding the start-up phase.
References: (2006/C 194/02)

Small and Medium-sized Enterprises (SMEs): The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro.
References: Extract of Article 2 of the Annex of Recommendation 2003/361/EC

Start-up capital: financing provided to companies, which have not sold their product or service commercially and are not yet generating a profit, for product development and initial marketing.
References: (2006/C 194/02)

Venture capital: investment in unquoted companies by investment funds (venture capital funds) that, acting as principals, manage individual, institutional or in-house money and include early-stage and expansion financing, but not replacement finance and buy-outs.
References: (2006/C 194/02)

Working capital: enterprises's current assets (short term inventory, receivables, cash equivalents, cash) minus current liabilities (short term liabilities, prepayments).
References: COCOF_10-0014-05-EN REVISED VERSION 08/02/2012

Introduction

European Territorial Cooperation Programmes aim to improve the effectiveness of regional development policies, contribute to the economic modernisation of Europe and increase its competitiveness. Under the INTERREG IVC programme, a European project on financial engineering initiatives was launched in January 2012. Called FIN-EN (Sharing Methodologies on **Fin**ancial **En**gineering for Enterprises), this project seeks to list and analyse the initiatives of 13 partner European regions with a view to enhancing the best practices in this field. These will facilitate the increase in financial engineering instruments and simplify their implementation in the context of the 2014-2020 Programme.

Financial engineering instruments as defined in article 44 of Council Regulation (EC) No 1083/2006, represent venture capital, guarantee and loan funds, as well as sustainable urban development funds, primarily intended for small and medium-sized enterprises. During the 2000-2006 Programme, the European Commission was already committed to improving SME access to funding through the use of all these financial engineering instruments, by offering Member States joint funding of such initiatives by Structural Funds.

The European Regional Development Fund (ERDF) supports projects designed to benefit the economic development of regions. The European Social Fund (ESF) supports projects for employment and the European Fisheries Fund supports projects contributing to the sustainable development of fishing and aquaculture. As such, each fund may be concerned by a financial engineering programme depending on the objectives and criteria of each one.

Such policies became much more common during the 2007-2013 Programme, particularly with the setup of the Joint European Resources for Micro to Medium Enterprises (JEREMIE) Initiative by the European Commission and European Investment Bank. Several Member States have seized this new opportunity to facilitate access to funding and constitution of equity capital for their SMEs.

13 partners:

Partner 1: Finlombarda SpA, Italy (Milan), Lead Partner
Partner 2: European Association of Public Banks, Belgium (Brussels)
The EAPB has entrusted the exchange of experiences to two institutions:
Investitionsbank in Berlin and Bulgarian Development Bank in Sofia
Partner 3: Agency for Innovation and Development of Andalusia, Spain (Seville)
Partner 4: National Development Agency, Operational Programme for Economic Development (EDOP) Managing Authority, Hungary (Budapest)
Partner 5: Regional Council of Auvergne, France (Auvergne Region)
Partner 6: SID Bank, Slovenia (Ljubljana)
Partner 7: Hipoteku banka, Latvia (Riga)
Partner 8: INVEGA, Lithuania (Vilnius)
Partner 9: Central Denmark Region, Denmark (Viborg)
Partner 10: WIBank, Germany (Offenbach)
Partner 11: ETEAN SA, Greece (Athens)
Partner 12: MA COMPETE, Portugal (Lisbon)
Partner 13: Department for Communities and Local Government (DCLG), UK (Warrington)

The Regional Council of Auvergne is in charge of Thematic Working Group 1 that gather in October 2012 to discuss the preparatory stage of putting together the financial engineering operations. This stage is part of an overall process comprising three stages. The Spanish partner will oversee the second stage (1st quarter 2013), and the Hungarian partner will manage the third and final stage (2nd quarter 2013).

Overall process for setting up a financial engineering initiative

PROGRAMMING	IMPLEMENTING	MONITORING & REPORTING
Preliminary analysis Investment strategy Operational Programme Management structure Governance Funding agreement State aid / Management costs	Transfer of funds Selection, role and tasks of financial intermediaries. Management costs Communication	Monitoring & reporting: Development of tools Quantitative indicators Ex-post impact and evaluation

The purpose of this report is to determine the methodology of the programming stage for putting together a financial engineering initiative.

We will start by explaining what prompts a State/a Region to set up this type of mechanism before describing the stages leading up to this setup. We will end by clarifying how to structure it.
Each section is organised to follow a chronological process, determining the objectives of each stage, the procedures to follow and the best practices. These, along with a wide range of examples given throughout the report, are ***the fruit of a convincing exchange of experiences*** *between the FIN-EN project partners.*
In conclusion, we will summarize the key success factors facilitating the programming of financial engineering instruments.

I. Why and how should a Financial Engineering initiative be set up?

A. Objectives

a. Improve public policies for financing companies

REVOLVING FUNDS

The search for effectiveness in public financing is now an objective shared by all European public stakeholders, and it therefore seemed necessary to **revise the European Union's grant policy.** The whole point of financial engineering is its **principle of revolving funds.** Loan, guarantee or venture capital mechanisms are meant to recycle their funds by allowing the final recipients to obtain funding for their investments. Reimbursements, capital gains and interest generated by this funding will in turn be **reinvested in new projects.**

LEVERAGE EFFECT

One of the fundamental characteristics of financial engineering is the **leverage effect among existing public and private investors** that it can trigger. This is because co-investment on the part of European public funds prompts the State, territorial authorities or private partners to invest in or with the tools on offer. Intervention by the public authorities makes investment **less of a risk** for the company and its private financial backers. Moreover, investors are drawn by **fund transparency and the diverse range of investments proposed** – particularly as regards holding funds.

➔ *A public guarantee fund with a high leverage: example of INVEGA in Lithuania*

INVEGA

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Another interesting example to consider is the Guarantee Fund of Lithuania, managed by INVEGA, the national guarantee agency, providing guarantees since 2001. This fund, cofinanced by ERDF, is a 100% public fund and operates as a scheme of proper counter-guaranteeing of losses in the guarantee portfolio contracted by INVEGA. With a starting amount of EUR 36.37 million and a multiplier per 3 calculated according to actual default rate, the amount of issued loans will be up to EUR 140.10 million (taking into account 80% of maximum guarantee rate). Actually, the total amount of issued loans is higher than expected and taking into account the SME's own resources (at least 20%), the total amount of investment activated is 230.45 million euros.
INVEGA succeed to provide a very high leverage effect, attracting private funds.

PROFESSIONALISATION OF PUBLIC FINANCING

Accordingly, thanks to a public/private partnership at various levels, **public financing of companies is adopting a more professional approach.** Even if its status does not permit mention of a fully performance-oriented process, it takes on a picture of the company at least focused more on performance.

A responsible approach to business among the beneficiary companies is brought to the fore, which also fosters **the regional development of the territory** in which the company is doing business.

REDUCTION OF THE AUTOMATIC DECOMMITMENT RISK

Lastly, holding funds, intended to be used temporarily in financial engineering instruments, "enable loans from the structural funds to be mobilised and used more swiftly in the OPs, which **reduces the risk of automatic decommitment** at the end of the year."[1]

Furthermore, they allow for a higher amount to be programmed, which will improve the programming rate without the funds being invested in the final recipients for all that.

It goes without saying that using this practice for this benefit alone would be counterproductive.

b. <u>Fill a gap in the range of financing options available to companies</u>

Financial engineering helps above all to facilitate access to financing **by meeting the needs of companies,** which may require more funds to develop, benefit from a loan to start up or obtain guarantors to access the proposals of banking institutions. But it is the role of the public authorities to give these companies the chance to benefit from development aid. The European funds thus intervene to fill in any gaps in the market of financing options, particularly, for example, for small companies, companies in the (pre-)start-up phase and innovative companies.

What's more, financial engineering initiatives promote **entrepreneurship by encouraging risk-taking,** since founding or taking over a company – in the same way as the subsequent strategies concerning development, product diversification and innovation on niche markets – is an at-risk sector severely lacking in options.

So the European Commission's commitment to become actively involved in the knowledge economy and turn its attentions to smart growth geared towards the research and development sectors will encourage innovative companies to set up. And this means that a large number of financial engineering initiatives co-financed by Structural Funds fit more easily into this market, especially in terms of start-up – and even pre-start-up – capital.

[1] http://direccte.gouv.fr/IMG/pdf/guide-eligibilite-05-04-2011_parties3-4-Annexes.pdf (in French)

According to the partners of the project, the goal of the use of financial engineering instruments isn't to take the place of private banks. It is really to fill a gap in the local market and to invest in more risky projects. That's why venture-capital and investment capital funds are perfectly appropriated (especially start-up capital, pre-seed and seed capital, mezzanine debt where reals lacks were identified in several countries). Pure loans products should be more concentrated at the bank level. However, due to European economic crisis and the drop in private financing, public financing is developing and using all types of FEI. Consequently, it is very difficult to assess the part of additionally and substitution to private financing. It is important to note that if the creation of an entity is a good thing, it's also essential to reinforce the existing ones.

B. The forms for programming a financial engineering policy

a. A regional or national initiative

The financial engineering initiative can be a regional or national initiative depending on the country in question and the level of decision-making granted to its regions. In some cases, it can be a multiregional initiative as is the case in Portugal, where the initiative meets the policy of the Convergence "Competitiveness Factors" OP and brings together 3 regions: Norte, Centro and Alentejo.

b. Creation of a holding fund or specialised financial engineering instrument

The beneficiaries of Structural Funds for setting up financial engineering operations are able to organise them through holding funds – i.e. "funds set up to invest in several venture capital funds, guarantee funds, loan funds and urban development funds".[2]
The Managing Authorities can also choose a Financial Engineering Instruments (FEI) manager to set up a financial engineering instrument investing directly in final recipients without going through a holding fund. It will be a stand-alone fund.

Partners having chosen to set up a holding fund did so for several reasons. On the one hand, the creation of a Holding Fund is beneficial for the new comers because it allows building a complete program and benefiting from an expertise, particularly as it was the case with the JEREMIE initiative. On the other hand, this structure can bear a complex initiative, with a lot of financial intermediaries and a strong amount of money, as it is the case in Hungary.
The main advantage in using such a fund is **its flexibility,** for it is possible to adjust the investment policy over time and to set up a progressive investment in financial

[2] Regulation (EC) No 1083-2006, article 44

intermediaries. As such, the scheduled provisions can be redirected from one instrument to another, better controlling the allocation of resources.

The portfolio approach also allows for **more effective adaptation to changes in the market** and for a **diversification of risks** thanks to different investment directions, by making use of various tools that meet distinct requests – with the consequence of varied expected performances.
Lastly, setting up a holding fund means that **a single entity can be governed** and the management entrusted to professionals well-versed in financial engineering instruments can be monitored. These professionals will be tasked with the daily administrative and accounting management of the fund, and above all the examination, follow-up and management of investment outflows to the beneficiary companies.

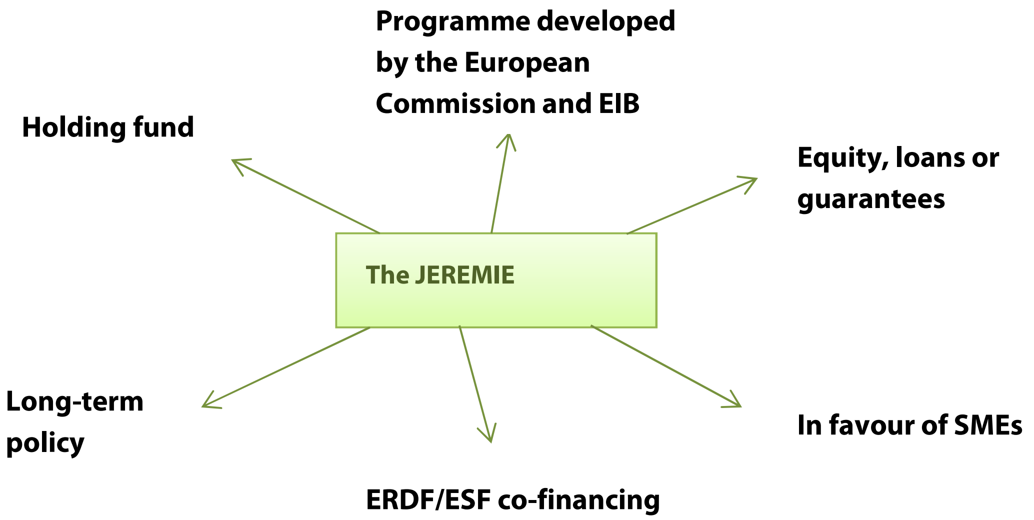
However, not setting up holding funds can also prove to be a strategic choice. The creation of a stand-alone Fund without Holding Fund is often used on a territory which has already the existing and well established structures. It is the case in Germany's Länder, where implementing a Holding Fund would even have been considered as redundant if not competition.
The size and volume of the fund's investments are a matter for consideration and a limited amount devoted to financial engineering instruments does not need a holding fund to be set up.
Moreover, **this structure is more complex** to manage, thereby generating more red tape that some partners find tedious. Indeed, two-tier management involving several managers and several tools is more expensive than a leaner mechanism.

In conclusion, it's difficult to speak about best practices considering the decision to opt or not for a Holding Fund because it really depends on the territory, on its existing structures, on its political decisions, on the amount of the initiative and on the size of the structure.

c. Choosing the JEREMIE initiative

According to the definition of the European Investment Fund, the Jeremie initiative gives EU Member States – through their national or regional managing authorities – the possibility of using part of the resources paid by the EU Structural Funds to finance SMEs with equity, loans or guarantees, through a sustainable holding fund acting as a "fund of funds".

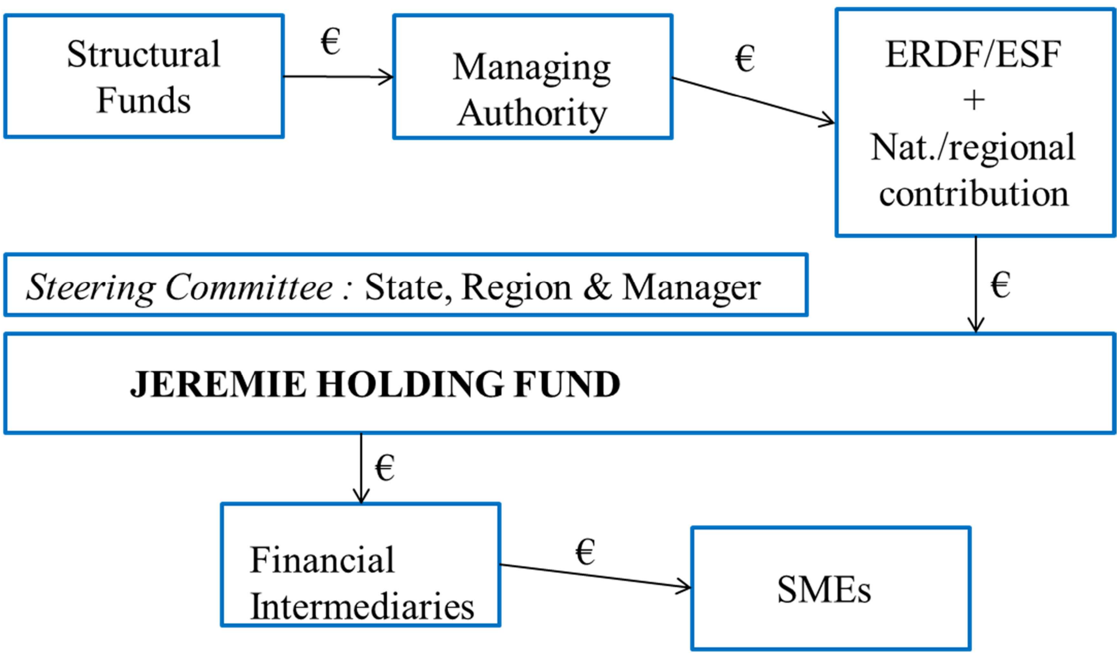
<u>The characteristics of JEREMIE:</u>



It is important to quote that JEREMIE was, at the beginning, considered by the European Commission as a technical assistance for European countries/regions. In the future, FEI implementation options will be proposed at Union level, under central management, and at national/regional level, under shared management with Member States, through:

- Off-the-shelf instruments: pre-defined and ready-to-use instruments
- Tailored instruments: existing or newly created.

<u>The JEREMIE process:</u>



The partners choosing the JEREMIE initiative (7 out of 14) have often done so because the market failures of their country/region, needs of their companies and political resolve of their government were in line with the programme put forward by the European Commission and the EIB.

The partners who chose the EIF as their fund manager – as we will see below with Bulgaria's example – also adopted the JEREMIE initiative because of the involvement, when the study was being carried out, of this stakeholder possessing significant expertise in financial engineering instruments and longstanding experience in venture capital tools.

However, many partners preferred to benefit from a local public or private manager already in place or which could support the JEREMIE initiative thanks to its experience and skills.

The table below sums up the initiatives of the FIN-EN project partners. It specifies the geographical level of the mechanism, initiative set up and instruments defined in this context.

	Level	Initiative	Instruments
Lombardy	Regional	ERDF JEREMIE HF	Loans and guarantee funds
		ESF JEREMIE HF	
		Revolving Fund for Entrepreneurship	
		Made in Lombardy Fund	
Brussels			
Berlin	Regional	SME-Fund Berlin, Berlin Kapital, VC-Fund Technology and Creative Industries	Microloans, loans, mezzanine and venture capital
Sofia	National	JEREMIE HF	Microloans, guarantee and venture capital
Andalusia	Regional	JEREMIE HF	Venture capital and multi-instruments
Hungary	National	JEREMIE HF	Loans, guarantee and venture capital
Auvergne	Regional	JEREMIE HF	*Prêts d'honneur* and venture capital
Slovenia	National	Loan Fund	Loans
Latvia	National	ERDF Competitiveness Loan Programme	Loans
		ESF Start Programme	Consultations, training, loans and grants
Lithuania	National	JEREMIE HF	Loans, venture capital, Business Angels and guarantee
		INVEGA HF	Loans and venture capital
		Entrepreneurship Promotion Fund HF	Loans
		Guarantee Fund	Guarantee
Central Denmark Region	Regional	Midtjysk Iværksætterfond	Loans and pre-start-up private equity
Hessen	Regional	ERDF KfK Innovation Plus ERDF Hessen Kapital I ERDF Mittelhessenfonds	Venture capital and loans
Greece	National & Regional (regarding budget lines)	HF for Energy Efficiency in households	Loans
		HF for Entrepreneurship	Loans and guarantee
		Enalio Fund HF	Loans and guarantee
Portugal (North, Center, Alentejo)	Multiregional	HF FINOVA	Venture capital and credit lines
North West England	Regional	JEREMIE HF	Venture capital and loans

With holding fund

Without holding fund

II. The stages prior to setting up a Financial Engineering initiative

1. The ex-ante evaluation of financial engineering instruments

A. Objectives

This evaluation is a preliminary analysis of what companies – and particularly SMEs – need in terms of accessing funding and of the response to these needs on the regional/national market. It lists the actions taken by SME funding stakeholders and perceives the market failures. It guides the Managing Authority towards a choice regarding investment policies and gauges the size of the mechanism to be set up.

For many of the FIN-EN project partners, this gap analysis was performed by the European Investment Fund free of charge.

The main objective of this initial stage is above all to consider whether providing funds through financial engineering instruments constitutes a regional/national development tool.

B. Procedures

a. <u>Draw up a list of points that this evaluation must cover</u>

From the reports conducted by the EIF, it is possible to draw up a fairly precise list of the market points to be analysed:

- Demographic and economic growth situation
- SME characteristics and environment (size, sector, number of creations and buy-outs, company survival rates and so on)
- Is there any driver for growth for SMEs and employment?
- Listing of national aids for supporting SME creation and development
- Priorities of the ERDF OP: SWOT analysis and regional/national economic development strategy
- Listing of regional financial operators
- Analysis of micro-finance supply and demand
- Analysis of guarantee supply and demand
- Analysis of private equity supply and demand
- Market failures in these three sectors
- Financial recommendations as to the management structure
- Resource allocation proposal and overall size of the fund

To summarize:

Comprehensive analysis of the local market	Situation of economic and demographic growth
	Characteristics of SMEs and their environment
	Drivers of growth for SMEs
Analysis of economic development strategy	Existing national/regional aids for companies
	Existing financial institutions
	OP priorities
Analysis of specific markets	Supply & demand for loan/microcredit/guarantee
	Supply and demand for capital investment
	Market failures to be addressed
Financial recommendations for management structure	Total amount of initiative
	Ressources allocations
	Financial objectives and indicators

b. Draw up a list of external stakeholders to be consulted

After an exchange of experiences with the partners, here is a non-exhaustive list of the stakeholders to be consulted:

- Contacts at the Ministries concerned (Economy, Finance, etc.)
- Representatives of the regional authorities
- National/Regional Economic Development Agency
- Public and private banks, public and private banking associations
- Local savings funds
- Public foundations
- Research institutes
- Non-governmental and consular organisations (CCIs, etc.)
- Local public institutions: regional council, county council
- Regional private equity, micro-finance and guarantee operators
- Industrial branch associations
- Groups of employers
- Target group of entrepreneurs
- Local consultants familiar with the territory's key issues
- Business Angels

It is also important to consult all types of documentation: newspapers, analyses published online (from reliable sources), the publication of statistics and sector-based studies and information.

For the next programming period (2014-2020), the Council of the European Union gives a list of elements that have to be in the ex-ante evaluation of FEI, in the objective to have the most complete study as possible. We can observe that this list is very precise and very close to the investment strategy.

Here are these elements:

- Gap analysis on the market failures
- Value-added evaluation on financial instruments and consistency with other forms of public intervention
- Measures taken to reduce market distortions
- Theoretic leverage effect
- Analysis of the need to plan preferential clauses to attract co-investors
- Lessons learned from similar experiences in the past
- Investment strategy (instruments, beneficiaries, targets, combined instruments with grants…)
- Expected results and indicators
- Applications for a review clause of the ex-ante evaluation

C. Critical issues and key success factors

During the gap analysis phase, critical issues experimented by partners are the following :

- Not enough having involved local actors
- Not having made a complete evaluation: strategic points were not enough detailed in the gap analysis, leading sometimes, for example, to an under- or overestimated allocations amount or a lack of partners to implement the initiative. We can easely understand why it is a compulsory point in the Europen Council requirements for the next period.
- Not having enough anticipated the economic changes

a. The importance of local expertise and collaboration

The method devoted to the evaluation may vary slightly from one country to another. Some partners placed it entirely into the hands of the European Investment Fund while others chose to carry out the analysis themselves.

For all that, the best practices that can be identified from this initial stage prior to setting up a financial engineering initiative are the same irrespective of situation or means.

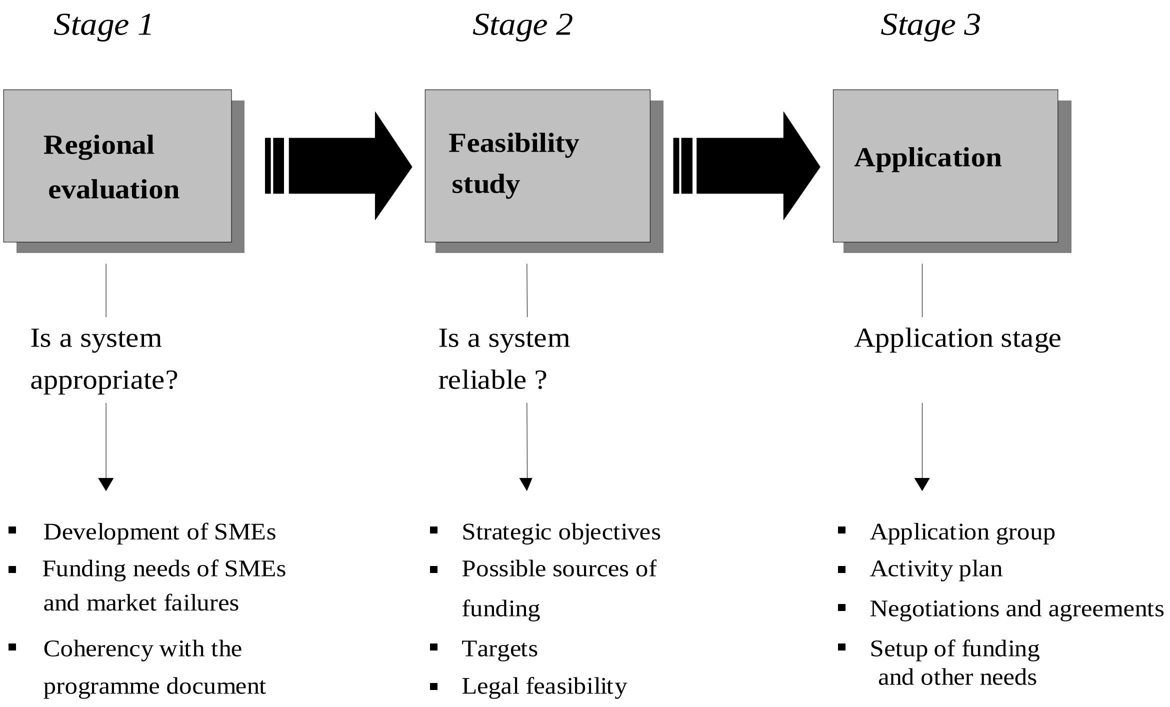
First of all, **knowing the territory and its key issues inside out** seems vital. Every territory has its own characteristics and way of thinking, living and evolving. Detecting market failures and the potential it presents requires in-depth deliberation that relies more easily on **local perception and understanding.**
What's more, calling on SME financing specialists and carrying out documentary research of studies and public data available only help to make this analysis more reliable.

As we have seen, one of the distinctive features of financial engineering operations is the leverage effect they generate, particularly in terms of private investments. The gap analysis is the first thing to do when planning on using these operations. And it is already an integral part of a **collaborative initiative and a public/private partnership.** Involving private and public SME funding stakeholders in this preliminary study, which clearly concerns issues of which they are fully aware, will facilitate production of the report, the objectiveness of viewpoints and active participation in assisting with setting up the project.

b. Carefully analyse the feasibility of the financial engineering policy

The ex-ante evaluation of FEI must present the existing market, what's missing in terms of access to funding and companies' needs. But it is essential, in addition to considering these points, to think about **the territory's capacity (stakeholders and workforce) to meet these needs, to support the actions set up and to conduct this policy.** This study is a key component of this stage as it prevents this analysis from being overlooked.

In the "Guide to Risk Capital Financing in Regional Policy" published in October 2002 by the European Commission, particular attention has been paid to the fact that the programming of a financial engineering initiative ideally comprises 3 stages:



The deliberations should therefore be in-depth and clearly identify the strategic objectives (which type of venture capital, which beneficiaries, etc.), the possible financing sources (European, national/regional, private sector, etc.), the fund management and structure options, the financial objectives and the legal environment.

All of these subjects are matters for consideration, which will then be finalised in the investment strategy. The point here is not to establish precise points but to actually define hypotheses for objectives and setup with a view to analysing their viability.

It is therefore necessary to stress the importance of including it in the ex-ante evaluation.

c. <u>Anticipate changes in an economic situation</u>

The ex-ante evaluation of FEI provides a snapshot at a specific moment in time, which represents the market reality but does not really take into account of how the country's economic situation may change. It is vital to include a **forward-looking view of the changing needs of companies in terms of funding.**

Furthermore, the analysis of the current situation must be done **within a determined period of time** to ensure perfect grasp of it. Indeed, a study that takes several years to complete would lose all reliability as the economic and social climate of a country moves at a much faster pace. It would even be sensible, as suggested by most of the partners, to write up a **mid-term evaluation to verify if context conditions changed and to readdress the policy and financial instruments.**

D. Best practice

➔ *Doing the ex-ante evaluation of FEI with its own resources: example of WIBank in Hessen (Germany)*

WI Bank Wirtschafts- und Infrastrukturbank Hessen
WIBank
Patrick Schlupp Patrick.Schlupp@wibank.de

Some partners have chosen not to entrust this market analysis to the EIF but have preferred to carry it out themselves. This is the case for the *Land* Hessen which called on the financial specialists at WI Bank, a public institution in charge of the *Land's* development as well as at its subsidiary, BM H. By analysing newspapers, analyses published online, statistics, sector-based studies and research institutes' studies, they were able to come up with an investment strategy. The main strength for performing this gap analysis was BM H's extensive expertise in private equity – shored up by its knowledge of market failures and problems concerning SME financing.

2. The investment strategy

A. Objectives

The ex-ante evaluation plays a key role. Once the full market evaluation and project feasibility study have been carried out, and should the conclusions prove positive, the next stage consists of proceeding with the programming. Definition of the investment strategy will comprise precise prerequisites for the initiative to be set up smoothly. All of the stakeholders consulted during this analysis must also be involved in defining the strategy.

B. Procedures

a. How are the investment strategy and legal construction of a Financial Engineering Initiative defined?

The investment strategy must specify at least the following:

- Architecture of the mechanism and type of financial engineering instruments funded
- Legal structure of the fund: governance and management
- Type and proportion of co-investors
- Type of company and sector
- What development stage in a company's development?
- Budgetary breakdown of financial provisions

- Investment period and calendar
- Performance indicators and objectives

b. <u>Take the regulations on State aid into account</u>

The European regulations on State aid take into account the development of the European internal market and free competition. On principle, the Treaty on the Functioning of the European Union (TFEU) prohibits State aid so that free competition is not undermined (article 107 §1). However, the principle of prohibiting State aid contains a number of exceptions enabling its authorisation for the public good (social, environmental, regional, cultural and other regions).

Notification is the procedure by which the European Commission acknowledges the plan to grant aid. The Treaty gives the Commission the power to decide whether or not to authorise the new aid for which it receives notifications from States and to monitor existing aid.

There are several channels for granting aid:

- <u>Aid expressly authorised by the Treaty</u> (compatible in all cases)
- <u>Aid authorised as it is compatible with the common market:</u> **case for State aid aimed at promoting private equity operations in SMEs**

Such aid must be notified. The Commission will then determine whether or not the State aid is present at one of three levels: aid to investors; aid to an investment fund, to an investment vehicle and/or to its manager; aid to companies in which the investment is made.

The risk-capital measures must specifically exclude the granting of aid to companies:
- in difficulty, in the meaning of European guidelines concerning State aid for rescuing and restructuring struggling companies;
- in the shipbuilding, coal and steel industries.

- <u>State aid exempt from notification</u>

Private equity is a key instrument for SME financing. Aid in the form of private equity, through the creation of private investment funds in which the State intervenes as partner, investor or participant – under less advantageous conditions than other investors for all that – is exempt from notification pursuant to the General Block Exemption Regulation. The investment fund may invest up to EUR 1.5 million per target company and per 12-month period.

- <u>So-called de Minimis aid</u>

The Commission believes that small aid amounts do not undermine competition. This threshold is set at EUR 200,000 maximum in public aid authorised for the same company over 3 financial years.

In concrete terms, the company must complete a prior declaration of all the aid it has received. It is important to note that, in the event of aid granted illegally, the fine is borne by the company itself.

C. Critical issues and key success factors

One critical issue of this action plan could be considering a too rigid investment strategy, with a real lack of flexibility according to the changing needs of the companies. To resolve this issue, one point is clearly to be the most flexible as possible and another point is to be very close to companies, as we will detail after. Indeed, the motivation for performance and the skills of the companies have to be carefully taken into account.

a. The importance of strategic flexibility

All of the partners' experiences converge towards the same key point – concerning not just the investment strategy but also everything that might concern a financial engineering initiative, from its programming to its actual implementation: **flexibility**. Financial engineering instruments are used to make up for gaps in access to funding by having the many aforementioned characteristics. To successfully carry out their mission, they must be **very flexible to use**, so as to be able to adapt to market constraints.

The advantage of the holding fund is to be able to make investments throughout the investment period depending on how the economic context is developing and the absorption capacity of financial intermediaries.

b. As close to hand for companies as possible

The end objective of each initiative taken by each country is to develop the companies on their territory. Making up for market failures is only the means. Follow-up of the final recipient by the fund manager will help to ensure the quality of the investment.
While these close and complete follow-up practices are common to all partners, their implementation is sometimes quite specific and coaching can be stepped up.

D. Best practices

➔*Multi-instrument fund: example of IDEA Agency in Andalusia (Spain)*

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Agencia IDEA

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Andalusia has chosen to put the JEREMIE Initiative into practice and split its mechanism into 2 financial engineering instruments: one is a venture capital fund and the other a multi-instrument fund. The latter's objective is to provide a company with a complete solution to meet its financial needs. This fund offers a variety of different financial instruments: equity capital, mezzanine funding, loans, convertible loans, guarantees. This makes the fund extremely flexible and enables it to meet financial needs, particularly in a difficult economic environment.

➔ *Fund flexibility and development course: example of the Central Denmark Region*

midt regionmidtjylland
Central Denmark Region

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Central Denmark Region has not chosen a mechanism with a holding fund. The need to act on loan and investment markets has been detected by ex-ante evaluation of FEI. Because there was already a guarantee fund in the country, a second guarantee fund was not deemed necessary. Creation of a microloan fund was equally irrelevant as the target group needed more funds than microloans could give them. As such, Central Denmark Region set up a EUR 13.5 million fund, **which is distinct by its flexiblity: the fund manager decides whether to use a loan or investment (or a combination of the two) as capital on a case-by-case basis.**

Moreover, every six to 12 months, around 75 to 100 companies are examined and 20 to 25 selected by the private fund manager based on their potential for growth. The companies selected are presented to an investment committee in which investment experts appointed by the fund co-financiers take part. The investment committee selects up to 10 companies which access an intensive five- to six-month-long commercial development process. The objective of this process is for the company to be able to ensure its development on the market by drawing up an action plan over a 12- to 18-month period and/or thus grow more quickly.

The process will test entrepreneurs and their performance aptitudes. Their business will develop with the help of commercial development experts from around the globe. It is free for the company selected. Companies that complete the process are entitled to apply for funding.

The applicants are then evaluated by an investment committee: the investments are defined depending on the company's financial performance over the six-month commercial development process, as well as on their appeal as an investment object (this means that they will join the market within 12 to 18 months so as to become an attractive investment for Business Angels and venture capital businesses). The size of investments will range from EUR 100,000 to EUR 700,000. The financial engineering instrument is expected to invest in around 40% of the companies that applied.

The fund manager will keep very close tabs on the portfolio of companies and possibly help them to carry out their implementation plan.

➔ *"Start Programme", combining financial engineering instruments with training activities: example of Hipoteku Banka in Latvia*

Hipotēku banka
AR DOMU PAR RĪTDIENU

Mortgage and Land Bank of Latvia

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In 2006, the Business Start-ups Training, Consultation and Financial Support programme, jointly funded by the ESF, was set up by the Mortgage and Land Bank of Latvia (MLB), a public development bank. Given the satisfactory results of this initiative, the government decided to continue this initiative by launching the Start Programme in 2009. Intended to boost the country's economic activity by developing the know-how and skills of start-ups, this provides them with the financial aid they need to start up. The MLB has 32 branches or sub-branches covering the whole of Latvia and where specialist consultants work. The latter invite customers (start-ups and newly established companies) to interviews analyse their theoretical and practical knowledge and subsequently offer training activities. Financial aid composed of grants and loans is then given to them. Since it was set up in August 2009, the Start Programme has given out 782 loans and trained 1,445 start-ups.

➔ *"Combined Micro Loan Program", combining financial engineering instruments with grants: example of the National Development Agency in Hungary*

National
Development Agency

EDOP

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Hungary adopted JEREMIE at national level in 2007. Since then it has launched new programmes every year offering SMEs a diversity of instruments. In January 2011, Hungary set up an innovative tool: combining microloans and grants for micro-enterprises. The micro-entrepreneurs submit their application to a financial intermediary who then has three weeks to assess the loan application. If a positive decision is reached, the financial intermediary makes the micro-entrepreneur a loan proposal. At the same time, the "intermediate body" has to assess the grant application within 30 days. The financial intermediary and "intermediate body" inform the Managing Authority of their decision. The final decision is made by the Managing Authority.
At least 10% of the total investment must be provided by the micro-entrepreneur as own resources. The loan may range from EUR 3,500 to EUR 71,400 and the grant from EUR 3,500 to EUR 35,700. Since this product has been launched, the approval rate for financing applications and interest from enterprises has been rising steadily.

3. Incorporation in the Operational Programme

A. Objectives

In order to use Structural Funds to set up financial engineering mechanisms, this must be mentioned in the Operational Programme.

There are various possibilities in this respect:

- Make financial engineering a priority of the OP
- Include financial engineering as a measure of one of the OP's priorities.

Here are the partners' choices:

	Priority	Title
Lombardy	Measure	
Brussels		
Berlin	Measure	
Sofia	Priority 3	"Financial Resources for Developing Enterprises"
Andalusia	Measure	
Hungary	Priority 4	"Financial engineering"
Auvergne	Priority 6	"Attractive financial arrangements (JEREMIE)"
Slovenia	Measure	
Latvia	Priority 2	"Access to Finances "
Lithuania	Measure (in 2 OP)	
Central Denmark Region	Measure	
Hessen	Priority 2	"Start-up development and promotion of business competitiveness and employment, particularly in small and medium-sized enterprises"
Greece	Priority	"Competitiveness and Entrepreneurship"
Portugal	Priority 3	"Financing and risk sharing of innovation"
North West England	Priority 1 & 2	"Stimulating enterprise and supporting growth in target sectors and growing markets" / "Exploiting innovation and knowledge"

B. Procedures

How is financial engineering included in the OP?

The arguments put forward by the partners who chose to consider financial engineering as a priority in their OP are as follows:

- Size of the sum allocated (which requires a priority in the OP)
- Clearer differentiation with regard to grants, the rules for which are completely different.

- The government defining financial engineering as a genuine priority: guarantee of public funding

On the other hand, other partners said that financial engineering instruments were part of the help-for-businesses priority, on the same footing as grants, and that they did not wish to turn these instruments into a more important tool.

C. Critical issues and key success factors

Modification and adaptation of national/regional law

Sometimes, difficulties to implement financial engineering initiatives were so hard that it has been an obligation to adapt law.
Some partners ancipated the issues and a national or regional law was created to facilitate the implementation. Other time, partners had to modify the existing law, not to facilitate but to allow this implementation. It was a long and difficult process.

The two key words defining more effective incorporation of financial engineering tools in the Operational Programme are **clarity** and **simplification**, with a view to preventing problems arising over interpretation. What's more, resolving regulation problems as soon as possible in the programming of financial engineering initiatives saves time in the later stages.
It is therefore crucial to gain expertise in the field of regulations, and even negotiations and exchange with national and European Authorities.

Finally, even if the majority of partners benefited from ERDF grants, some of our partners launched funds co-financed by other Structural Funds. It's important to know that the opportunity exists to use different Structural Funds, covering wider sectors.

D. Best practices

➔ *Public Finance Act, anticipating the law: example of Slovenia*

SID Banka
Ideje premikajo meje.

SID Banka

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The Public Finance Act is a document governing the composition, preparation and setup of the annual budget of the Republic of Slovenia. Since financial engineering is a new action aimed at mobilising public funds and at being ready to welcome these new measures in the budget, the Ministry of Finance suggested that regulations concerning financial engineering instruments with and without holding funds be set. Based on article 44 of Regulation (EC) No 1083/2006, this act has facilitated the setup of the initiative by anticipating the measures to be taken.

➔ *Experience, a best practice for clarity and simplification: example of IBB in Berlin (Germany).*

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The *Land* of Berlin began to introduce financial engineering instruments co-financed by the ERDF from the 2000-2006 Programme. The 2014-2020 period will therefore benefit from significant experience in terms of this partner's best practices.
First of all, the *Land* believes that the OP should not contain too many details about types of instrument; simply a total amount of resources and result indicators should be inserted with a view to being more open to changes in market demand.

➔ *Using the European Fisheries Fund: example of ETEAN SA in Greece*

ETEAN SA
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Greece is currently in the middle of setting up a fund – the ENALIO Fund – co-financed by the Fisheries Fund. The objective is to facilitate access to funding for SMEs working in the fishing, fisheries and aquaculture products processing and marketing industries. This fund, worth EUR 35 million, uses two financial engineering instruments: the Loan Fund and the Guarantee Fund. This fund, worth EUR 35 million, is formed with the capacity to use two financial engineering instruments: a Loan Fund and a Guarantee Fund. However, it has been initially decided to start only with the formation of the "Enalio Guarantee Fund". The Enalio Guarantee Fund will provide guarantees to bank loans, which are part of business plans approved in following Measures of the Operational Programme "Fisheries 2007-2013". The procedure is under way and the Fund is due to be launched in 2013.

➔ *Using the European Social Fund for the JEREMIE initiative: example of Finlombarda SpA in Lombardy (Italy)*

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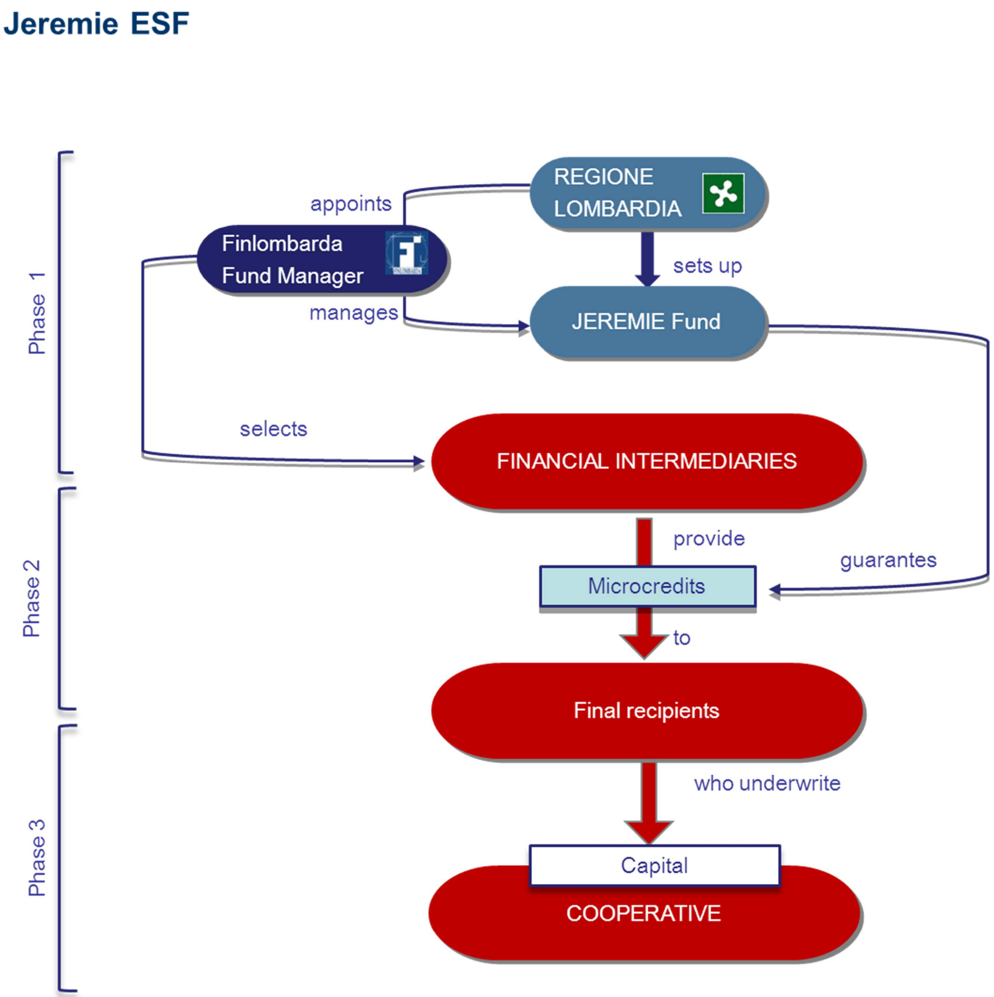
The Lombardy Region has set up four financial engineering mechanisms: two with no holding funds (FRIM and Made In Lombardy) and two under the JEREMIE Initiative, one of which is co-financed by the ERDF and the other by the ESF. The objective of JEREMIE ESF is to combat social exclusion and create new jobs through cooperatives working with underprivileged people. Up to EUR 17 million of this EUR 20 million fund is co-financed by private banks.

Italy points out that it is important to factor in the big difference between financial instruments for companies and those working with human capital. The two types of instruments must be considered separately.

<u>Here it is its process:</u>



4. Co-financing

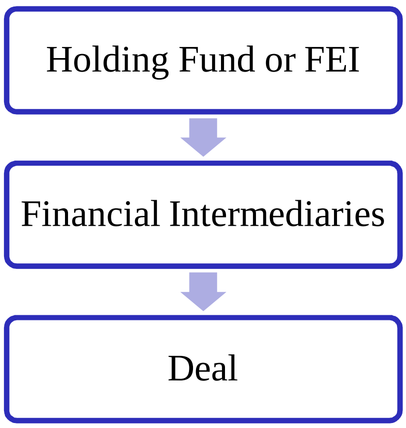
A. Objectives

<u>There are two types of co-financing:</u>

1/ the national/regional compensation. Indeed, to obtain the ERDF and save for a few exceptions (concerning financial engineering and more specifically the Jeremie Initiative), the Member State must be able to provide financial compensation, the proportion of which is set according to criteria concerning the country and depending on the objective the country is working towards (convergence or competitiveness).

2/ the private co-financing.

<u>There are three levels of co-financing:</u>



- To directly invest in the Holding Fund
- To invest in Financial Intermediaries
- To invest in deal (for example, to respect pari-passu treatement, we can have 50% of private co-investment in the companies'deal)

B. Procedures

As such, it appears necessary to initiate incentive measures for private co-funding.

a. <u>How can they be reassured?</u>

It is important to reassure co-investors about the merits of the measure they are considering, by highlighting several points:

- The opportunity to meet new customers (final recipients) for banks
- Benefit from an investment opportunity and a diversified strategy
- Share the risks with the State/Region
- Invest in a socially responsible manner (creation of jobs or innovative companies for example).

b. How can they be motivated?

The Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006 (Cocof note) indicates in its paragraph on State aid, and more specifically on *pari passu* treatment, that "Different arrangements might be applicable where a specific state aid scheme approved by the Commission allows for them."

Thus is the possibility to set up preferential clauses with a better repayment for private co-investors in order to attract them.

C. Critical issues and key success factors

The level of co-financing is very important. It's very difficult to have co-financing at the Holding Fund level because the structure is too large and the benefits are more limited or more difficult to assess for private investors. Consequently, to attract co-investors at the deal level is easier. Nevertheless, some countries managed to attract co-financing at the holding fund level.

It's necessary to have a very balancing tool between private and public interest. It can be necessary to put in place different arrangements to provide more benefits to private financers, making the investment more attractive for them. In addition, the more the funding agreement is clear, the better relationship is with private-coinvestors

Several examples will be presented in the "Best practices" part.

Here is a table giving an overview of the co-funding of financial engineering mechanisms in the FIN-EN project partner countries.

		Initiative amount (in Euros)	ERDF/ESF share	Private co-investment	Type of co-financier
Lombardy	Jeremie ERDF	20,000,000	39.64%	4,000,000	Confidi
	FRIM	35,000,000		40-50%	Banks
	MIL	33,000,000		400,000,000	Banks
	Jeremie ESF	20,000,000	42.36%	17,000,000	Banks
Brussels					
Berlin		200,000,000	50%	Around 700,000,000 on top (project level)	Banks, private VC-funds
Sofia		199,000,000	85%		
Andalusia		235,000,000	70%	30,000,000	Saving banks
Hungary		869,147,549*	85%	75,000,000	Banks, micro-finance institutions, financial enterprises, co-investors
Auvergne		25,200,000	71%		
Slovenia		150,000,000	0%	100,000,000	EIB
Latvia		294,000,000	63%		
Lithuania		297,000,000	95% (ERDF) + 5% (ESF)		
Central Denmark Region		13,500,000	50%	6,750,000	Private
Hessen		58,000,000	50%		
Greece		541,000,000	80%	1,082,000,000	Banks
Portugal		377,000,000	70% (credit-lines) 100% (V-C)		
North West England		204,000,000	50%	102,000,000	EIB

*calculated with 280HUF/EUR.

D. Best practices

➔ *A high percentage of private co-investors: example of Finlombarda SpA in Lombardy*

Financial engineering instruments are intended to be co-financed. Because the amount of funds available is on the constant decline, it is necessary to closely involve local economic stakeholders as co-financiers: this is a virtuous mechanism that calls on the different participants in a joint local project and which develops a subsequent leverage effect. As a result, Finlombarda was genuinely committed to finding co-financiers and changed two of these instruments to attract more private investors. Regarding the FRIM loan fund designed to support innovative SMEs, the percentage of financial help provided by the fund has been increased to the benefit of the percentage of co-funding provided by banks (which has been reduced), so as to make the instrument more attractive for the latter. In addition, with regard to JEREMIE ERDF, the investment period of Confidi (Italian intermediaries specialising in granting guarantees) has been halved from 24 to 12 months and the possible choice of financial intermediaries expanded. The objective of this change was to increase the level of fund expenditure by motivating the Confidi to be effective in a short space of time and to increase the number of beneficiaries reached.

➔ *The example of the Central Denmark Region, which demanded that the fund manager brings in private co-investors*

The identification of co-financiers was a selection criterion of the call for tenders launched to select the fund manager. Indeed, the tenderers had to bring in co-investors whose contribution would be equivalent to the ERDF financing (1:1). In this way, the co-investors joined the fund to highlight their social responsibility and with the intention of contributing to the region's entrepreneurship. But above all, they joined this initiative because of their great confidence in the aptitudes of the managing tenderer to generate a positive yield.

➔ *Preferential clauses: example of the National Development Agency in Hungary*

In case of venture capital calls, Hungary has called on private investors for jointly financing final recipients. It has introduced a "yield restriction" clause and a "loss mitigation" clause to attract as many co-investors as possible.

"Yield restriction": during the final evaluation, if the fund has a positive yield overall, a restriction on the latter may be applied in terms of the national resources invested in the capital. This means that only a pre-defined sum of the yield may be attributed to the State – and any surplus is returned to the private investors.
"Loss mitigation": respectively, if the fund has a negative yield, a certain percentage of loss equal to the highest subscribed capital of the fund will be absorbed by the JEREMIE (state owned) part of the fund. The remaining sum of the loss will be shared between the State and the private investors in proportion to their contribution.

➔ *Attracting EIB as a private co-investor: example of DCLG in the North West of England*

Communities and Local Government
DCLG
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The North West of England has opted for the JEREMIE Initiative by setting up the North West Fund. After obtaining EUR 102 million in ERDF co-funding, the holding fund required an equivalent amount from the European Investment Bank in the form of a reimburseable loan. A financing agreement has been signed between the Region and the EIB, clearly mentioning that the loan taken out must be reimbursed as a priority. It includes an obligation for the holding fund to keep separate accounts between the funds from the ERDF and those from the EIB. The funding via resources that are not State resources in the meaning of article 107 Para. 1 of the EC treaty is considered to come from private investors. This is particularly the case for funding by the European Investment Bank and the European Investment Fund.

➔ *Public/private partnership with a Business Angels programme: example of MA Compete in Portugal*

COMPETE
PROGRAMA OPERACIONAL FACTORES DE COMPETITIVIDADE
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MA Compete is the Managing Authority of the Competitiveness Factors Operational Programme that supports 3 regions in Portugal and has set up a Business Angels co-investment programme worth EUR 41 million. This includes the financing of 50 companies with over 200 Business Angels.
The Business Angels must bring to the new company 35% of the necessary funds, while MA Compete will make a 10 year (maximum) loan of 65% of the necessary funds. The repayment ratio between Business Angels and MA Compete will occur in 3 different phases: phase A – until Business Angels receive their investment (80-20%), phase B – until MA Compete receives its loan back (50-50%) and phase C – after MA Compete and Business Angels have received their investment, until the exit strategy occurs (80-20%). Therefore, phase C will begin when the ROI has achieved a value of 156%.

The success of this initiative lies in the fact that the Business Angels are more local to SMEs and more flexible than venture capital funds (which have specific objectives and intervention areas). According to the Portuguese partner, it is one of the best solutions for start-up capital.

III. Setting up the management initiative

1. Selecting the fund manager

A. Objectives

Once the previous stages in programming a financial engineering initiative are complete, and before it is actually established, a certain number of elements need to be set up to provide a framework for this mechanism.

The fund manager, in the case of a Holding Fund as well as without Holding Fund, plays a key role in a financial engineering initiative. Its tasks are many and its expertise and advice essential:

- It puts forward, sets up, follows and presents if necessary a proposal to revise the investment strategy to the Steering Committee
- It creates and manages the fund
- It organises Calls for Expression of Interest to select the financial intermediaries
- It examines the tenders, negotiates the investments terms and conditions, puts them forward to the Steering Committee and ensures their follow-up
- It ensures that the investments conform to the European provisions concerning State aid
- It monitors the activity and investments carried out by the financial intermediaries and refers them to the Managing Authority
- It takes part in financial intermediary involvement committees, keeps an eye on their investments, outflows and reimbursements
- It draws up reports in accordance with the ERDF regulatory requirements in force
- It informs the Steering Committee of how the investments, outflows and reimbursements made are progressing
- It manages the fund's cash flow, administrative and accounting tasks

B. Procedures

a. <u>The various possibilities of selection</u>

The fund manager can be a public or private institution.

In the case of a holding fund, article 44 of Regulation (EC) No 1083/2006 gives different possibilities for selecting the Holding Fund manager:

- a) the award of a public contract in accordance with applicable public procurement law;

- b) in other cases, where the agreement is not a public service contract within the meaning of public procurement law, the award of a grant, defined for this purpose as a direct financial contribution by way of a donation:

i) to the EIB or to the EIF;

ii) to a financial institution without a call for proposal, if this is pursuant to a national law compatible with the Treaty.

Each country has therefore made a different choice:

	Fund manager	Type of manager	Call for tender
Lombardy	Finlombarda SpA	Public	No
Brussels			
Berlin	Investitionsbank Berlin	Public	No
Sofia	EIF	Public	No
Andalusia	Agencia IDEA	Public	
Hungary	Venture Finance Hungary Plc	Public	No
Auvergne	SOFIMAC Partners + CCIR	Joint public/private group	Yes
Slovenia	SID Bank	Public	No
Latvia	Altum	Public	No
Lithuania	INVEGA and EIF (Jeremie)	Public	No
Central Denmark Region	Nupark Accelerace Management	Private	Yes
Hessen	Beteiligungsgesellschaft Hessen (BM H)	Public	No
Greece	ETEAN	Public	No
Portugal	PME Investimentos	Public	No
North West England	North West Business Finance Ltd	Private	No

b. Management costs

Article 43 of Regulation (EC) No 1828/2006 states that "Management costs may not exceed, on a yearly average, for the duration of the assistance any of the following thresholds, unless a higher percentage proves necessary after a competitive tender:

- 2% of the capital contributed from the operational programme to holding funds, or of the capital contributed from the operational programme or holding fund to the guarantee funds;
- 3% of the capital contributed from the operational programme or the holding fund to the financial engineering instrument in all other cases, with the exception of micro-credit instruments directed at micro-enterprises;
- 4% of the capital contributed from the operational programme or the holding fund to micro-credit instruments directed at micro-enterprises."

Most of the partners, in accordance with European regulations, ask for management costs of between 1 and 3% of the fund amount.

It is important to **provide for the remuneration of fund managers after the programming period under way,** for management of a financial engineering instrument is longer than the programming period, which corresponds to the investment period and not the disinvestment period. As such, the manager must be paid out of a grant planned for the duration of the fund.

C. Key success factors

REDUCE RED TAPE

The red tape involved in reporting emerges as an obstacle to managing funds by a private stakeholder. This is because such constraints are the opposite of what a private stakeholder is used to – who looks for more results and productivity. Reporting and monitoring create red tape that is not compatible with this productivity goal. All of the FIN-EN project partners agree that all of these procedures need streamlining to foster a working environment that is likely to attract co-investors.

Thanks to the partners' experience, it has been possible to write up a list of selection criteria for a FEI manager/Holding Fund manager:

- Track record
- Team expertise and skills: technical aspects of financial engineering co-financed by structural funds
- Local presence: perfect grasp of regional, national and European financial and banking networks, knowledge of local financial engineering needs
- Ability to perceive public challenges: flexibility in their thought process
- Advisory and creative role to create ad hoc solutions
- Ability to support such an initiative: suitable internal organisation for the administrative burden
- Contribution of added value

D. Best practices

➔ *Management of JEREMIE by a joint partnership (public/private): example of the Auvergne Region*

Conseil Régional d'Auvergne

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The Regional Council of Auvergne and French State (Managing Authority) have chosen to select a manager for its JEREMIE programme through a call for tenders. Two tenderers responded and one fully met the criteria sought by the Managing Authority. This is a multiregional private management firm, SOFIMAC PARTNERS, which forms a joint group with the Auvergne Region Chamber of Commerce and Industry (CCIRA). This private manager, with 35 years of experience in the private equity profession in Auvergne, has already been entrusted with managing financial provisions of the Auvergne Region in some of its funds.
Accordingly, this public/private partnership has found an innovative solution covering all of the fields of action. Indeed, SOFIMAC PARTNERS manages the holding fund and oversees follow-up of the venture capital investment portfolio and the CCIRA the loan fund portfolio. The effective collaboration between these four stakeholders is one of the key factors for the success of the JEREMIE Initiative in Auvergne.

2. The funding agreement

A. Objectives

This lays down the conditions associated with awarding a public contract or a grant (direct financial contribution through donation) and the implementation of the funding plan. The funding agreement is a document that can be drawn up at two levels.

In all cases, the funding agreement will officially establish the terms of the contract between the Managing Authority and the FEI/HF manager. In the case of a holding fund, a second agreement will be signed with each of the financial intermediaries.

B. Procedures

Determine the contents of the agreement

In order to obtain the detailed list of information that must be taken into account in the funding agreement between the duly mandated representative of the financial engineering instrument and the Member State or Managing Authority, refer to article 43 of Regulation (EC) No 1828/2006 which provides it.

“The funding agreement (…) shall include at least:

a) the investment strategy and planning;
b) monitoring of implementation in accordance with applicable rules;
c) an exit policy for the contribution from the operational programme out of the financial engineering instrument;
d) the winding-up provisions of the financial engineering instrument, including the reutilisation of resources returned to the financial engineering instrument from investments or left over after all guarantees have been honoured that are attributable to the contribution from the operational programme.”

Regarding the funding agreement that the State or Managing Authority concludes in the context of a holding fund, this must specify the funding arrangements and results to be achieved, as well as the findings of an evaluation of gaps between supply of such instruments to, and demand for such instruments by, SMEs.

<u>To be more exact, article 44 of the same regulation provides that this agreement shall contain:</u>

“a) The terms and conditions for contributions from the operational programme to the holding fund;
b) A call for expression of interest addressed to financial intermediaries or urban development funds;
c) The appraisal, selection and accreditation of financial intermediaries or urban development funds by the holding fund;
d) The setting up and monitoring of the investment policy or the targeted urban development plans and actions;
e) Reporting by the holding fund to Member States or managing authorities;
f) Monitoring the implementation of investments in accordance with applicable rules;
g) Audit requirements;
h) The exit policy of the holding fund out of the venture capital funds, guarantee funds, loan funds or urban development funds;
i) The winding-up provisions of the holding fund, including the reutilisation of resources returned to the financial engineering instrument from investments made or left over after all guarantees have been honoured which are attributable to the contribution from the operational programme.”

C. Key success factors

A best practice for drawing up the funding agreement easily is to **avail oneself of skills in public law,** for the partners have often voiced their regret of not having sought enough advice and support or called sufficiently on experts in this field.

Some partners are considering **setting up a working group**, which could be made up of two teams. **The combination of legal and operational specialists** would be a wise choice for combining different but complementary points of view.

It is also necessary to **foster dialogue with the authorities as much as possible** to adapt the regulations and iron out any differences in interpretation.

3. Choosing the investment vehicle

A. Objectives

When creating a fund – whether or not it is a holding fund – there are two possibilities: **create a distinct fund** (this may take a wide variety of legal forms) that will manage the grants, or incorporate it into a financial institution's activities **under a separate account.**

B. Procedures

a. <u>Choosing the legal structure</u>

The partners have made various choices:

	Separate body	Investment vehicle
Lombardy	No	Separate block of finance
Brussels		
Berlin	Yes	Limited Company for venture-capital and separate block of finance for loans and mezzanine
Sofia	Yes	Special Purpose Vehicle: joint stock company
Andalusia	Yes	Fund without own legal personality
Hungary	Yes	Private Limited Company (independent legal entity)
Auvergne	Yes	*Fonds Commun de Placement à Risque* (venture capital investment fund)
Slovenia	No	Separate block of finance
Latvia	No	Separate block of finance
Lithuania	No	Separate block of finance
Central Denmark Region	Yes	Commercial Fund
Hessen	Yes	Limited Company for venture-capital and separate block of finance in the WIB for loan
Greece	No	Separate block of finance with ETEAN SA
Portugal	Yes	Public fund
North West England	Yes	Private Sector Company Limited by Guarantee

b. Fund security

Financial engineering tools are, for the most part, governed by a national financial authority ensuring the control and security of funds for shareholders and subscribers of the latter. European funds have, in addition to this, control of services provided at variable intervals (quarterly/six-monthly/annually) as well as regular audits of the Managing Authority (regional and national level) and European Commission, in which the managers and final recipients of the funds must participate.

C. Key success factors

In order to make the right choice of investment vehicle, **the expertise of the team setting up the vehicle** must above all be called on, particularly in terms of regulations, management and control.

Furthermore, **understanding the type of fund is very useful for making strategic choices.**

The choice of investment vehicle largely depends on national regulations. In Spain, the funds supervised by the National Securities Exchange Commission benefit from a tax reduction (of only 1%) but are very limited for all that (stake in the capital and capital-replacing loans only).

Accordingly, the IDEA Agency has opted for an unregulated fund (without legal personality) that is subject to tax but which, on the other hand, has more flexibility in terms of financial instruments. The fact that the fund is 100% public facilitated the choice of this legal structure (flexibility was more important than tax exemption and profit). A different choice could have been made if private investors had been involved.

4. Governance

A. Objectives

Governance is ensured by the Steering Committee made up of the Managing Authority and sometimes its co-financiers. As for the manager, this may also be a member of this Steering Committee with or without decision-making powers.

B. Procedures

The missions of the Steering Committee

- The Steering Committee approves and adapts the investment strategy by proposal of the manager.
- It defines the schedule for the Operational Programme's contribution payments to the fund.
- It monitors the extent to which the financial engineering operations conducted by the manager are in line with the investment strategy objectives.
- It gives opinions that may or may not conform to the manager's proposals.
- It approves the manager's management reports.

- It approves the process for selecting the FEI financial intermediaries.
- It ensures that the financial intermediaries' operations are in line with the OP objectives.

The Steering Committee meets at regular intervals, more or less often depending on the country.

C. Key success factors

a. The importance of management bodies' investment

- Amicable relations and communication
- Collaboration for economic development
- Reduction in the number of contacts
- Reduction in red tape
- Meetings at regular intervals
- Confidence in the manager

These factors are crucial in an effective decision-making process so as to detect and resolve potential problems swiftly.

b. Necessary skills

- Rigour and the ability to draw up clear procedures
- Knowledge of European regulations and public administration
- Manage the initiative from start to finish by the same team to have a complete picture and better knowledge of the process.
- There must be enough staff with the necessary skills for each stage.

Conclusion

The exchanges of experience with the FIN-EN project partners have pinpointed the main key success factors in programming a financial engineering mechanism.

THE FACTORS TO SUCCESS

Three notions are vital for a project of this size to succeed. The mechanism must be **flexible** at all levels, for in a changing economic context the likes of which Europe and the rest of the world are currently experiencing, it is important to be able to adapt the decisions made at short notice, particularly as regards the investment strategy. It must be possible to revise the findings of the gap analysis and thus make amendments in line with companies' needs.

In the same way, **adaptability** is essential as the more adaptable the instruments defined, the more the sums may be allocated differently, thereby keeping up with change in a quick and effective manner.

Last but not least, the importance of **creativity** must be considered. Indeed, rigid structures have no place in a financial engineering process aimed at establishing a new form of aid for companies looking to the future and focused on performance. Creating ad hoc solutions, drawing inspiration from common market practices but demonstrating innovation, is a key success factor for overcoming the problems encountered when setting up these initiatives.

SIMPLIFICATION AND CLARITY

Another key factor in successfully setting up a financial engineering project is simplification and clarity, which thus gets rid of any problem caused by misunderstanding or incorrectly interpreting the process. Red tape is counterproductive in this type of mechanism.

THE IMPORTANCE OF COOPERATION AND COLLABORATION WITH PARTNERS, EXPERTS AND CO-INVESTORS

Financial engineering programmes are all the result of collaborative working – whether between Member States and the European Commission or between Managing Authorities and FEI/HF managers. Each stage in setting up a financial engineering initiative must be carried out jointly by different stakeholders, representatives of public or private institutions and participants in the mechanism. It is crucial to include experts in the various fields concerned in the process and to call on competent specialists with a role to play in regional/national development.

ORIENTATIONS ON FUTURE

All European project partners are sharing the will to continue using Structural Funds for the next programming period and to think about how to use the experience in order to gain time and to facilitate the implementation of FEI, as well as how to attract co-investment.

<u>The objective is:</u>

- the improvement of strategies and tools
- the improvement of attraction for financial intermediaries and co-investors

The opening to new sectors is strongly considered, for example in energy efficiency, in tourism, in agriculture, in financing of infrastructure. A doubt remains concerning agriculture because it is a field where a lot of agriculture actors are depending from grants.

The majority of partners won't change the general architecture of the mechanism and will keep the same as currently (Holding Fund or singular Fund). Indeed, the lessons learned from the experience will help implement a more efficient initiative, based on the same structure.

The financial instruments will also be based on the same scheme. The majority of partners will use the same instruments they are currently implementing. However, some other instruments will certainly be tested. For example, some partners are attracted by public-private partnerships like Business Angel programmes, and others by leasing and factoring instruments. **Actually, the objective for every partner is to cover the wider instruments' panel.**

The majority of partners plan to cover all sectors (both industry sectors and services) allowed by the EU Regulations and to widen the use of financial instruments. Moreover, it seems that there is still an attraction to the support of knowledge-intensive activities in the first stage of creation and companies with a high potential for growth.

All partners agree that attracting private sources is essential but as it depends on each particular instrument, no strategy has already been decided. As a result of a best practice, it would be essential to involve private investors since the beginning of the programming activity to define suitable involvement solutions.

To conclude, even if we know that the majority of partners will continue in the same way for the future, it's necessary to wait a few months to have more concrete elements on their orientation, as the policy decisional process for the 2014-2020 Operational Program is still in progress.