| | |
|---|---|
| **By:** | Mark Dance<br>Cabinet Member for Regeneration and Economic Development<br><br>David Smith<br>Director of Economic Development |
| **To:** | Governance and Audit Committee<br>Trading Activities Sub Group<br>20th November 2014 |
| **Subject:** | The creation of an East Kent Equity Investment Fund via a Limited Partnership |
| **Classification:** | Unrestricted |

---


**Summary**

This report sets out the governance arrangements for the establishment of a Limited Partnership (LP) to make equity investments in small and medium enterprises where these have the potential to expand and create employment in East Kent. It is proposed that the activities of the LP will be financed by the Regional Growth Fund (RGF) and will complement existing RGF-funded loan schemes administered by KCC.

The Committee is recommended to approve the governance arrangements.


---

## 1. Background

1.1. Kent County Council currently administers £55 million from the Government's Regional Growth Fund for products offering direct access to finance for businesses seeking to expand and create jobs. This is delivered through three programmes:-

a) Expansion East Kent, worth £35 million operating in Ashford, Canterbury, Dover, Shepway and Thanet.
b) TIGER (Thames Gateway Innovation, Growth and Enterprise), worth £14.5 million and operating in Dartford, Gravesham, Medway, Swale and Thurrock.
c) Escalate (worth £5.5 million) (operating in Rother, Wealden, Hastings, Sevenoaks, Tunbridge Wells, Maidstone, Tonbridge & Malling).

1.2. Although Expansion East Kent, Tiger and Escalate are separate programmes with separate governance arrangements, they are all marketed as 'repayable finance' schemes. This means that they offer interest-free, normally unsecured, loans to eligible businesses on grant conditions which link the funding to a specific project and require employment and other outputs to be met. All repayments are reinvested in the programme to be recycled to future beneficiaries.

1.3. Expansion East Kent was launched in April 2012 and has, so far, issued loan agreements worth over £31 million, which will create over 1,800 jobs. Tiger and Escalate were launched in 2013 and have committed funds of over £19 million and will create 1,570 jobs.

1.4. While Expansion East Kent, Tiger and Escalate in the main offer debt finance, a number of business proposals have come forward seeking equity investment. In addition, the Expansion East Kent Investment Advisory Board[1] has considered a number of loan applications which could be better suited to equity investment. These equity investments may give a better return to the fund than the standard repayable finance model. In the case of three companies applying to Expansion East Kent, the Board has recommended equity investment as preferable.

1.5 Based on this, approval has been given to offer RGF-financed equity investment through the establishment of the 'East Kent Equity Investment Fund and the forming of a Discovery Park Technology LP for the Expansion East Kent Programme only

## 2. The case for offering RGF-financed equity investment

2.1. Expansion East Kent aims to address a general market failure, as banks remain reluctant to lend despite the range of Government initiatives designed to increase general lending. It also aims to provide direct support to those businesses with the potential and appetite for growth and job creation.

2.2. Successive national surveys have demonstrated that there is a gap in the supply of limited amounts of equity finance to SMEs with high growth potential. This is because the cost of assessing the likely risk and return on smaller investments encourages private investors to focus on more established, lower risk businesses at the expense of early stage venture capital, especially in a more risk-averse general economic environment. This means that potentially high growth businesses lack access to investment, with the gap commonly thought to be in market provision of investments between £250,000 and £2 million[2]. Although there are no specific local surveys of the equity gap, anecdotal evidence from High Growth Kent suggests that it is as prevalent as in the rest of the country and is likely to be especially challenging in East Kent. Limited supply of equity investment also has a circular effect in limiting demand, with many businesses lacking information on equity finance[3].

## 3. State aid considerations

3.1. Within the Government grant agreements for Expansion East Kent, Kent County Council is permitted to make equity investment with RGF funds where this is offered as 'aid in the form of risk capital'. This enables public

---

[1] The Investment Advisory Board is the body established to consider applications to the Expansion East Kent fund and to make recommendations to KCC as the accountable body for the fund. It includes private sector representatives with a range of business experience and is chaired by the Leader of KCC.

[2] BIS/ SQW Consulting (2009), The supply of equity finance to SMEs: Revisiting the equity gap

[3] BIS (2012) Economics Paper 16, SME Access to External Finance

funding to be invested in a company provided the investment is made on commercial terms. To provide assurance that that the investment is commercial, equity from the public sector fund may only be made available on an equal basis with finance from a private investor (i.e. the size of the investment made by the private investor should be at least equal to the public sector investment, and the terms of the investment should be identical). All public sector equity funds operate on this basis.

## 4. Legal Advice

4.1. Legal advice has been sought from KCC's Legal Team, Geldards (acting as a sub-contractor to KCC) and Hogan and Lovells (specialist in corporate law) regarding the vehicle which would be required to enable KCC to make equity investments using RGF funding. The advice received states that the type of vehicle required depends on the purpose for which the equity investment is being made.

4.2. Firstly, if company shares are being acquired for a non-commercial purpose (for example, to improve general well-being), KCC could rely on Section 12(a) of the Local Government Act 2003, permitting the Council to invest directly without the need for a company to be established.

4.3. However, if shares are being acquired for a commercial purpose (i.e. if KCC intended to subsequently sell the shares at a commercial rate of return), Section 4(2) of the Localism Act 2011 states that a company would need to be established for that purpose.

4.4. Based on this legal advice, officers have considered that KCC's power to purchase shares should derive from **Section 4(2) of the Localism Act**, and that an LP should be established, for two reasons:-

4.5. Firstly, the state aid rules state that public sector equity investment should be made on the **'market economy investor principle'**. This states that KCC should invest in the expectation that it will receive a return in due course at the same level as that which would be acceptable to a private investor. The state aid basis of equity investment is therefore different from the interest-free loan products currently offered by Expansion East Kent, since while the latter are explicitly non-commercial forms of state aid. Consequently, it is considered that KCC's investment should be considered commercial, even though the reasons for establishing the fund are to support wider economic growth, rather than KCC's financial gain.

4.6. Secondly, analysis of existing schemes in the UK shows that where local equity investment funds have been established with public funding, they have usually been set up via separate company vehicles, investing alongside a private sector investor. This includes cases (such as Finance Birmingham) where the fund capital derives from the local authority[4].

4.7. Given that KCC's investment should be considered commercial to ensure compliance with state aid regulations, and based on experience elsewhere,

---

[4] It should be noted that we have not undertaken an analysis of the legal basis for the establishment of the various publicly-backed equity schemes around the UK. However, in practice, these schemes conventionally operate through company structures.

establishing an LP as provided for in the Localism Act therefore appears preferable.

4.8. KCC has issued a Commitment Letter to Narec Capital ('NC') dated October 15, 2014 whereby it agrees in principle to commit £5 million into an Equity Investment fund ('Fund'), in which it will be the initial sole partner and of which Narec Capital will be manager. The Fund is to be established in accordance with the submissions and documents provided to KCC and prepared by the legal firm Hogan Lovells.

***Notes***

1. Narec Capital East Kent Incubator LP (the "Fund") should be established as a limited partnership. This is a tax transparent vehicle that PE and VC investors are familiar with (thereby facilitating raising third party capital in due course). The LP will also facilitate the grant of carried interest as this is in accordance with the BVCA and HMRC MoU on carried interest.

2. The General Partner and the Special Limited Partner (which receives the carried interest) will be established as wholly owned subsidiaries of KCC, so that all of the participants in the Fund are in the same corporate group. This ensures that the Fund is not a collective investment scheme for UK regulatory purposes during Phase 1.

3. ExEK Investment Advisory Board (IAB) will be the committee of the General Partner and will be responsible for the investment activities of the Fund during Phase 1. The Board will have the benefit of advice provided by Narec Capital in its capacity as an authorised representative of its FCA regulated parent company.

4. The Special Limited Partner will assign carried interest to the intended recipients on establishment of the Fund.

## 5. Principles of the LP for the East Kent Investment Fund

5.1. The proposed governance arrangements for an East Kent Investment Fund would operate according to the following principles:-

<u>Principle 1: Source of investment</u>

5.2. The company would only be able to invest Regional Growth Fund monies made available to it for the purposes of equity investment (i.e. it would not be able to invest KCC core funds or funding from other sources).

5.3. Because the Expansion East Kent RGF scheme is subject to separate grant agreements and governance arrangements, the company would operate separate funds for each, with the decision to make RGF funds available made by KCC as the accountable body for each scheme in accordance with the scheme investment strategy. This would mean that the LP would manage an Expansion East Kent Equity Fund in accordance with the grant agreements and investment strategy but could offer additional Equity Fund programmes if required at a future date.

Principle 2: Co-financing

5.4. All equity investments will need to be made on a commercial basis, with the same anticipated return as that sought by a private investor. Therefore, at least 50% of the proposed total equity funding must be secured through private sector investment.

5.5. There are various options available for ensuring the public sector equity funds are co-financed. Based on a preliminary assessment, it is proposed that private sector co-financing will be secured by Narec Capital prior to its application for funding[5]. Private investment sources may include business angels and angel syndicates, venture capitalists and potentially investment by the owners of the business.

Principle 3: Return and sustainability

5.6. The company will seek to make a commercial return on its investments, with an expectation that most shareholdings will be sold after 5 years.

5.7. All returns on investment will remain within the Expansion East Kent Investment LP and made available for future rounds of investment. The equity funds managed by the LP must therefore be *sustainable*, but they are not *perpetual*, as the decision on when and whether to close the funds rests with KCC but would be based on recommendations from the Sub-Committee.

5.8. In order to guarantee the sustainability of each fund, and to ensure that no illegal state aid is provided to business through the operation of the company, it will be necessary to charge an arrangement fee to cover management and administration costs. Typically, arrangement fees in public sector-backed equity schemes are between 2% and 5% of the investment amount; some schemes also charge annual monitoring fees. These charges will be at the cost of the fund and not KCC.

Principle 4: Transparency

5.9. The creation of an East Kent Equity Investment LP will mean that additional finance products can be offered by Expansion East Kent. It is proposed that the process for applying to the LP for equity investment will be marketed in the same way as the existing loan schemes, with criteria and application details published openly.

---

[5] The proposed arrangement is used by a number of public-sector backed equity funds, including Finance Birmingham and the Scottish Seed Fund (managed by Scottish Enterprise). Alternative arrangements include the creation of a 100% co-financed fund with a private sector investor, or the designation of a limited number of 'approved' private investment partners. The merits of these options need to be considered in further detail, although the flexibility of the proposed option appears (on an early assessment) to be preferable.

5.10. Principle 5 : Mandate for Investments

The mandate for investments is as follows and will form the basis of all investments:-

| | |
|---|---|
| **Fund Structure** | English (regulated by English Law) Limited Partnership. Initially contained within a captive investment vehicle for Expansion East Kent, before converting to an AIFMD approved CIS scheme. |
| **Investment Objective**<br><br>**Location**<br><br>**Economic Impact**<br><br>**Commercialisation** | To invest in high growth sustainable energy and lifescience / medical technology SME's, focused around the East Kent area.<br><br>SMEs will locate at Discovery Park or the surrounding East Kent area.<br><br>The fund will seek to maximise economic impact within East Kent (inward investment, tax returns, local employment). The initial tranche of £5m from ExEK will leverage £45m of private capital into the fund (on transformation to CIS status) and £150m of captive co-investment. The investment plan will generate 500+ high value jobs on exit, within the East Kent area.<br><br>SMEs will be subject to a robust commercialisation process led by Narec Capital and agreed upfront with each company |
| **Target Fund Size** | Up to £50 million (£5m initial tranche from ExEK) |
| **Minimum Fund Size** | £5 million |
| **Minimum Commitment** | Minimum investment for any future Limited Partner is £500,000 (50 Participations) |
| **Participations** | Participations will be of £10,000 each consisting of £1 of partnership capital and £9,999 of partnership loan. Commitments to the Fund are legally committed on admission to the Partnership |
| **Carried Interest** | The Founder Partner is entitled to carried interest of 20% of net profits from the Fund after amounts contributed have been returned to investors. There is no hurdle |
| **Term** | 10 Years |
| **Investment Criteria** | The Fund will invest in companies producing sustainable energy and life science / medical related technologies and products. The<br>Investment Policy will be set out in accordance with the rules of the relevant RGF fund parameters. |

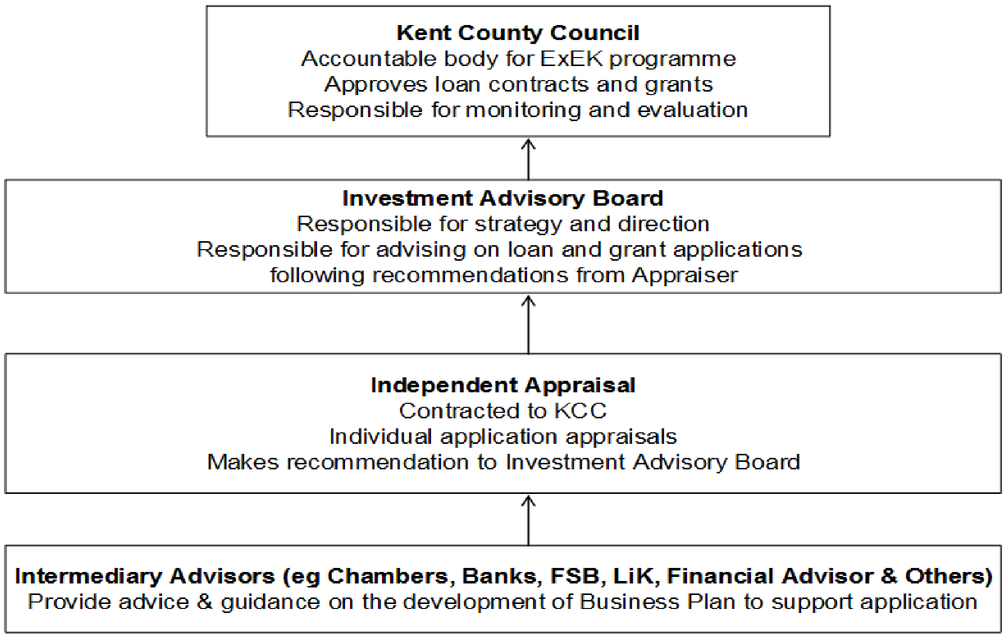
| | |
|---|---|
| **Reporting** | Investors will receive a six monthly update report on the investments in the portfolio and an annual report and accounts which will constitute periodic statements for the purposes of FSMA. In addition, ExEK IAB will also receive updates regarding economic impact analysis (jobs, leveraged investment) in order to track and monitor key RGF outputs. |
| **Set-up Costs** | 1% of total commitments to the Fund up to a maximum of £500,000 (limited to £50,000 during initial ExEK tranche) |
| **Management Fees** | A management fee of 3% of total commitments to the Fund per annum whilst below £15m, moving to 2% when £15m+ is achieved.<br><br>*(Both set-up costs and management fees will be taken from the fund allocation of £5 million)* |
| **Operating Expenses** | The Fund will be responsible for ongoing operating expenses relating directly to the Partnership, including the annual fees of the Operator and all audit, accountancy, valuation, legal and other professional fees |
| **Investment Committee** | The Investment Committee provides final approval of all investments. KCC will have the right to assign 2 x Directors to the committee (with veto rights). Details of the Investment Committee are set out in the accompanying legal documentation. |
| **ExEk IAB** | The ExEK IAB will set this investment mandate, maintain oversight of the performance of the fund and key economic outputs via regular updates from the funds Investment Committee. |
| **Target Initial Closing Date and Next Steps** | Initial tranche of £5m (ExEk) by September 2014. Remaining £45m by April 2015, once the permissions are in place to convert the fund to CIS status. |

## 6. Governance Arrangements

6.1 In May 2012 KCC accepted the role of accountable body for the Expansion East Kent funding programme. The governance arrangements for the programme were also approved by the Cabinet Committee on 14th May 2012. The following paragraphs set out the proposed way in which the current governance arrangements will be maintained whilst incorporating the East Kent Investment LP. The structure was formed following consultation with Legal and Democratic Services and is in line with the principles of the fund.

6.2 The diagram below sets out the governance structure that has been in place since 2012. This structure maintains a balance between independent, private sector advice and clear accountability.

**Expansion East Kent Governance Structure**




ExEK/Jacqui Working Docs/ExEK Governance Structure

6.3 The ExEK IAB will approve all investments. The proposals for equity investment will be presented to the Board (please see Annex 1 for structure diagram). The full membership of the ExEK IAB is as follows:-

Paul Carter (Chair)
Mark Dance (Vice-Chair)
David Smith
Miranda Chapman (Managing Director, Pillory Barn Creative - Media)
Ian Ellis (Director, McCabe Ford Williams - accountancy)
Simon Howell (private sector)
Elias Dencker (Renewables Strategy)
Eliot Forster (Managing Director, Creabilis SA – pharmaceutical R+D)
Laura Sandys MP

6.4 The ExEK IAB will approve each investment and the Fund Documents must reflect that stipulation by the Board. In practice, IAB and Narec Capital shall work closely together with KCC to ensure that this process is efficient.

6.5 KCC has raised the prospect of grandfathering existing investments into the Fund. The Fund documents will therefore allow for the concept of KCC and Narec Capital agreeing that certain existing KCC equity investments may be grandfathered into the Fund and thus managed by Narec Capital under the Fund.

## 7. Recommendations

The Trading Activities Sub-Group is recommended to:-

(a) approve the governance arrangements as detailed above.

Report author:
Jacqui Ward (Jacqui.ward@kent.gov.uk)
RGF Programme Manager
Tel: 07740-183812

# Annex 1 – Proposed Fund Structure & Governance (Phase 1)