WMCA Board

Date	23 July 2021
Report title	West Midlands Co-Investment Fund
Portfolio Lead	Finance - Councillor Bob Sleigh
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Report has been considered by	Investment Panel - 7 June 2021 WMCA FD's Meeting - 17 June 2021 Investment Board - 29 June 2021

Recommendation(s) for action or decision:

The WMCA Board is recommended to:

(1) Approve the setting up of the proposed WMCO, a Co-Invest Equity Fund designed to facilitate investment into Growth SME's to aid the recovery of the West Midlands economy. Note an FBC will follow before the Fund is launched.

(2) Approve the initial grant funding request of £12.5m from the WMCA Investment Programme as set out in the Outline Business Case (OBC), subject to approval of a Full Business Case detailing the form of Delivery Vehicle. The request represents 50% of the funding required to deliver this proposal.

(3) Note that the onward development of the proposal, Full Business Case, delivery options and financial modelling will be taken forward through detailed scrutiny and consultation of the West Midlands Finance Director group.

(4) Note that WMCA have approached the British Business Bank (BBB) to pursue the potential to secure match funding of £12.5m from Central Government sources. If available, then BBB are likely to require a match funding contribution from WMCA as requested in the OBC. The next stage FBC will include detail of the full funding structure.

1. Purpose

1.1. This document provides the outline information regarding a proposal for a new business friendly investment fund, aligned to the strategy, ambition and needs of the West Midlands Region. Crucially, it is designed to promote economic growth post COVID.

2. Background

2.1. The June 2020 Recharge the West Midlands paper proposed an Enterprise Investment Growth Fund which sought to work with Central Government to co-develop a large-scale equity fund to a) recapitalise viable firms and b) inject equity into high-growth potential firms. Since that point, Government implemented several initiatives to address the recapitalisation of viable businesses on a national scale, ranging from recovery loan schemes to the Future Fund (convertible loan to equity matched by private sector).

2.2. Aside from the Future Fund, there are few new public funds or initiatives to address equity funding for SME's, fulfil the objective in the Recharge paper to "inject equity into high-growth potential firms". Where equity is available, it is in short supply, is not directly aligned to the specific regional strategy (e.g. Local Industrial Strategy) and cannot adapt investment criteria quickly enough in response to change in regional priorities.

2.3. SME's offer high growth potential and it is particularly important that this sector is in good health if the Region is to accelerate growth post COVID. Growth SMEs are positioned to be the fastest to gain momentum coming out of recessionary periods. They tend to be agile, adapting quicker to change than large corporates, particularly in terms of technology innovation, where SMEs come up with creative solutions to old problems, introducing new concepts or ways of doing things. Furthermore, SMEs account for 60% of the private workforce and around 50% of UK GDP.

2.4. Whilst the West Midlands performs well with the number of start-up businesses created here, it has fewer that go on to 'Scale Up' stage when compared to other regions. Scale Up's create remarkably high value for the regions they are based in, mainly in the form of jobs, technology development, and attracting investment from other regions/countries. This can be evidenced by Gymshark's recent growth journey. The West Midland's also has the 3rd worst record for equity deals into SMEs with only Northern Ireland and East Midlands behind. Note 2% equity deal share compared with North West at 6%[1].

2.5. Many of this Regions active public sector equity interventions stem from the Midlands Engine Investment Fund (a Fund of Funds covering both East and West Midlands). Midven and Mercia are the two prominent equity Fund Managers operating both public sector and private sector funds within the region. The Midlands Engine funds they manage have investment criteria to assist growth and meet inclusive growth/ social impact aims. However, they are sector agnostic and not capable of being rapidly adjusted to reflect this Region's agreed priorities. This Fund is not designed to compete with these sources (which are welcomed) but seeks to reach further into the ecosystem and SME market to identify new companies in need of investment and support. This proposed Fund is of course not just a valuable additional source BUT also offers the additional benefits as set out in the four clear objectives as outlined below.

[1] British Business Bank Small Business Equity Tracker 2020

2.6. The West Midlands financial ecosystem appears to have all the right ingredients, but they are not operating in harmony. Launching a West Midlands Co-Investment Fund offers an opportunity for unique insight of Investors and SME's to assist in understanding the ecosystem, where barriers exist, and how to make improvements. Establishing region specific co-investment funds to successfully support SMEs and the ecosystem is not a new idea, with many regions throughout the UK establishing such funds. Scotland, Wales, London, Greater Manchester and Northern Ireland have set up funds with other regions understood to be planning imminent launches.

3. West Midlands Co-Investment Fund

3.1. Overview

3.1.1 This proposal for the West Midlands Co-Investment Fund ("WMCO" or "The Fund") provides a high impact intervention at a quantum calculated to be the minimal amount that sufficiently spreads risk. It would have £22.5m of funds to invest (excluding operating costs) and is designed to provide initial and follow-on equity funding alongside the private sector into 45 high-growth potential companies in the West Midlands region.

3.1.2 WMCO has recoverable investment characteristics, with the potential to recover the majority or all of the investment (depending on fund performance). However, if a loss arose, this is limited to the amount of the investment. Funds are requested from the Investment Programme, which is funded under the Devolution Settlement and there is therefore no further liability arising above this sum if there was a total loss of investment.

3.1.3 Operating over a ten-year period (industry standard for this type of fund), the Fund will target: 45 revenue-generating SMEs (those with fewer than 250 employees) with registered and trading address within the West Midlands, a demonstrable scalable business model; and sector alignment to regional strategy e.g. LIS, #WM2041. WMCO will appoint a professional investment team to meet its objectives.

3.1.4 WMCO is intended to operate a co-invest model which will invest alongside the public and private sectors. We expect as a minimum, **each £1 invested by WMCO will be matched by a minimum of £1 of private sector money** with a target to increase this as we successfully increase the pool of active West Midlands investors. This will lead to the additional benefits listed below.

3.1.5 A new Advisory Committee will be established allowing representation from Local Authorities, LEPs, WMCA and the Mayor. The Committee would ensure good governance and hold the investment team and Committee to account. Advisory Committee members would also have a role in taking soundings from industry bodies representing SME's and informing their members, whilst ensuring that other public initiatives gel with the activities of the Fund e.g. Innovation Board, WM5G, activities within #2041.

3.1.6 Establishing WMCO will enable WMCA to achieve **<u>4 clear objectives</u>**:

(1) Lead SME post Covid recovery
The Government has implemented several financial interventions to address the recapitalisation of viable businesses on a national scale. Interventions are however predominantly debt focused. An SME equity fund addresses a gap in the investment market and can boost regional economic performance that has been damaged by the pandemic. Equity finance can act as a stimulus to help the region's SMEs thrive.

(2) Provide support to the regions SMEs

Equity provision will undoubtedly assist in growing good businesses and it's important to see this as additionality – adding to the equity available through other sources and not a replacement for it (it should be noted that Greater Manchester operates its own funds in addition to the Northern Powerhouse Investment Funds). The Fund will directly tackle growth challenges, working to connect investee companies with other relevant parts of the ecosystem to add further value/support.

(3) Improve the ecosystem

We do have the ingredients needed for a successful ecosystem. Stakeholder engagement indicated that each element could be working more harmoniously with the next, albeit the mechanism to facilitate this was not immediately apparent. By operating a fund, we would have direct experience of where SMEs and Investors need help and first-hand feedback of what they believe should be enhanced. The co-invest nature of WMCO means the interactions will be honest and engaging, with open access to data that will be valued by all. We will also seek to activate investors inside and outside this region. We have few private sector Venture Capitalists investing here, and it appears many resident High Net Worth's are not active or not regularly active here (although they invest elsewhere).

(4) Build track record and capability

Demonstrating track record and having an organisation that is already in operation, are considered critical factors in successful bids for funds that may be available in the future from Central Government. In the future, the Region may wish to consider other Access to Finance initiatives. By starting with this co-investment fund, we would build track record and recognised capability.

3.2. **Success and outputs**

3.2.1 Aside from focusing purely on generating a positive return, the additional measured outputs will be both socio-economic and financial. The report commissioned from Jerroms (expert consultant in this field) noted that we could expect to see the following outputs:

- Number of growth SMEs supported: **45**
- New to Company Product supported: **23**
- Indirect jobs created and safeguarded: **788** (estimated 563 are jobs created)
- Anticipated return to WMCA (Gross): **£19.7m - £31.2m** (dependent upon fund performance. NB the position prior to deducting the £25m funding outlay.)
- Private sector co-investment leveraged: **£33.75m** (£1.50 for every £1 deployed)
- GVA Gross: **£49m**
- GVA per £1 of public sector funds invested: **£1.96**

4. Capital and Revenue Deployment

4.1. The proposed Fund will utilise £28m and operate over 10 years (industry standard). Of this total funding, £3m will be generated through the investment period direct from SME's in fees and realisations, according to market practice. Therefore an investment of £25m is required (this paper is proposing half of this), with £22.5m being capital funding (the investment fund) and £2.5m revenue.

4.2 Operational costs were assessed by the consultant Jerroms, as being comparable with similar Active investor vehicles. Over 10 years these are budgeted at £2.5m from the Investment Programme and £3m generated from the investee companies. In response to queries raised during the Assurance process, the costs will be interrogated further to validate this further and assure it is best value for money, along with refining the exact form of the delivery vehicle, at the FBC stage.

4.3 In total, £22.5m will be invested into 45 high growth companies. The Fund will look to build its portfolio of investee companies within the first 5 years of operation, making follow-on investments up to year 7, by which time we anticipate some of the companies would be in a position to exit. Each SME will receive an average £250k initial investment, with 36 companies receiving an average £250k follow on investment, and a further 9 companies receiving a second follow on investment averaging £250k. 80% of investments will be in the form of equity, with 20% being in the form of convertible loans instruments at market rates of interest.

4.4 WMCO has recoverable investment characteristics, with the potential to repay the majority or all of the £25m outlay (depending on fund performance). A number of return scenarios have been modelled based on fund performance, demonstrating net results from -£5.3m to +£6.2m. A prudent base case is that the Fund returns a net gain of c.£2.4m (on top of returning the £25m funding) has been assumed. As the requested funding is from the Investment Programme via a Grant, this is a unique opportunity to deploy a Grant where in a downside scenario, the majority of the investment is expected to be returned.

4.5 This proposal has progressed through the assurance process with the following observations covered or to be addressed during FBC stage:

4.5.1 An assumption is made that, although match funding is to be secured and its terms are yet to be negotiated, if inputted the Investment Programme may be required to bear all of any loss, as this is the Grant element. As noted above, the modelled scenario planning demonstrates a net result from -£5.3m to +£6.2m. Any amount of loss would then form an irrecoverable element of the Grant already imputed and there would be no additional call on the Investment Programme.

4.5.2 That the use of the existing delivery vehicle, West Midlands Development Capital (WMDC), is considered as an option and a comparator when refining the proposal between this OBC and FBC. WMDC already manages the £210m of real estate debt funding on behalf of WMCA.

4.5.3 That the indicative fees included in the costs of running the Fund are appropriate for the type and scale of Fund as set in the FBC and that these are to be benchmarked against market fees to ensure value for money. This exercise to be conducted by FBC stage.

4.5.4 That the indicative Governance structure adds consideration of Independent Chair and External Industry Expert Members to the Investment Committee and that this is considered for the FBC stage.

4.5.5 Onward development of this proposal to include delivery options and financial modelling will be taken forward with detailed scrutiny by and consultation with the WMFD Group.

5. Financial Implications

5.1. **This OBC requests in principle approval to allocate £12.5m of grant funding from the WMCA Investment Programme subject to an FBC**. The funding will be in the form of a Grant as is usual from the Investment Programme. The Investment Programme is funded under the Devolution Settlement and there is no liability to the WMCA if there was a total loss of the £12.5m. However, it is noted that in this instance there is a likelihood that the majority of funds, possibly all, are capable of being recycled when the Fund closes.

5.2. WMCA is in dialogue with the British Business Bank (BBB) to secure match funding for the £12.5m. BBB are understood to look more favourably on support if match funding can be demonstrated and therefore this proposal is in advance of furthering dialogue. None of the £12.5m would be spent until an FBC has been approved by WMCA Board and this FBC will fully detail the funding source, any conditions and timing.

5.3. The overall financial requirement and funding can be summarised as follows:

Cost		**Funded By**
Development, set-up and operation	£2.5m	WMCA
Equity Investment	£10.0m	WMCA
	£12.5m	British Business Bank/ HMG
Total	**£25.0m**	

5.4. As noted above, equity investment carries a high level of risk and a positive return is not guaranteed. Professional advice has been obtained from Jerroms (Fund strategy and Investment) and Weightmans (Legal and Governance) as well as utilising in-house expertise at WMCA and reviewing this proposal via a Working Group of industry experts. However, as with any investments of this nature there is no absolute certainty that all or part of the investment will be returned.

5.5. The WMCA Board of March 2021 agreed a £70m extension to the Investment Programme affordable limit. This funding was mostly allocated (with a residual, unallocated sum of £15.4m earmarked for regional recovery priorities), albeit with £15m held provisionally for emerging WMCA capital / revenue budget risks and £29.5m being awarded as ‘funder of last resort’ to allow for development and delivery of the six rail stations, including Perry Barr.

5.6. Given the deferred Investment Programme spend in 2020/21, the projection for interest rates to remain at historically low levels and the fact that the Co-invest requirement is likely to be recyclable over the longer term, the WMCA Section 151 Officer is comfortable to recommend that both this proposal and the CoW Tech investment (subject to a separate report on the agenda) can be endorsed for consideration by WMCA Board, to be accommodated from within the overall Investment Programme affordable limit.

5.7. WMCA exposure is further mitigated by the nature of the request being to allocate (rather than contractually commit) the funding. At the point contractually binding commitments to incur expenditure are made, this will be subject to the WMCA S.151 officer being assured on the affordability of the proposal relative to the expected headroom within the Investment Programme financial model.

6. Legal Implications

6.1. The West Midlands Combined Authority (WMCA) was statutorily created by virtue of the West Midlands Combined Authority Order 2016 (SI 2016/653) (Order) as enacted under the Local Democracy Economic Development and Construction Act 2009 (LDEDC 2009). This resulted in powers being inherited and transferred to the WMCA by virtue of the terms of the Order. This includes the general powers set out within s.113a LDEDC 2009 which were added by the Localism Act 2011; namely a combined authority can carry out *anything it considers appropriate for the purposes of the carrying out of any of its functions (its 'functional purposes')*; which could include matters relating to economic development and regeneration.

6.2. The proposal to set up WMCO or otherwise use an existing delivery vehicle to carry out the functions set out in the body of this report are permitted, in line with the contents of paragraph 6.1. above.

6.3. WMCA legal and externally appointed advisers (Weightmans LLP) will continue to advise and assist as necessary in respect to any legal implications, insofar as they relate to proposals forming part of the FBC.

7. Equalities Implications

7.1. None from this paper.

8. Inclusive Growth Implications

8.1. WMCO is committed to working with WMCA to identify where outputs can be tied to the region's inclusive and sustainable growth agenda, utilising oversight via the governance structure outlined in the OBC.

9. Geographical Area of Report's Implications

9.1. WMCO will operate across the whole WMCA area (three LEP geography), including non-constituent members.

10. Schedule of Background Papers

10.1. Outline Business Case Submission and supporting Appendices including WMCA Co-Investment Fund Report (Jerroms Corporate Finance)