European Investment Bank

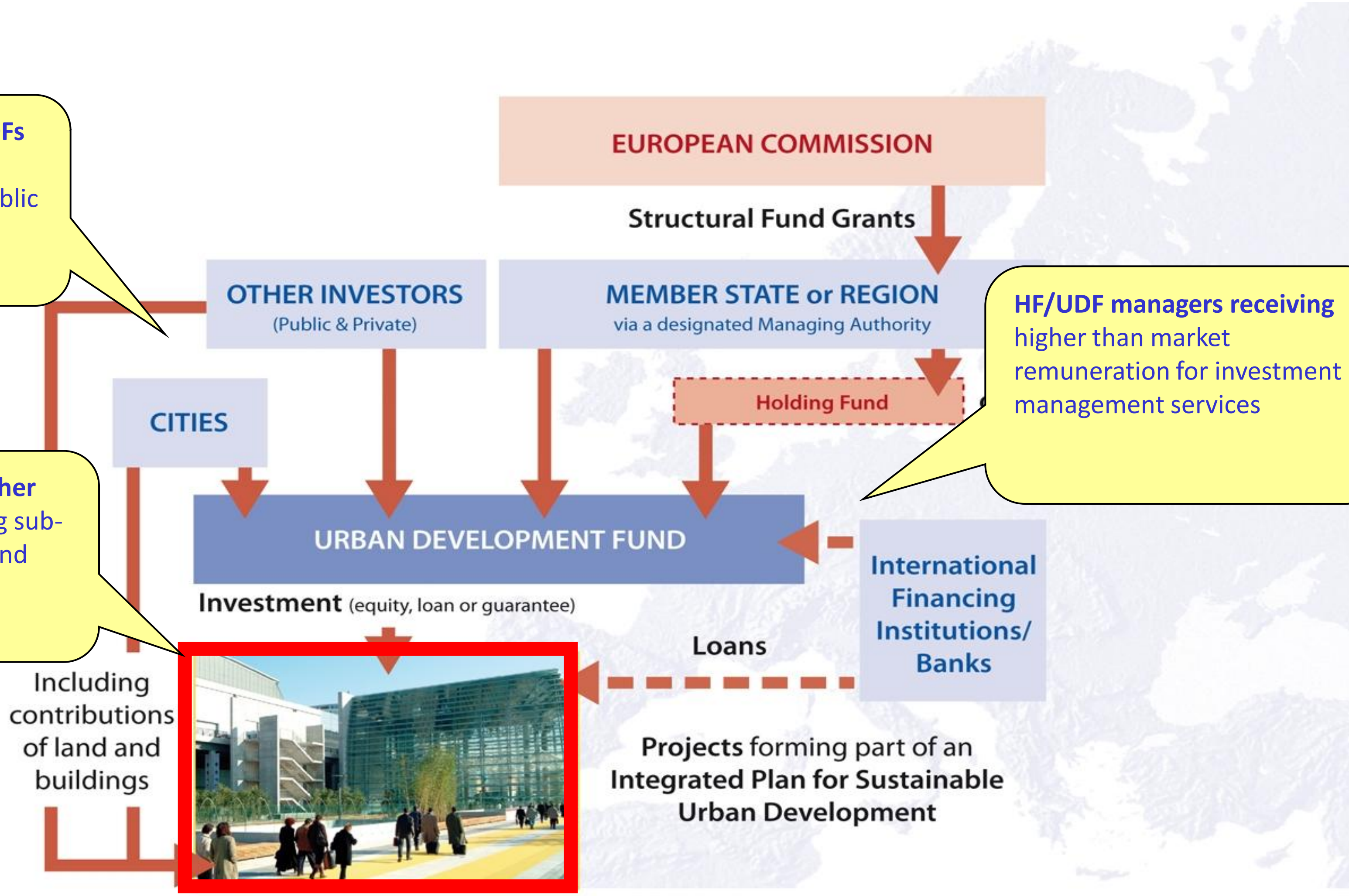
Northwest State Aid Decision

Potential State aid beneficiaries

Private investors in HF/UDFs receiving preferential treatment compared to public investment

Project promoters (and other project investors) receiving sub-commercial equity, loans and guarantees

HF/UDF managers receiving higher than market remuneration for investment management services



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Development of State aid Notification

September 2010 Pre-Notification

EIB led

UK wide

submission

December 2010 – April 2011 Commission Feedback/Formal Notification

Northwest specific measure developed by EIB & NWDA

April – June 2011

Detailed dialogue with Commission

Measure modified by EIB & NWDA to address key concerns

Commission approval July 2011

European Investment Bank

Overall objective of the measure

→ To encourage private sector investment by providing loan and/or equity funding to projects that are not viable if financed on a commercial basis – broadening potential pipeline and benefit.

- A ten year duration
- The measure enables UDFs to provide a greater range of incentives to private investors to deliver projects in line with the UDF Investment Strategy:
- Where:
  - Projects have viability gaps as a result of high initial costs and/or low values caused by market failures
  - Projects are not commercially attractive for market investors
  - The project developer and investors are unable to generate a fair rate of return
  - The project would not proceed without the use of the measure

Funding architecture

→ **The measure relies heavily on the funding architecture and the suite of Funding/Operational Agreements of the Northwest Urban Investment Fund. It includes specific roles as follows:**

- **The Holding Fund**:
  - Selection, investment and performance monitoring of UDFs
  - EC reporting obligations
  - Procurement of Independent Expert
- **The UDF:**
  - Responsibility for the application of the measure, including
    - Establishing the need for the measure through due diligence
    - Determining the fair rate of return
    - Identifying the most appropriate tool (s) of the measure to apply
    - Reporting and audit obligations
- **The Independent Expert:**
  - Responsibility for providing an opinion on the FRR and the significance of the private equity contribution in certain circumstances and in all proposed grant proposals.

Measure Principles

<u>The measure proposes:</u>

- Loans at lower than market rates;
- Equity/quasi-equity with non *pari-passu* risk sharing of the upside and/or downside between public and private investors.
- Grant

<u>To ensure proportionality:</u>

→ **UDF sub-commercial investments (in any form) must be adjusted to the minimum necessary to limit State aid to investors both at project or UDF level**

- UDF may not invest at loss - at least an initial UDF investment value should be repaid based on estimated investment performance;
- UDF sub-commercial investments may not result in higher than market returns on private investment (fair rate of return) at UDF or project level.
- If the investment outperforms, a profit-sharing mechanism must be in place;
- If the investment underperforms, a loss-sharing mechanism must be in place

Measure Tools - Debt

- **Senior debt:**
  - At below market rates, allowing the project to break even.
  - Applied in limited circumstances where projects are unable to secure senior debt at all or at a level which enables the project to generate market returns.
- **Subordinated loans:**
  - At below market rates, allowing the project to break even.
  - By their nature, subordinated loans are structurally subordinated to senior loans, thus non- pari passu compared to senior debt, as repayments and any other claims are subordinated to senior debt, but rank ahead of equity.

Measure Tools - Equity

- **Preferential rates of return**
  - The UDF rate of return could be below that of private investors, subject to a floor of zero return to enable the project to break even.
  - The project developer's rate of return would be capped at what had been deemed to be the FRR.
- **Priority return**
  - The return would be first paid to the private equity investor, up to the level of the FRR before the UDF. Once the private equity investor has received its FRR, the UDF public investment will then be entitled to receive its FRR.
  - The UDF has to wait in this case until the private investor has received its full FRR before it receives any return.

Measure Tools – Equity continued

- **Timing**
  - Enables the UDF to invest first, before the project developer or other third party investors in the project.
- **First Loss**
  - Enables UDF equity investments to rank behind private equity for repayment, therefore effectively being exposed to first loss in the case of poor investment performance.
  - For use only where project is not estimated to make a loss on the capital invested, but in instances where an actual loss is made on the capital invested
  - the UDF would adopt a capped "first loss" position of 25% of the overall outstanding loss, in any case limited to the level of the UDFs investment in the project.
  - By applying the first loss tool, the UDF would reduce the risk profile on the development and subsequently the viability gap.

Measure Tools - Grant

No specific funding source identified but….

- **Where following the application of the debt and equity tools, viability gaps still persist and:**
  - The project scores highly as a regeneration priority:
    - Grant is proposed, capped at the level required to enable the project to break even and generate a fair rate of return
    - Grant requirement to be reviewed by the Independent Expert

Eligible Projects

- **Projects must form part of an integrated plan for sustainable urban development (IPSUD) and by compliant with the UDF Investment Strategy**
- **Eligible beneficiaries:** any size, multi-sectoral, not companies in difficulty, no State aid recovery.
- **Geographic requirements:** UDP must be carried out in the target areas defined in the Investment Strategy.
- **Eligible activities and costs:**
  - Project activities and costs must reflect the requirements of the ERDF Investment Frameworks and ERDF eligible costs
- **Financial sustainability:**
  - Projects must be capable of at least repaying the UDF capital investment, following the application of the measure (unless grant requirement identified).

Co-investors in projects

- **UDF may not finance a project without the following requirements being satisfied:**
  - The private investors must cover at **least 50**% of the total eligible project costs, which must be free of any public support.
  - The maximum UDF investment exposure (in any form) in each project is limited to **GBP 6 million or 20% of the HF investment in the UDF**.
  - **Within the 50% of private investment there** must be a significant equity contribution by the project promoter**. Consequently, the UDF will never be a sole equity holder in a project and will share investment risks with project promoters and other investors.**
  - **Co-financing can take place** at fund level **or at the** level of individual projects**.**

Structuring investments under the measure

- UDF project investments have to be based on a **business plan** and an ex-ante defined **exit strategy**.
- UDF managers are expected to structure – preferential – investment conditions in a way that **minimizes Staid aid** to private investors resulting in a fair rate of return.
  - **Preferential option** is to run a **competitive process** i. e. **public tendering or appropriate negotiations with at least two potential co-investors,** records thereof being kept at Commission's disposal.
  - Where the **competitive process** is **not possible** appropriate **non pari-passu investments conditions** have to be verified **by an Independent Expert**.
  - **Independent Experts** will use **industry benchmarks adjusted to project specific investment risks** when establishing **appropriate advantages for private investors.**

Role of Independent Expert

- The IE will be required to be engaged by the UDF from the EIB Framework Panel on a project where there has been no form of public procurement or competitive benchmarking to establish the FRR

- The IE will be expected to draw on comparative data, market benchmarks and previous relevant experience of similar projects as part of process

- The IE will be required to confirm that the equity-style variant chosen is appropriate and that the rate of return applied is commensurate and reasonable

- The IE must provide an opinion on the significance of the equity investment proposed in the context of the overall project costs, taking into account the form of the UDF contribution, the nature of the project and the reliability of the project cash flows

- The IE will be engaged on all grant proposals

Other Requirements

- UDFs to **monitor and control the performance of each project** for the investment period seeking to improve operational performance and increase the value of the investment.
- **Implementation will be monitored** by the UDF managers.
- A return on equity investments will be realised through an investment “**exit**” which must be defined in advance before structuring an investment deal.
- Before the exit, there will be an **independent valuation** of the UDF equity holding.
- **UK has an annual reporting obligation** to the Commission**,** sufficient to **verify compliance** i.a. with **State aid provisions.**
- **Standardized information sheets (SIS)** for projects utilsing the measure with in excess of **EUR 5 million UDF investment.**
- **Individual notification** of projects larger than **EUR 50 million**
- **State aid approvals limited to 10 years –** revisions maybe possible (e.g. to broaden scope of eligible activities, but will require a robust evidence base and market failure analysis).

Progress so far

- **State aid decision used for two projects, in the NW.**
- **In both instances the decision combined grant and UDF investment:**

Chester Cordis

£4.78m 0% loan to Muse Developments

First use of unique NW JESSICA State Aid Notification that allows zero per cent interest rate to support unviable schemes to proceed

Provides new supply of grade A office

Progress so far …..

Duke Street, Liverpool

- Project retains and expands a key business in Liverpool
- Total development cost of £10.3m
- Chrysalis Loan of £1.4m alongside ERDF grant of £2.8m
- To commence in April 14 and open in Oct 14
- Loan repayable at PC