FINANCIAL INSTRUMENTS

Executive Summary

Ex ante assessment for 2014-2020 ERDF Financial Instruments in Región de Murcia

On behalf of *Instituto de Fomento de la Región de Murcia*

Ex ante assessment for 2014-2020 ERDF Financial Instruments in Región de Murcia

Article 37 of Regulation 1303/2013 prescribes that the support through Financial Instruments shall be based on an ex ante assessment, which demonstrates the existence of market deficiencies or suboptimal investment situations. This ex ante assessment has been carried out by Red2Red – Afi-CAP on behalf of Instituto de Fomento de la Región de Murcia (hereinafter, INFO), which is considering the implementation of Financial Instruments to partly execute the 2014-2020 ERDF Operational Programme of Región de Murcia (hereinafter, Murcia). The ex ante assessment encompasses two elements: a market assessment and a set of provisions intended for the management of the Financial Instruments.

Socio-economic analysis of Murcia

GDP growth in Murcia and Spain during 2015 was higher than the EU average, with rates of 3.1% and 3.2%, respectively. Therefore, Murcia has left behind the recession and, should forecasts for 2016 and 2017 materialise, will reach pre-crisis GDP levels. Nevertheless, economic growth in Murcia and at national level is based on transitory tail winds such as low oil prices, QE by the European Central Bank, or favourable exchange rates, which will dissipate in the medium term. The crisis has not been fully overcome, as there are still adverse effects on the level of GDP per capita, the labour market and the productive structure of Murcia.

The loss of enterprises during the crisis has been more acute in Murcia than at national level. However, this deterioration has come to a halt in 2014 and since 2015 the number of enterprises is again growing. 99.9% of enterprises are SMEs, out of which 95.5% are microenterprises, most of them enterprises without employees. In general terms, the vast majority of enterprises are linked to sectors associated with lower value added such as tourism or retail commerce, despite the fact that there is also an industrial base in the region. The importance of the tourism sector is proven by its contribution to the economy (9.8% of GDP) and its share of employment. However, foreign tourism is lower than the national average and it is a sector characterized by high seasonality.

Investment in R&D has been historically lower in Murcia than in Spain and in the EU. Its evolution during the years of high GDP growth has been very positive but this trend has been interrupted by the economic crisis. In 2014, the expenditure on R&D with respect to GDP was 0.9% in Murcia, compared to 1.2% in Spain and 1.9% in the EU. Furthermore, is worth mentioning that private R&D investment has been characterized by a more significant contraction than public investment.

Murcia has an economy that is relatively more open than the Spanish economy on the whole, a trait which has been remained true during the last years. In spite of this, Murcia has been running a trade deficit during most of the analyzed period. From the perspective of the type of exported products, Murcia exhibits a strong competitive position in food products and in fuels and lubricants, which combined represent 45% of exports.

The demographic profile of Murcia does not show population ageing to the extent seen at national level. In 2016 the working age population stood at 67%, which will remain so in 2029.

Analysis of the financial situation of enterprises in Murcia
Cost of capital has had a substantial repercussion on the balance sheets of enterprises in Murcia, due to its unitary cost as well as it volume. The fall in aggregate demand and its slow recovery has been the main explanatory factor for falling profitability of firms in Murcia.

Analysis of the financial market for investments by enterprises in Murcia
The implementation of a specific methodology, taking in consideration both supply and demand, developed by Red2Red – Afi-CAP has allowed identifying the nature of investments carried out by market agents.

Analysis of the demand for business financing

Approximately 80% of Spanish firms include investments in their strategic plans. The most common aim of investments is the main activity of the firm, accounting for 61% of investments. In terms of the destination of business investments, data points to the fact that firms invest both domestically (43%) as well as in other European countries (19%) and in LATAM (17%).

Access to finance has lost importance as a pressing issue for SMEs. While in 2009 34% of firms had difficulties accessing finance, at the end of 2015 this was only the case for 10% of interviewees. Nevertheless, there is a perception amongst businesses that the supply of finance does not entirely match demand. The substantial contraction of bank lending to the private sector in Murcia has resulted in obstacles to carry out initiatives and drive competitiveness. As access to finance fades as a hurdle, anaemic aggregate demand is now considered as the main threat for businesses. Other sources also highlight increased competition as an issue. In addition collateralization requirements are more stringent in Spain than in the Eurozone on average. Most of Spanish enterprises must provide between 75% and 100% of the loan, sometimes also reaching 150%. Moreover, a comparison at European level reveals that loan volumes are significantly lower in Spain and that loans are associated with relatively high interest rates.

Bank lending is the main source of finance for SMEs in the EU, in Spain globally and in Murcia in particular. In spite of this, there is a pool of firms that does not request funding due to excessive pricing or because they are excluded by lending policies of the banking sector. A proof of the modest sophistication of financial markets is the marginal importance of fixed income and capital markets. It is also important to note that the deleveraging process in the context of the economic crisis has receded, as the net balance between firms that increased or decreased debt is now positive.

In terms of lending to the private sector, from 2009 on growth rates have been negative in Murcia as well as at national level. From 2014 on, there is a change in the pattern of the series, which has not yet reached positive rates as of 2015. The structural liquidity ratio, i.e. the relationship between bank deposits and credit, reveals the significant capital inflows to Murcia. The ratio has been increasing during the crisis but as of 2015 has only reached 74%, considerably lower than the national average at 89%.

Only 6.7% of interviewed firms made use of alternative sources of finance and one out of five highlighted that these sources had gained importance. Demand for alternative finance is mainly associated to early stages of the entrepreneurial process, when traditional bank lending is not yet available due to insufficient track record or collateral. An explanatory factor to this is that there might be a modest volume of viable projects, given the idiosyncrasy of venture finance.

Analysis of the supply of business financing

The restructuring process in the sector of the regional savings institutes has resulted in market concentration and the takeover of banking activities by banking groups. The only group local to Murcia is Banco Mare Nostrum. In terms of specialization in business financing, there is a negative correlation between regional focus and lending volumes.

Venture capital and private equity have a modest importance in Murcia. As of 2015, there was only one agent in the region, Murcia Emprende. Aside from 2011 and 2013, when large-scale deals took place, the total quantity and volume of operations have decreased further from an already low level. Between 2008 and 2015 investment plummeted by 96% from EUR 18 m to approximately EUR 0.5 m. Analysing venture capital, it must be pointed out that investments decreased by 70% between 2014 and 2015, while the number of deals increases. This has resulted in a decrease in average deal size, which has changed to EUR 0.18 m in 2015 from EUR 0.56 m in 2011. At local level, it is worth mentioning MurciaBAN, the regional business angels network and WannaSeed, a co-investment vehicle specialized in start-ups. ENISA and CDTI are also present in Murcia providing mezzanine finance.

The main agent in the guarantees market in Murcia is AVALAM, a reciprocal guarantee institute, whose objective is to grant all kinds of guarantees as well as to offer advisory services in financing. Outstanding balances have been gradually declining, with outstanding operations being 50% lower in 2015 with respect to 2010.

INFO is the regional development agency of Murcia being legally established as public Enterprise affiliated to the Department for Employment, Universities and Company. With its three offices in Murcia, Cartagena and Brussels, its main goal is to promote growth and employment in Murcia. To that aim, INFO puts in place measures to encourage the development of SMEs and improve competitiveness.

SWOT matrix and estimation of funding gaps

The information gathered by means of the market assessment has been summarised with a SWOT matrix. This matrix is instrumental in making an objective representation of enterprise financing in Murcia. Endogenous factors such as trends in variables and markets as well as exogenous factors such as macroeconomic or social circumstances have been taken into account.

A rigorous literature review, the insights gained through a workshop at local level and the conclusions of the abovementioned SWOT matrix have all fed into the identification of a number of market failures:

1. Asymmetric information
2. Adaptive preferences and risk aversion

3. Externalities and credit rationing for specific sectors

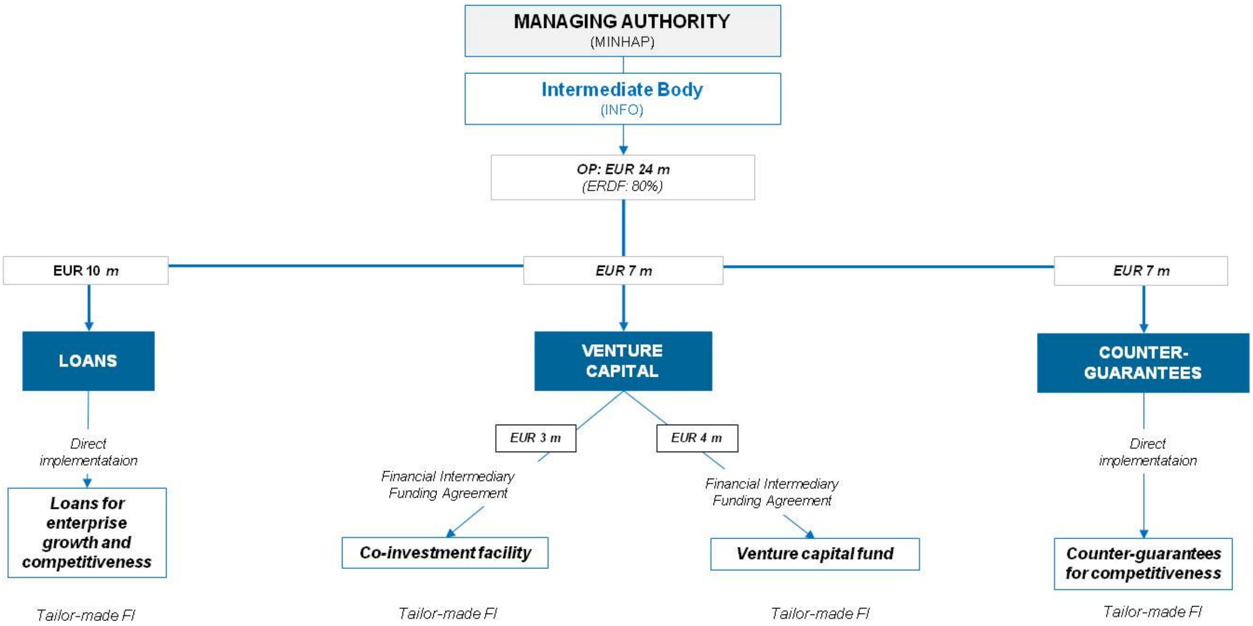
To quantitatively estimate the funding gaps in these three fields, a projection of the public financing needs has been carried out. Funding gaps to the tune of EUR 4.8 m for entrepreneurship, EUR 4.7 m for growth and EUR 34.5 m for guaranteed credit have been estimated. In the case of energy efficiency no funding gap justifying a financial instrument has been identified.

Preliminary proposal of Financial Instruments
Based on the previously carried out analysis, the following financial instruments are proposed:

Financial Instrument	Goal	Investment Priority in the 2014-2020 ERDF Operational Programme	Public contribution
Co-investment Venture Capital - Early Stage	Partially cover the funding gap for early stage venture capital.	3.a	EUR 3.000.000
Venture Capital - Late Stage	Partially cover the funding gap for late stage venture capital.	3.d	EUR 4.000.000
Counter-guarantees	Partially cover the funding gap for guaranteed credit.	3.d	EUR 7.000.000
Loans for enterprise growth and competitiveness	Partially cover the funding gap for business loans.	3.d	EUR 10.000.000

Functioning and management of the 2014-2020 Financial Instruments
Red2Red – Afi-CAP propose the establishment of independent Financial Instruments. This is a result of the foreseen selection of financial intermediaries to manage the venture capital financial instruments, tapping into their management skills, experience and diversification potential. So, the implementation tasks shall be delegated to a private entity in accordance with article 38.4. b) iii) of Regulation 1303/2013.

Alternatively, the counter-guarantee and loan financial instruments shall be directly implemented, as article 38.4 c) offers. It has to be highlighted that the Intermediate Body is deemed to have adequate skills and experience at its disposal to directly manage the financial instruments, as an independent manager would be able to.



1. *Co-investment early stage venture capital Financial Instrument*
   This Financial Instrument is based on the *off-the-shelf* co-investment facility foreseen in Regulation 2016/1157.

   The Financial Instrument for early stages will be established as capital fund managed by a financial intermediary that will invest in SMEs. Additional investments will be leveraged by means of co-investments with private investors on a deal-by-deal basis.

   The financial intermediary will have to contribute at least 1% of total resources in the fund. The remainder shall be drawn from the public contribution of the Operational Programme. The stake in SMEs of the Financial Instrument must be capped at 70%, with a 30% private contribution, for State aid reasons.

   The financial intermediary will sign a funding agreement with INFO and will be responsible for deal identification, due diligence, selection, documentation and execution of all investments in equity and quasi-equity.

2. *Late stage venture capital Financial Instrument*
   This Financial Instrument shall finance SMEs with growth potential. The Financial Instruments must contribute with a maximum of 33% of the total volume of the fund or investment vehicle and the financial intermediary shall contribute with at least 67% of the total resources.

The financial intermediary will sign a funding agreement with INFO and will be responsible for deal identification, due diligence, selection, documentation and execution of all investments in equity and quasi-equity.

3. *Counter-guarantee Financial Instrument*
   It is foreseen that INFO will directly grant guarantees to SMEs as Intermediate Body. INFO will provide a Strategy Document, which will be presented to the Managing Authority and the Monitoring Committee.

   INFO and the entities selected by means of a tender process will sign a re-guarantee contract complementary attached to the previous existence of a re-guarantee contract with CERSA, which must be lower than 75% of the guarantee granted by the selected entity. INFO will grant a counter-guarantee covering principal and interest on the guarantee operations granted by the selected entities. The eligible projects will be the ones previously established in the re-guarantee contract with CERSA.

4. *Loans for enterprise growth and competitiveness Financial Instrument*
   It is foreseen that INFO will directly grant loans to SMEs, as provided by Regulation 1303/2013. INFO will provide a Strategy Document, which will be presented to the Managing Authority and the Monitoring Committee.

   The Financial Instrument is aimed at the lower & middle tier market, i.e. at SMEs in consolidation or expansion and will finance investment projects in Murcia which contribute to growth and business competitiveness, generating and/or maintaining jobs.

   Long term debt will be offered, since this is the type of product that is best tailored to the underlying projects that are intended to be promoted.