

26 MARCH 2018 MEETING

UPDATE ON PROGRESS – CSC PROJECT

REPORT OF CSC PROJECT LEAD AUTHORITY - MONMOUTHSHIRE COUNTY COUNCIL

AGENDA ITEM: 5

Reason for this Report

1. To provide Regional Cabinet with an overview report on progress with delivery of its first investment programme – the CSC Project.
2. To seek variation to pre-condition 4.3 in the Development Agreement for Lease to ensure a reasonable approach is taken to validate tool projections when entering into the next phase of clean room spend.
3. To seek Regional Cabinet approval for any of the Chief Executives in the Cardiff Capital Region to also have delegated decision making authority to approve payments for this project to the Special Purpose Vehicle (SPV) in the absence of the Programme Director.

Background

4. On 2 May 2017, the Regional Cabinet approved investment in the CSC Project, subject to conditions and provisions subsequently discharged at the meeting on 14 July 2017. To advance the project in line with the approved objectives and all legal and contractual agreements, a Special Purpose Vehicle (Company Limited by Shares), CSC Foundry Ltd, was established and incorporated on 28 July 2017. Representatives from all ten Councils have been nominated to serve as Directors on the Board of CSC Foundry Ltd. The third meeting of the board is due to take place on 28 March 2018. In view of the function and responsibility of CSC Foundry Ltd, the Board plays an active and ongoing role in overseeing and monitoring all key aspects of project delivery and implementation. As such, this report aims to provide a high-level overview for the Regional Cabinet, with more comprehensive and detailed information available ongoing via CSC Foundry Ltd.

5. The report provides updates on substantive areas of progress around the following headings: Governance; Risk; Project Progress (Operations Update and Job Creation Update); IQE Market Position and, Cluster Development.

Key Issues

Governance

6. CSC Foundry Ltd, with ten shareholders representing each of the ten Councils, incorporated on 28 July 2017 enabled activation of all of the necessary contracts for the property acquisition and transfer; granting of the lease and enactment of all initial site development works (landlord works) with effect from 3 August 2017. Section 10.6 of the original CSC Project Proposal Report contained a number of conditions and provisions requiring action for discharge and all have been completed.
7. The Board of CSC Foundry Ltd held its first two meetings in October 2017 and January 2018, with its next meeting scheduled for 28 March 2018. The Board meets quarterly and has invested additional time in touring production facilities, becoming acquainted with the Foundry building and establishing product knowledge. Board papers, which include detailed information on project delivery, forward planning, financial profiling, risks and overall project implementation are provided to each board meeting. Board minutes, decisions and actions are approved, recorded, and available to the Regional Cabinet on request.
8. The administration arrangements are working well with strong support from the Accountable Body and project management support from the Programme Management Office (PMO). The process of investment drawdown is effective, and across the Accountable Body and PMO, all monies have been validated, approved and drawn down in a timely way.

Risk

9. A comprehensive and live Risk Register has been a feature of the CSC Project since inception. This continues and the PMO administers monitors and updates the Risk Register on an ongoing basis. The Risk Register is available as part of the Project Update Reports received quarterly by CSC Foundry Ltd. There are currently no new live issues reported, however the Regional Cabinet may wish to note the following points of progress relevant to historic and ongoing risks:
 - Energy security – IQE's negotiation with Scottish and Southern Energy regarding fulfilment of future energy requirements is progressing well with signals that the installation of the required sub-station will converge with the next phase instalment of reactor tools (tools no. 11-30).
 - Planning approvals – the current and extant planning approval has been revised to demonstrate compliance with a restrictive covenant user clause

(applying to the lessee of the neighbouring property owned by Welsh Government) and currently awaits approval.

- Restrictive Covenant – copies of plan revisions demonstrating IQE’s compliance with the area bound by restrictive covenant have been provided to Welsh Government, as the owner of the neighbouring property. These have been made available to the lessee and no further issues have arisen.
- Activation of the Bridging Loan – although the JWA Business Plan is nearing full sign-off and approval by the ten Councils, it has been necessary to activate the Bridging Loan via RCT CBC. An initial RCT Bridge loan of £1.7M has been drawn down. Officers are working on assessing the requirement for the March draw down at the end of this month, which will either be funded by the balance of the RCT Bridge (Reserved Matter NOT discharged) or Council Contributions in the event the reserved matter is discharged.
- Conversion of CSC Foundry Ltd (Company Limited by Shares) to a Limited Liability Partnership – the board has discussed the potential to adapt the company structure. Conversion to a LLP (or other recommended structure) would enable optimisation of tax efficiencies. The matter is scheduled for further discussion at the meeting on 28 March 2018.
- Purchase of surrounding and adjacent land – a number of businesses and establishments in the CSC supply chain have now made enquiries regarding securing closer proximity to the Foundry. In addition, there are opportunities to situate a Skills Academy on the site. Discussions are ongoing with WG around acquisition of the land and given the opportunities attached to it, around growing the Cluster – it is important these talks be brought to fruition.

Project Progress – Operations

10. Progress overall is slightly ahead of projections. By the end of March 2018, ten cleanrooms will have been fully installed with five reactor tools on site and product testing and qualification commencing. Construction of cleanrooms 11-20 is also due to begin from end of March/ beginning of April 2018. There has been a slight delay in relation to dilapidations and ancillary works, mainly relating to unforeseen work to the building roof and to fabricate stairwells, which has taken longer than anticipated. Neither of these issues have an impact on the critical path nor are there associated cost overruns.
11. In terms of project expenditure, the table below demonstrates that against the approved total project investment, of which £37.9m is invested by CCR via CSC Foundry Ltd., the current position is:-

| Investment | CSC Foundry Ltd |
|--|------------------------|
| Committed expenditure to 31 March 2018 | £17.125m |
| Remaining expenditure | £15.32m |
| Total | £37.9m |

* IQE PLC is required to make its agreed project investment as CSC Foundry Ltd. Monies are drawn down.

Project Progress – Economic Impact

12. Progress with economic impact is set out in the table below.

| Job Creation | Target | Progress to Date | Notes |
|---|-----------|---|---|
| Direct Jobs - Newly Created Jobs | 501 | 28 | 28 jobs created in line with expectations. IQE indications show that high value engineering, science and data analyst jobs will be created from mid-end of 2018 onwards as production at the Foundry is yet to commence. |
| Direct Jobs – (Safeguarded jobs) | 156 | 156 jobs safeguarded at IQE St Mellon's | 156 R&D and manufacturing safeguarded jobs at IQE likely to be under threat if CSC Project failed to be enacted. |
| | 550 | 550 jobs safeguarded at Infineon/ Newport Wafer Fab | IQE also intend for this investment to safeguard a further 550 jobs at the existing wafer manufacturing plant that shares the same site (Infineon/Newport Wafer Fab) |
| Induced Jobs – Jobs in the wider economy via spending from employees | 493 | - | KPMG economic impact assessment report suggested potential for up to 493 induced jobs to be created and safeguarded in the wider economy linked to the Foundry development |
| Cluster Development | 3000-5000 | - | <p>4 key elements of success for a cluster project involve – core businesses, support businesses, soft support infrastructure and hard support infrastructure. S Wales already have many key elements and if successful could create significant additional job creation. Current estimates based on similar developments elsewhere could mean 3-5000 jobs during the period over which cluster development occurs.</p> <p>To date, several companies have made approaches regarding re-location. These discussions are ongoing and being connected into WG teams responsible for Foreign Direct and Inward Investment.</p> |

IQE Market Position

13. IQE in partnership with CS Connected, SPTS, Newport Wafer Fab, CS Catapult and Cardiff University, delivered a presentation on CSC activities in the Cardiff Capital Region, at the Wales in London Week at the beginning of March 2018. Immediately following this, Barclays Bank, IQE's lender, issued a report setting out the strength of IQE's market position; the growing CS Cluster in the region and the importance of IQE's joint venture activities. Some of this sought to address issues regarding speculation about IQE's Joint Venture with Cardiff University from stock market short-sellers. Investors and AIM have also commissioned independent reports that arrive at the same positive and favourable conclusion as Barclays. In headline terms, the Barclays report sets out:

- Target share price of £2.10 (at the time of writing this report, the share price fluctuated between £1.40-50)

- Market capitalisation of c£1.08bn
 - The strength and potential of the growing CSC Cluster bringing together cutting-edge research and bridging the gap from research to commercialisation
 - The growing opportunities around continued commercialisation of the CSC technology developed at the CSC Foundry in Newport.
14. In relation to CSC Foundry in particular, the report states: *‘As part of recent developments within the Cluster, IQE is to be the anchor tenant of the new mega epitaxy foundry near Newport, Wales. As announced by IQE and the cluster last year, the facility will ultimately have capacity for 100 tools, with IQE currently installing the initial 5 tools and with a further 15 planned for over 2018/19. We expect the tools being installed presently to support the strong 2H18 volumes we expect as Apple employ the True Depth sensor across the iPhone range from September onwards; the additional 15 tools should support the growth of VCSEL usage into the Android market and initial adoption in other areas’.*
15. The report concludes that *‘Significant economic value can therefore be generated if the entire supply chain can be built out successfully’.*
16. IQE’s year-end trading results were published on 20 March 2018 for the full year ending 31 December 2017. Headline results, include:
- Full year revenues ahead of market expectations at £150m
 - Three primary markets showing sustained (year-on-year) growth in Infrared, Photonics and Wireless
 - 100% growth in target markets such as Photonics (2016 to 2017)
 - Sustainable market leader in production of VCSEL wafers
 - Increase in wafer sales has continued in 2017 to drive an expansion of wafer margins resulting in pre-tax profits for the Group to be ahead of market expectations. Wafer sales in particular are materially higher. This margin expansion is after IQE’s upfront investment in overheads to establish the new Foundry that will begin operations in 2018.
 - A progress report on the Foundry and entry into the second phase of cleanroom installation and investment in a further ten reactor tools
 - Mass market adoption of VCSELS as a key revenue driver in the year and a long term growth driver for the group across a diverse range of applications

Cluster Development

17. IQE has developed and registered the name ‘CS Connected’ as a brand and identity for the CSC Cluster. Discussions are underway with Welsh Government and others already to link to the CS Connected brand such as the CS Catapult, Cardiff University and local supply chain companies, to develop a business case for the growth and development of the Cluster. The number of enquiries into the Foundry and Cluster are growing – from global high profile handset suppliers, to UK-based companies considering re-locating physically in order to be co-located with IQE, the CS Catapult and the supply chain. It is important that discussions and negotiations with WG regarding the sale of the land surrounding and adjacent to the CSC Foundry building be

stepped up given the opportunity to give a physical footprint to the Cluster. In addition, IQE has commissioned a Skills Study that sets out key training, learning and development requirements within the labour market. There is clearly an opportunity, which shall be built into the business case for CS Connected, to establish a Skills and Training Academy on, or close to the Foundry.

18. IQE is also in conversation, supported by Cardiff University and City Deal Lead Authority, with the new UKRI regarding the potential to secure a Single Sector Deal under the auspices of the Industrial Strategy and the Industrial Strategy Challenge Fund.

Validation of Tool Projections

19. As confirmed by the update with project progress construction of cleanrooms 11-20, the next phase of clean room fit-out, is also due to begin from end of March/ beginning of April 2018. The Development Agreement for Lease (DAfL) currently requires a number of pre-conditions to be met before funding can be released to IQE to commence construction of the subsequent phase of work.
20. Pre-condition 4.3 to the DAfL was originally drafted and required IQE to provide its own projections based upon volume estimates from their principal customers sufficient to demonstrate the reasonable view that there will be demand for the 10 clean rooms in the next phase within a reasonable timeframe.
21. Discussions with IQE have been ongoing and as a result of very stringent NDAs and stringent commercial sensitivities that the company must adhere to with its principal customers, IQE is not at liberty to provide detailed volume estimates and projections. We understand that any attempt to reference estimates / projections from its principal customers will result in IQE breaching the terms of the NDAs and exposing itself to significant financial penalties. The reasonableness of the proposed projections must therefore be viewed in the context of the current financial standing of IQE and the supporting independent and publically available information.
22. The company has however been able to provide independent information and provide access to specific publicly available reports, all of which reaffirms the strength of demand from current and projected iPhone sales and where their VCSEL wafers are a component part, as well as demonstrating the expected significant increase in wider global demand for VCSEL wafers from other android handset manufacturers. This has been corroborated and confirmed by further research that has been undertaken and is set out in the Barclays Report referenced above and is a prominent feature within the year-end trading reports for the company for the financial year ending December 2017.
23. Given that IQE currently holds 95% in VCSEL wafer production this translates into there being more than sufficient demand to warrant the further investment in tools for the next phase of clean room investment. The tool projection provided by IQE confirms market projections and anticipated growth and again justifies the subsequent investment in clean rooms 11-20.

24. As a result of what can be validated in order to provide assurance around future demand projections there is a requirement to seek a variation to pre-condition 4.3 of the DAfL. This has been discussed and agreed with legal advisors, who previously advised on the drafting of the DAfL, as being a reasonable and appropriate means to satisfy the pre-condition and that seeks to obtain reassurance around future projections of tool requirements. The variation that is subsequently proposed reads as follows:

“the Tenant has provided to the Landlord the Tenant's own projections of tools requirements and assisted the Landlord in providing independent and publically available information that helps to demonstrate the reasonable view of the Tenant that there will be demand within a reasonable time frame agreed between the Landlord and the Tenant (acting reasonably) for the 10 clean rooms in that Phase in addition to those included in the previous Phase.”

Reason for Recommendations

25. For Regional Cabinet to note the progress in relation to the CSC Project;
26. To approve the variation to the pre-condition 4.3 of the DAfL as detailed in paragraph 23 of this report; and
27. To approve the authority delegated to the Programme Director, in respect of authorisation of recommended payments, be also delegated to any of the CCR Chief Executives / Managing Directors in the absence of the Programme Director.

Financial Implications

28. The report provides an update on progress made against the Compound Semi-Conductor project investment, approved by Regional Cabinet at its meeting of the 14th July 2017. Paragraph 10 of the report confirms that the project remains on time and on budget, with committed expenditure amounting to £17.125 million to the 31st March 2018.
29. The report outlines the need to approve a variation to pre-condition 4.3 of the Development Agreement for Lease (DAfL). Paragraphs 19-24 set out the background and rationale for the change, with Paragraph 24 confirming that the external legal advisors who assisted in the drafting of the DAfL are content that the new arrangements are a reasonable and appropriate means of satisfying the pre-condition. The amended clause will require the Landlord (officers of the Lead Authority on behalf of Regional Cabinet) to seek the appropriate assurances from the Tenant and from independent and publically available information as to the sufficiency of future demand and volume related projections.

Legal Implications (including Equality Impact Assessment where appropriate)

30. The first recommendation is submitted for Members' information in relation to the CSC project. As such this recommendation does not raise any direct legal implications.
31. The second recommendation is to note further business case developments shall be submitted to the Cabinet for consideration. In terms of the need for decisions and other actions to be taken and carried out, it is understood this recommendation falls within scope of a Joint Committee matter as set out in Schedule 1 (Delegations Policy) to the JWA.
32. The third recommendation is to approve the proposed amendment to the Development Agreement and is detailed within the body of the report. The project has had the benefit of external legal advisers who have provided advice, amongst other things, in respect of drafting the Development Agreement generally and the proposed amendment.
32. Pursuant to the Joint Working Agreement the Joint Committee can appoint a Regional Programme Director from time to time to represent the interests of all the Councils in respect of their operational requirements for the City Deal.
33. In considering this matter regard should be had, amongst other matters, to:
 - (a) the Councils' duties under the Well –being of Future Generations (Wales) Act 2015 and;
 - (b) Public sector duties under the Equalities Act 2010 (including specific Welsh public sector duties). Pursuant to these legal duties Councils must in making decisions have due regard to the need to (1) eliminate unlawful discrimination, (2) advance equality of opportunity and (3) foster good relations on the basis of protected characteristics. Protected characteristics are: a. Age; b. Gender reassignment; c. Sex; d. Race – including ethnic or national origin, colour or nationality; e. Disability; f. Pregnancy and maternity; g. Marriage and civil partnership; h. Sexual orientation; i. Religion or belief – including lack of belief

RECOMMENDATIONS

The Cardiff Capital Region Cabinet is recommended to:-

- i) note the update in relation to substantive progress made with the CSC Project ;
- ii) approve the amendment of the pre-condition 4.3 to the Development Agreement for Lease, as set out in the body of the report; and
- iii) approve that delegated authority be extended to any of the CCR City Deal Chief Executives / Managing Directors in the absence of the Programme Director.

**Kellie Beirne, Deputy CEO, Monmouthshire County Council &
Peter Davies, Chief Officer, Resources, Monmouthshire County Council
20 March 2018**

Background Papers:

https://www.insidermedia.com/insider/wales/record-revenues-at-ige?utm_source=wales_newsletter&utm_campaign=wales_news_tracker&utm_medium=top_story_article