Update of the Ex-Ante Assessment of the Wales Business Fund

Final Report by Regeneris Consulting

July 2018

Welsh European Funding Office

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Contents Page

Appendix A - Consultee List

1. Introduction

Overview of the WBF

1.1 The Wales Business Fund (WBF) continues a long-term commitment within Welsh Government with the support of the European Union to using repayable financial instruments to address market failures in the provision of external business finance to SMEs in Wales. It builds on the success of the Wales JEREMIE Fund which invested over the period 2009-15, providing a key stream of finance to early stage and growth orientated businesses across Wales and securing substantial economic benefits.[1]

1.2 The use of repayable financial instruments provides a number of distinct advantages over traditional grant finance. They balance addressing market failures and securing economic benefits, with the recycling of finance for reuse in future periods. As the Wales JEREMIE Fund final evaluation noted, it also encourages the private sector to become more active in parts of the market, investing alongside the public sector backed funds and hence sharing risks and rewards.

1.3 The WBF is a £171m fund split into four operations which are defined by the geographies of the two 2014-20 ERDF programmes in Wales (East Wales and West Wales and the Valleys) and the thematic investment focuses of these programmes. The investment focuses are around the provision of finance for:

- business start-up and for business expansion (Specific Objective 2.1)
- innovative and R&D orientated early stage and growth orientated SMEs (Specific Objective 2.5).

1.4 The £171m fund size includes ERDF, Financial Transaction Capital (FTC) and Legacy funding. Following a re-evaluation of the ERDF programme, FTC and Legacy funding have been removed from the ERDF operation, but remains part of the overall WBF as funds to be invested after the ERDF operation period.

1.5 The WBF has already undergone modifications since its launch in June 2016. The WBF was initially proposed as a £136m fund following the original ex-ante assessment. The Business plan was then revised to account for an additional £45m being added to the fund, as a result of the availability of an increase in ERDF needing to be allocated earlier in

[1] Regeneris Consulting, Final Evaluation of the Wales JEREMIE Fund, 2016

the programme period. £35m of this £45m has been secured, with the potential for the additional £10m to be added at a later date. The delivery profile and targets of the fund were then revised again to take into account the additional £35m that has been secured.

Table 1.1 Wales Business Fund Allocation (£m)			
	Original ERDF Contract	**Revised Business Plan (+£45m)**	**Revised ERDF Contract (+£35m)**
Spatial			
EW	£45.1	£55.4	£45.3
WW	£90.7	£125.5	£125.5
Strategic Objective			
SO 2.1	£113.8	£134.3	£129.7
SO 2.5	£22.1	£46.6	£41.2
Total	**£135.9**	**£180.9**	**£170.9**

Source: WBF Business Plan and Delivery Profile. *refers to additional £35m

Table 1.2 Wales Business Fund – Core Outputs			
	Original ERDF Contract	**Revised Business Plan (+£45m)**	**Revised ERDF Contract (+£35m)**
No of enterprises invested in	415	522	491
Direct investment £m	£135.9	£180.9	£170.9
Deal level leverage £m	£75.9	£139.0	£115.1
Jobs created	3585	4208	3938
No. enterprises supported to introduce new to the firm products	25	47	47

Source: WBF Business Plan and Delivery Profile

Conclusions from the original ex-ante assessment

1.6 In line with Article 37 of the Common Provision Regulation and the European Commission guidance, the ex-ante assessment consisted of the following:

- An analysis of market failures, suboptimal investment situations, and investment needs for policy areas and thematic objectives or investment priorities to be addressed with a view to contribute to the achievement of specific objectives set out under a priority and to be supported through financial instruments.
- (b) An assessment of the value added of the financial instruments considered to be supported by the European Structural and Investment Funds, consistency with other forms of public intervention addressing the same market, possible state aid implications, the proportionality of the envisaged intervention and measures to minimise market distortion.

- (c) An estimate of additional public and private resources to be potentially raised by the financial instrument down to the level of the final recipient (expected leverage effect), including as appropriate an assessment of the need for, and level of, preferential remuneration to attract counterpart resources from private investors and/or a description of the mechanisms which will be used to establish the need for, and extent of, such preferential remuneration, such as a competitive or appropriately independent assessment process.
- (d) An assessment of lessons learnt from similar instruments and ex ante assessments carried out by the Member State in the past, and how these lessons will be applied going forward.
- (e) The proposed investment strategy, including an examination of options for implementation arrangements within the meaning of Article 33, financial products to be offered, final recipients targeted, envisaged combination with grant support as appropriate.
- (f) Provisions allowing for the ex-ante assessment to be reviewed and updated as required during the implementation of any financial instrument which has been implemented based upon such assessment, where during the implementation phase, the managing authority considers that the ex-ante assessment may no longer accurately represent the market conditions existing at the time of implementation.

1.7 The market assessment confirmed the persistence of market failures for debt and equity finance, although the nature of these market failures vary to some degree between the stage of business development and type of finance. It also concluded that the manner in which the market failures constrain the supply of business finance had been significantly accentuated by the recession and financial crisis.

1.8 The ex-ante assessment stated that, whilst the guidance seeks a quantification of the finance gap, it is challenging to (i) quantify the scale and nature of the gap which is accounted by market failure and to (ii) provide clear and unambiguous recommendations of the optimum scale and type of public sector intervention. The reasons for this are that the finance gap is not directly observable and is also shaped by the public sector's own preferences for balancing risk and return (both financial and economic development). These caveats also apply to this updated assessment.

1.9 The assessment pointed to investment to Welsh SMEs of between £23m and £31m per year or £116m to £155m over five years (excluding microloans). However, the robustness and continued appropriateness of this conclusion was dependent on a number of factors including: the prevailing market conditions; resolving any remaining uncertainty over the SME eligibility rules; and the risk and return profile which was adopted in practice during the investment period (recognizing that the balance of risk and reward of investment can fluctuate within the investment operating guidelines).

1.10 Overall, the ex-ante assessment concluded that there was a good alignment of the proposed investment strategy for the WBF to the market evidence. The proposed WBF annual investment rate was, at £19.4m, lower than the ex-ante assessment although this reflected an assumed longer investment period (7 years compared to 5 years assumed in the ex-ante assessment). A summary of the conclusions from the ex-ante assessment are outlined in the table below.

Table 1.3 Ex-ante Assessment Conclusions

Focus	Conclusion
Investment Rate	The assumed steady state rate for years 1-5 with c25% uplift in years 6 and 7, reflected a combination of the availability of funds to invest (given timing of returns from JEREMIE) and the greater need for follow-on in later years. The ex-ante assessment concluded the following annual upper investment limits: • Equity/mezzanine - £19m • Loans - £12m • Total - £31m
Spatial	The 60:40% split in investment between West Wales and the Valleys and East Wales was deliverable but it might be challenging to achieve an annual investment rate of £19.2m in WWV (especially for the risk capital investment associated with Strategic Objective 2.5)
Sectoral	The preferred generalist approach reflected Finance Wales's experience and the lessons from ERDF backed funds across the UK, whilst also balancing Welsh Government's sectoral priorities and the need for flexibility.
Default Rates	The operational plan uses higher rates than original or current actual JEREMIE rates which reflects a conservative approach
Operating Costs	At an assumed 27% of funds under management, the operational costs (including fund management fees) were judged to be reasonable and within acceptable benchmarks.
Returns	The assumed return of £75m after repayment of Financial Treasury Reserve (giving a net IRR of around -5%) was concluded to be in line with current experience in Wales and rest of UK.

Scope of this updated assessment

1.11 The updated ex-ante assessment has been triggered by a scheduled review to take place 3 years after the approval of the Fund, as well as coinciding with proposals to add additional amounts of ERDF to the Fund. This updated assessment will cover:

- Part A:
  - An analysis of the performance of the WBF to date, looking at investment rates, spatial patterns, and progress against KPIs.
  - An assessment to determine whether the current focus of the WBF is still consistent with policy priorities, given the changes in the economic & political landscape compared to the original ex-ante assessment.
  - An assessment of the economic performance in Wales, and changes in the demand and supply for SME finance compared to the original ex-ante assessment.
  - The implications of any notable changes in the SME finance market on the finance gap.
- Part B

  An assessment of the proposed changes to the Investment Strategy, focussing on the continued relevance, consistency and appropriateness of the Investment Strategy and hence the ERDF contract.

PART A

2. Performance of the WBF

Investment Performance

Business Plan modifications

2.1 There has been a series of modifications to the WBF, relating to both its size, funding sources, and profile of funding.

2.2 The WBF was initially proposed as a £136m fund following the original ex-ante assessment. After the fund began investing in August 2016 WEFO and Finance Wales began discussing the potential for an increased fund size as more ERDF had become available within Priority 2. As a result of these discussions Finance Wales developed a revised business plan in October 2016 to account for an additional £45m.

2.3 £35m of this has so far been secured, with the other £10m potentially being injected at a later date depending on the implementation of ERDF programme modifications & the conclusions of this assessment. The reasons for this are:

- The upper annual investment rate in the range identified in the original ex-ante assessment may be exceeded if the additional £10m is made available.[2] That is, the overall investment rate is 31% higher than the profiled investment rate.
- ERDF programme modifications - WEFO are in the process of proposing an ERDF programme modification. The additional £10m is available due to an underspend in Priority Axis 2 (which the WBF is a part of) and in Priority Axis 3: Supporting the Shift to a Low Carbon Economy. This has been earmarked to be injected into the WBF.

2.4 Therefore, the delivery profile and targets for the WBF were amended in November 2016 to account for the additional £35m only. £30m was allocated to the West Wales and the Valleys operations and £5m was added to the East Wales operations given the restrictions on the amount that could be injected into East Wales without the need for a programme modification. A summary of these revisions are outlined in Table 2.1.

[2] If late stage equity investment is combined with mezzanine investment, this would cause the upper annual investment rate to be exceeded. However, if mezzanine is not considered as part of equity (as it currently being treated in the WBF) then the upper annual investment rates will not be exceeded.

Table 2.1 Wales Business Fund Allocation, (£m)

	Original ERDF Contract	Revised Business Plan (+£45m)	Revised ERDF Contract (+£35m)
EW	**45.1**	**55.4 (+23%)**	**45.4 (+1%)**
Loan	*30.2*	*27.9 (-8%)*	*22.9 (-24%)*
Equity	*14.9*	*27.5 (+85%)*	*22.5 (+51%)*
WWV	**90.8**	**125.5 (+38%)**	**125.5 (+38%)**
Loan	*34.7*	*60.6 (+75%)*	*60.6 (+75%)*
Equity	*56.1*	*64.9 (+16%)*	*64.9 (+16%)*
Total	**135.9**	**180.9 (+33%)**	**170.9 (+26%)**
Loan	*64.9*	*88.5 (+36%)*	*83.5 (+29%)*
Equity	*71*	*92.4 (+30%)*	*87.4 (23%)*

Source: WBF Business Plans and Delivery Profile

Note: The reduction in the loan allocation in EW is due to the reprofiling of funding (the addition of ERDF and reduction in FTC and legacy).

2.5 As well as changes to the Fund size, there has also been changes to the profile of the funding. The WBF was initially proposed of three funding sources:

- £76m ERDF
- £60m FTC and legacy
- £75.9m deal level match funding

2.6 Following the re-evaluation of the programme, FTC and Legacy funding was removed from the ERDF operation, but remains part of the overall WBF as funds to be invested. FTC/Legacy will largely be invested after the ERDF investment period. ERDF and deal level match funding investment has been frontloaded given the availability of an increase in ERDF needing to be allocated. FTC/legacy will be invested later in the investment period for the WBF, but mainly outside of the ERDF investment period. A summary of these changes are shown in the table below.

Table 2.2 Wales Business Fund – Changes to Funding Sources (£m)

	Original			Current		
	ERDF	FTC/Legacy	Match (deal level)	ERDF	FTC/Legacy*	Match (deal level)
WWV 2.1	£50.8	£25.3	£50.8	£74.8	£0.0	£74.8
WWV 2.5	£14.7	£0.0	£14.7	£20.7	£0.0	£20.7
EW 2.1	£8.0	£29.7	£8.0	£9.9	£0.0	£12.4
EW 2.5	£2.4	£5.0	£2.4	£5.5	£0.0	£7.2
Total WBF	**£75.9**	**£60.0**	**£75.9**	**£110.9**	**£0.0**	**£115.1**

Source: WEFO.

Note: Figures refer to the ERDF investment period only.

*The current position is shown as £0, however FTC has already been invested for some projects in EW. FTC/Legacy will now be invested after the ERDF investment period.

Strong early investment rate

2.7 The WBF has made a very strong start, exceeding its investment targets at this stage in terms of the overall investment value and number of investments made. As of March 2018, it has made 125 investments against a target of 109, investing £49.9m compared to its target of £38.1m. This overall investment rate is 31% higher than the profiled investment rate, and is also higher than the annual averages assumed in the ex-ante assessment.

2.8 An analysis of investment by type of finance and by programme area is presented later in this section. Table 2.3 below illustrates the strong overall annual investment rate that has been achieved.

- The fund has performed very strongly in East Wales for both loan and equity finance, with an annual average investment rate above that of the revised delivery plan.
- Annual average investment has been lower in WWV compared to the annual average in the revised delivery plan.
- Overall, annual average investment for the WBF is above the assumed rate in the revised delivery plan for loan investment but lower for equity investment. This reflects to an extent the longer lead in time taken to stimulate equity investment deal flow.

2.9 It should be noted that the annual averages presented in the table below do not take into account the projected increase in the annual investment rate later on in the investment period (particular for equity investments) which the DBW have profiled into their delivery plan. The comparisons to the profiled rate of investment is presented later in this section.

Table 2.3 Annual Investment Rates (as at Q1 2018, £m)

	Total Investment	Annual Investment Rate (to date)	Revised Delivery Plan (Annual Average)	Variance
EW	**25.1**	**14.3**	**6.5**	**+7.8**
Loan	*11.3*	*6.5*	*3.3*	*+3.2*
Equity	*13.7*	*7.9*	*3.2*	*+4.6*
WWV	**24.5**	**14.0**	**17.9**	**-3.9**
Loan	*18.3*	*10.5*	*8.7*	*+1.8*
Equity	*6.2*	*3.5*	*9.3*	*-5.7*
Total	**49.6**	**28.3**	**24.4**	**+3.9**
Loan	*29.6*	*16.9*	*11.9*	*+5.0*
Equity	*20.0*	*11.4*	*12.5*	*-1.1*

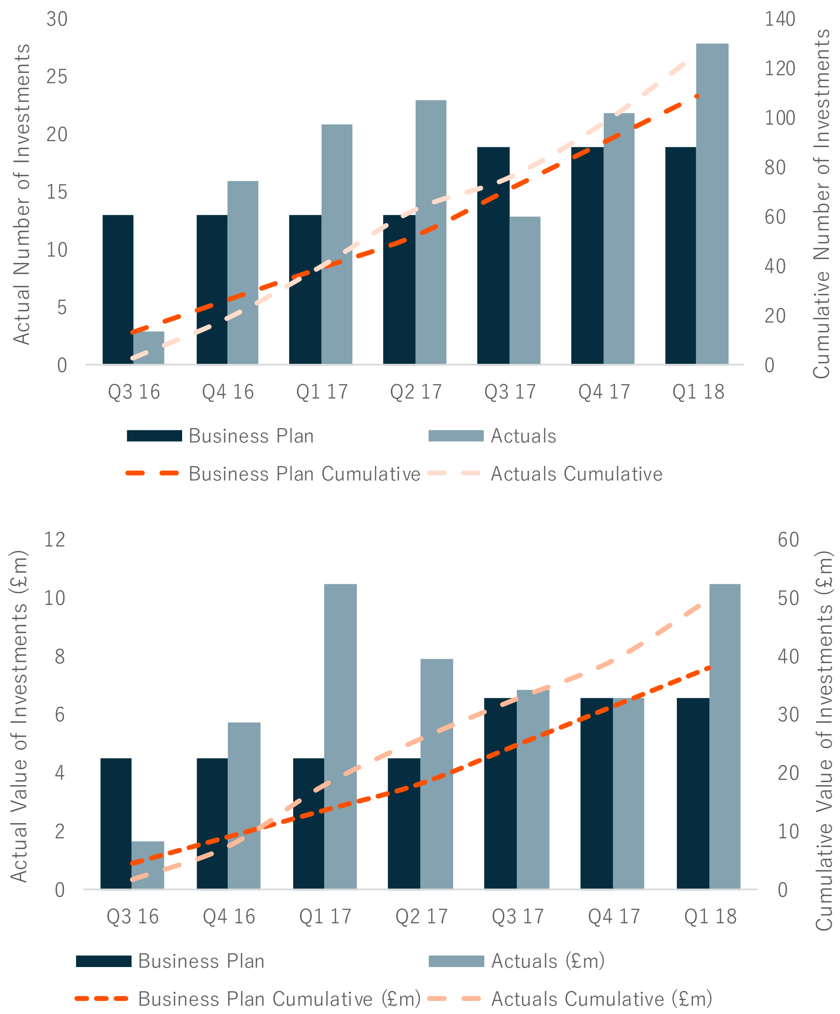
Source: WBF Monitoring Reports and Delivery Profile

2.10 This strong investment rate has been driven in large part by market conditions – the DBW has experienced very strong demand from SMEs that have been unable to obtain debt finance from their banks, as it appears that banks have stuck with their tight lending policies following the recession (see Section 4). Other reasons for the high investment rate include the following:

- Consultations suggests that the Brexit vote, and the anticipated economic impact of this, has yet to have a detrimental impact on the demand for external business finance amongst SMEs.
- The DBW has developed a closer relationship with Business Wales (BW) than has been the case in the past. This appears to have acted as a good gateway to the DBW for some companies seeking financial support and has contributed to high deal flow.
- The DBW now manage and deliver a large number of funds, targeted at a variety of business types (see Table 3.2). This means that the DBW has direct contact and exposure to a large number of businesses receiving support from multiple investment funds operated by the Bank. Whilst these businesses may not have been suitable for WBF investment at the time they approached DBW, over time many may have become suitable for WBF investment (ie through growth because of investment

from other funds). Therefore the other funds act as a pipeline for suitable SMEs to the WBF.

Figure 2.1 Number and Value of WBF Investments, Q3 2016 to Q1 2018



Source: WBF Monitoring Reports

Type of Finance

2.11 The Business Plan envisaged a 49:51 split between debt and equity (by value of investment). The latest quarterly report shows that loan investments account for 60% of total investment to date. There are various reasons for this difference compared to the Business Plan:

- The Fund is still relatively early on in its lifetime. It takes more time to generate deal flow for equity investment in particular with Welsh SMEs, given the cultural equity aversion that is present amongst a large proportion of these SMEs, and the importance of follow on investment with investee companies which builds up over time. The DBW are confident that the equity investment rate will increase.

- Equity investments require 30% co-investment from a private independent partner. Consultations with DBW staff suggests that this has been challenging to achieve, given the natural aversion to equity by some SMEs and the lack of equity finance providers within the market.

- As Figure 2.2 shows, the value of equity investments in WWV is less than half that of the value in East Wales. Reasons for this are primarily due to the sectoral make-up of the SME business base in these areas. There are currently more SMEs in East Wales suitable for equity investment, such as early stage technology companies and University spinouts. The growth in the number of accelerator and incubator spaces in East Wales has also reportedly played a role in the high demand for equity investment and therefore the high equity investment rate in EW compared to WWV. However in WWV, there are major universities such as Bangor, Aberystwyth and Swansea, which have received ERDF investment in R&D, which could create a pool of spinout companies which may be suitable for equity investment.

Figure 2.2 Investment type by programme area (as at Q1 2018, £m)

Source: WBF Monitoring Reports

2.12 There have so far been no deals classified as mezzanine investments (these are classified as part of the loan sub-fund). Reasons for this include the lack of clarity upon the definition of a mezzanine investment as well as a perceived lack of demand for this in the market. As a result of this, mezzanine investment has been removed from the WBF. If a mezzanine investment is to be made, it will be made from the loan sub-fund.

Table 2.4 WBF Investment to Date, by Finance Type (as at Q1 2018 £m)

	Amount Invested	% of Current Delivery Profile	Business Plan Split Assumption	Actual Split
Equity	£20.0	101%	51%	40%
Loans	£29.9	242%	49%	60%
Total	£49.8	130%	100%	100%

Source: WBF Monitoring Reports. Note: mezzanine investment is included in the loans sub-fund

High investment rate in East Wales

2.13 The WBF is a pan Wales programme but is allocated between the two ERDF programme areas. Whilst the value of investment in each area has been similar, the investment rate compared to the business plan assumptions is notably different.

Table 2.5 WBF Investment to date, by Programme Area (as at Q1 2018, £m)

	Amount Invested	Profiled Investment	% of Delivery Profile
EW	£25.1	£5.3	476%
WWV	£24.7	£32.8	75%
Total	£49.8	£38.1	131%

Source: WBF Monitoring Reports

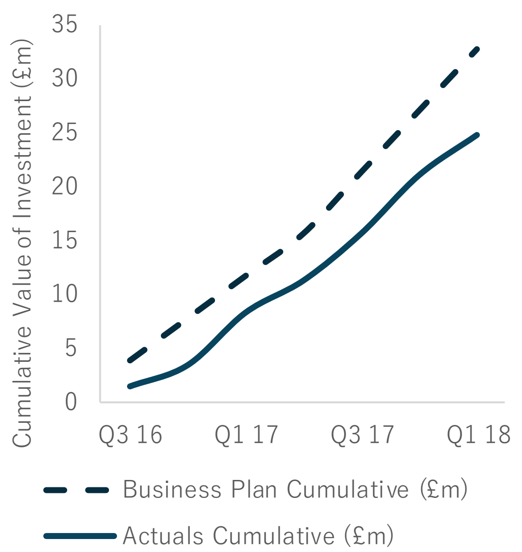
2.14 The investment rate in East Wales, in terms of both the number and value of investments, is far higher (+£19.8m) than the profiled level. Market conditions and the demographics of the SME business base has played a role here. Banks appear to have stuck to their tight lending policies, and so the DBW has therefore moved into this space of acting as the prime lender. Further, there is a far higher SME density in East Wales compared to WWVs, which in conjunction with the market conditions, has resulted in a greater level of demand for finance.

2.15 Other DBW managed funds have also played a role here too and have helped feed companies into the WBF. For example, the Technology Seed Fund has acted as a gateway for companies into the WBF. It has also had a high investment rate in East Wales, due to the growing number of technology and early stage companies in areas in East Wales such as Cardiff. This has meant there are a large number of companies who, once receiving tech seed investment, move onto WBF growth orientated investment (equity investment in particular).

2.16 Investment in WWV has lagged behind its profiled investment rate. There are a few reasons for this:

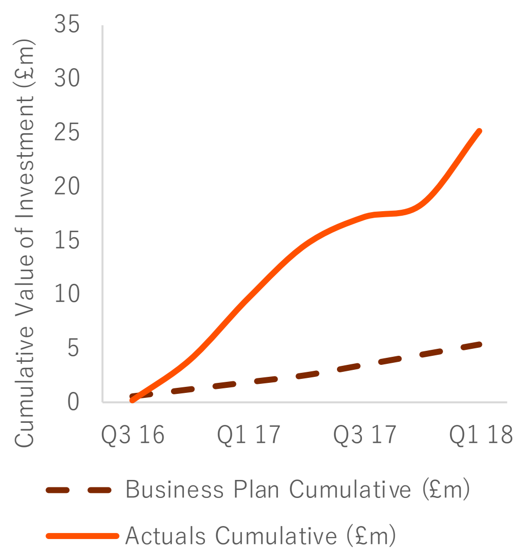
- The targets and outputs set for WWV are recognised by the DBW as ambitious, given the scale of the business base there, and increase in the annual investment rate of the WBF compared to the Wales JEREMIE Fund (an annual average of around £18m per year compared to £14m per year for the Wales JEREMIE Fund).
- The DBW has undergone expansion in terms of its staff, with a view to establishing a greater presence in WWV[3]. This is because, given the closure of many high street bank branches in these areas, it is important to have a presence there on the ground to stimulate deal flow. Naturally, it has taken time to recruit the appropriate staff, which has resulted in a time lag and therefore a lower investment rate compared to the Business Plan.

Figure 2.3 Value of WBF Investments in West Wales and The Valleys



Source: WBF Monitoring Reports

Figure 2.4 Value of WBF Investments in East Wales



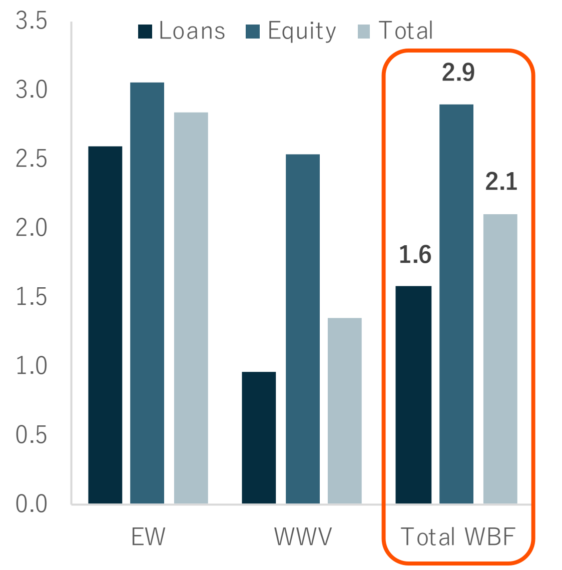
Source: WBF Monitoring Reports

[3] The DBW unveiled its new HQ in Wrexham which will accommodate around 50 jobs by 2020/21. The DBW also has other offices in WWV in St Asaph and Llanelli. The St Asaph office will close once the Wrexham office becomes operational.

High induced investment

2.17 The Business Plan assumed that by the end of Q1 2018, £39.6m private sector investment would be leveraged alongside the WBF direct investment[4]. The fund has significantly exceeded this target, with around £105m private sector investment induced. This has been driven by some exceptionally high levels of co-investment, particularly in later stage equity funding. For example, seven deals account for over 50% of this induced investment.

Figure 2.5 Induced Investment Ratio, as at Q1 2018



Source: WBF Monitoring Reports

2.18 Both the amount and ratio of induced investment has been higher in EW compared to WWV. Around £71.3m (or 68% of all investment induced) has been in East Wales, compared to £33.2m in WWV. Unsurprisingly, the ratios are higher for equity investments given both the small number of high co-investments in later stage equity funding, and the requirement that all equity investment must include 30% co-investment from a private independent partner.

Economic Development Performance

2.19 When interpreting performance against economic development indicators, it should be borne in mind that many of these outcomes will be realised in the future, particularly for investment in early stage and start-up businesses.

2.20 The data does show that the WBF is performing ahead of expectations on many of the KPIs. However, on one of the core targets, jobs created, it is lagging behind target, mainly as a result of (i) lower than profiled investment rate in WWV, and (ii) the DBW is still awaiting

[4] Including investment by the businesses beneficiaries and external investors

receipt of all of the questionnaire forms from beneficiary SMEs which state these impacts.[5] Nevertheless this represents encouraging performance for the other value added KPIs.

Table 2.6 WBF Economic Development KPIs (as at Q1 2018)

	Achieved to date	Target		% of Target	
		To Date	Lifetime	To Date	Lifetime
Jobs Created	190	314	3,939	61%	5%
Jobs Safeguarded	1,391	1,554	6,978	90%	20%
New to firm products	13	4	47	325%	28%
Cooperating with supported research institutions	10	2	26	500%	38%
New to market products	10	3	34	333%	29%
Patents registered	8	2	30	400%	27%

Source: WBF Monitoring Reports

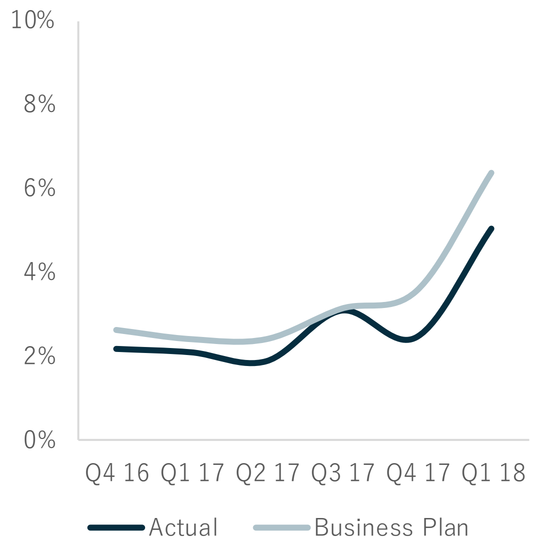
[5] The DBW issues a questionnaire on the first and subsequent anniversaries of investment to SMEs that have received investment, asking them to state their outputs. As the latest data is up to Q1 2018, the timing of this means it may be that SMEs haven't completed the questionnaires yet.

Financial Performance

Defaults and Write-offs

2.21 The overall default rate for the WBF has been consistently below the target set out in the Business Plan. This is based solely on specific provisions as there have been no write-offs to date.

Figure 2.6 Default Rate for WBF



Source: WBF Monitoring Reports. Note: Default rate = actual write off and specific provisions as a % of capital invested)

2.22 Whilst it is still fairly early in the investment life of the fund, consultations with the DBW suggests that the quality of propositions coming forward to the DBW so far have been better than expected. A suggested reason for this is the close relationship the DBW has established with Business Wales (BW). This was a key feature of the Business Case put forward by the DBW to WEFO. In practice, this means that there is sharing of knowledge between the two organisations and many companies are receiving support and advice on their business propositions prior to approaching the DBW for funding, and the DBW are referring some SMEs to Business Wales to strengthen their plans prior to receiving investment.

Operating Costs

2.23 The total fund operating costs so far are presented in Table 2.7. These costs are roughly in-line with the projections in the Business Plan, despite experiencing a higher rate of investment. Total gross operating costs currently represent around 19% of the amount invested. This compares to 18% for 20 ERDF-backed Venture Capital and Loan Funds reviewed as part of Regeneris' national evaluation work and 27% for the Wales JEREMIE Fund.

Table 2.7 WBF Operating Costs (£millions)

	Business Plan	Actual	Variance (%)
Management Fees	£6.0	£5.6	94%
Holding Fund Fee	£3.6	£3.4	94%
Professional Fees	£0.2	£0.5	215%
Total	£9.8	£9.5	**97%**

Source: WBF Monitoring Reports

3. Continued Relevance and Consistency

3.1 The original ex-ante assessment was undertaken in June 2013. The main SME competitiveness policy conclusions at that time were:

- In Wales, there was a pronounced policy shift away from non-repayable grants to re-payable investments. This further strengthened the policy rationale for the FI based funds and the Development Bank of Wales (then known as Finance Wales).
- Private sector market failure (and in particular risk averseness by banks at the time) was a key, on-going concern for Welsh Ministers in terms of economic development. From a policy perspective Finance Wales was therefore being expected to play an increasingly proactive role in funding SMEs rather than acting as a funder of last resort.
- There was a focus on nine priority sectors and the strategy for business support shifted towards a more sector focussed approach.
- Across the UK, a number of reviews on access to finance were published. These outlined a range of interventions and policies to address the market failures affecting SMEs to raise finance, but that interventions should not be used to distort the competitive market mechanism by propping up inefficient businesses. One of the main outcomes of this was the establishment of the British Business Bank, a UK government funded bank to help SMEs access finance. Many of the schemes operated by the British Business Bank are available to SMEs in Wales.

3.2 Since the original ex-ante assessment, there have been numerous important policy announcements relevant to SME competitiveness and access to finance. These are summarised below.

UK – The Industrial Strategy

3.3 The main relevant policy document produced for the UK since the original ex-ante assessment is the National Industrial Strategy White Paper (November 2017). This sets out a long-term plan to boost productivity in the UK. It included various interventions to improve the supply of finance to businesses, and thus confirmed that access to finance was still recognised by policy makers as a challenge that SMEs face. Interventions announced include:

- An Action Plan to help unlock over £20bn of patient capital investment to finance growth in innovative businesses.
- A new £2.5bn investment by the public sector into the British Business Bank, which would be co-invested with the private sector resulting in £7.5bn total investment. The investment focus is to make it easier to finance innovation and provide venture capital needed for knowledge-intensive, high-growth businesses to scale up.
- A commercial investment programme run by the BBB to support the development of clusters of business angels outside London.
- An extension of the BBB's enterprise finance guarantee scheme to March 2022.

3.4 On the demand side, the roll out of a network of British Business Bank regional managers was also announced. The intention of this is to improve demand side conditions by ensuring businesses are informed on how to access different sources of investment.

Wales – Prosperity for All: Economic Action Plan

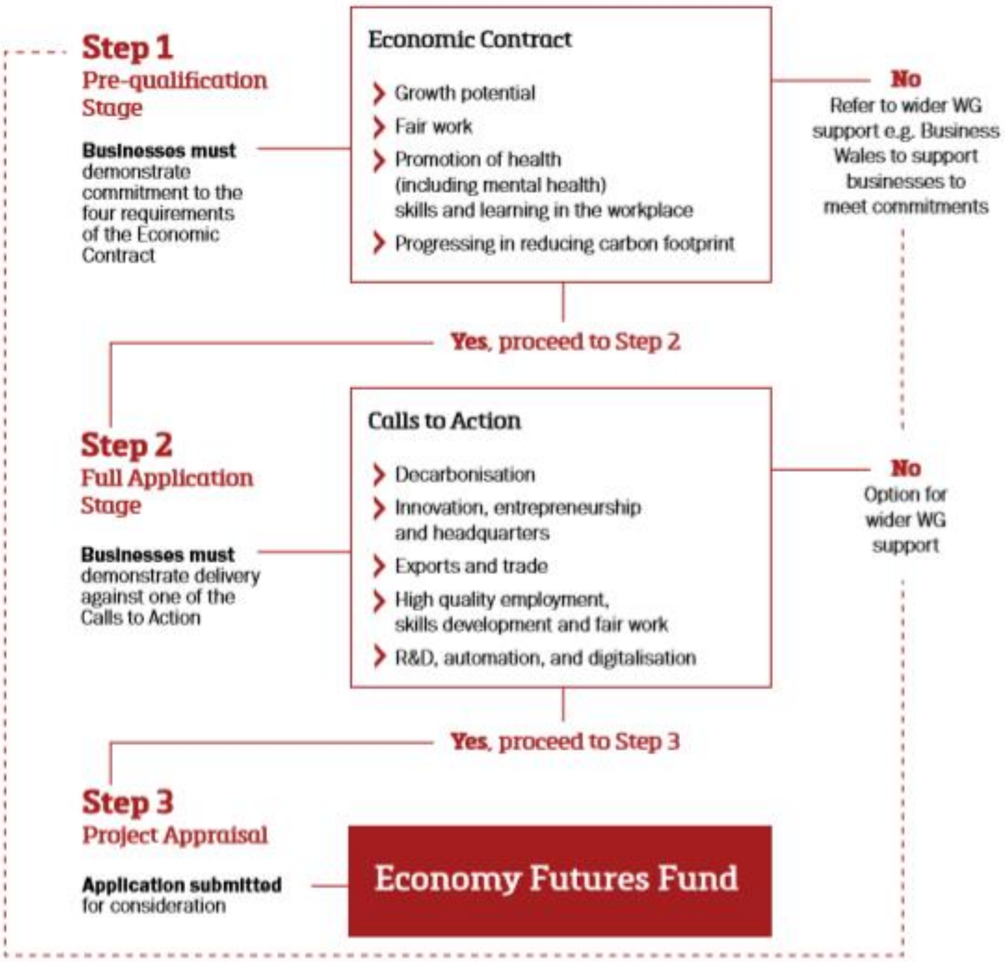
3.5 Prosperity for All: Economic Action Plan was published in December 2017, setting out how inclusive economic growth and reduced inequality will be achieved in Wales. The key relevant changes compared to the previous Welsh economic strategy relates to the new Economic Contract and the priority sectors.

Economic Contract

3.6 In terms of SME competitiveness, the Economic Action Plan outlines the new Economic Contract between businesses and government to stimulate growth. The Economic Contract will initially apply solely to direct Welsh Government (WG) financial support, but it may be extended to other parts of the public sector, including the Development Bank of Wales. It will require businesses seeking investment from WG to demonstrate certain commitments before support is provided. These commitments are outlined in Figure 3.1. The Economy Futures Fund referenced below is a simplified consolidated fund referring to financial support direct from WG. It will not include the commercial finance provided through the Development Bank of Wales.

3.7 The WBFs core outputs and targets are based on the requirements of the ERDF contract. The WBF also monitors other value added KPIs. Many of these are consistent with the requirements in the Economic Contract. Whilst businesses seeking investment from the DBW do not need to fully meet the requirements for the Economic Contract at this stage, it nevertheless should be borne in mind that these requirements may be extended to supported businesses of the DBW in the future.

Figure 3.1 Wales Economic Contract



Source: Prosperity for All: Economic Action Plan, Welsh Government, 2017

Priority Sectors

3.8 Also of relevance to SME competitiveness is the sectoral approach to business support. The priority sectors identified in the Economic Action Plan have been split into two groups: thematic sectors and foundation sectors.

3.9 The thematic sector approach recognises that the boundaries between sectors are becoming increasingly blurred due to innovation and technological change. These National Thematic Sectors will be the priority sectors that the Welsh Government will proactively work with.

3.10 The Foundation sectors are seen as *"the backbone of local communities across Wales".* They are the sectors that provide essential goods and services to residents, and in some areas (ie rural areas) they are the main source of economic activity.

Table 3.1 Wales Priority Sectors

Thematic Sectors	Foundation Sectors
Tradeable services (eg Fintech)	Tourism
High Value Manufacturing (eg compound semiconductors, composites manufacturing)	Food
Enablers (eg digital, energy efficiency, renewables)	Retail
	Care

Source: Prosperity for All: Economic Action Plan, Welsh Government, 2018

3.11 The WBF does not have specific sector targets - it was intentionally designed to be flexible in order to respond to demand and maintain investment rates. As such, the WBF is still consistent with the sectors identified in this Economic Action Plan.

Spatial Planning

3.12 The Wales Economic Action Plan also puts more emphasis on spatial planning with regards to economic development and regeneration. The Action Plan commits to a regionally focussed model of economic development, with the aim to *"develop the distinctive strengths of each region in pursuit of growth, but to do this inclusively, recognising and addressing the regional disparities in wealth and opportunity between different parts of Wales."*

3.13 This includes developing a robust governance model that aligns the economic regions to those used for other initiatives and local government collaboration: North Wales, Mid and South West Wales, and South East Wales.

3.14 The expected benefits that this regionally focussed model of economic development will bring include:

- Joined up economic development planning.
- Stronger local and regional supply chains.
- Better integrated transport.
- Strategic planning on a range of issues from land use to housing to skills.
- Stronger complementary economic and cross border collaboration.

3.15 The WBF's spatial approach to investment is based on ERDF programme areas. This does not necessarily contradict the approach proposed in the Economic Action Plan - it reinforces and confirms the regional investment infrastructure that the DBW has put in place (including strong links developed with each of 3 Welsh regions), and this therefore aligns with the Economic Action Plan going forward.

Brexit

3.16 A key event in the policy landscape was the vote by the UK to exit the EU in 2016. In March 2017, the UK government invoked Article 50 of the Treaty of the European Union, meaning the UK will leave the EU in March 2019.

3.17 The exact nature of the relationship with the EU post Brexit is still being negotiated. As such, no strategy or policy documents have been produced, and the future relationship remains unclear. However, in Autumn 2016 the Chancellor confirmed that the UK Government will guarantee EU funding for structural and investment fund projects, signed after the Autumn Statement and which continue after the UK has left the EU. This provides reassurance that funding for the WBF will still be available to be drawn down in-line with the delivery profile of the fund.

3.18 Looking ahead, based on existing national polices, access to SME finance is likely to remain a key priority for governments, regardless of the nature of the UK and EU's relationship.

The Development Bank of Wales

3.19 The Development Bank of Wales Investments (14) Ltd is the appointed Holding Fund manager for the WBF (i.e. managing and administering the fund on behalf of Welsh Government), as an Entrusted Entity. DBW FM Ltd are the fund managers for the WBF, responsible for managing the investment with SMEs..

3.20 A Task and Finish Group was appointed by the Minister for Economy, Science and Transport in June 2014 to produce a report on the possible form, function and feasibility of a Development Bank for Wales (DBW). The report identified a number of issues with regards to the provision of finance for Welsh SMEs, and that there was a geographic bias regarding the availability of bank credit, informal investment and venture capital to businesses in Wales.

3.21 The report concluded that a more efficient government intervention should be implemented compared to what was currently in place. Therefore, a new institution was

REGENERIS

proposed - the DBW - that integrated the functions of Finance Wales and would be the UKs first regional development Bank.

3.22 The DBW intended to provide a step change in the scale of finance and flexibility with which it can meet the finance needs of businesses. The DBW follows a hybrid model where the primary focus is on addressing market failure in key sectors of the SME community by working more closely in partnership with key stakeholders to deliver a wider range of financial products and services to Welsh SMEs. The DBW also manages its own funds, including those developed in partnership with other organisations. A summary of the funds the DBW manage is shown in Table 3.2 below.

3.23 The shift from FW to the DBW has been perceived positively by stakeholders. Consultees suggest that it has gained a high level of awareness and has significant presence and traction in the market with Welsh SMEs, evidenced by its high investment rates across the funds the DBW manage.

Table 3.2 Funds Currently Managed by the DBW

Fund	Focus	Fund Size (£m)	Investment Period	Amount Invested
Wales Micro-business Loan Fund	Start-up and growth loans between £1,000 and £50,000 for micro businesses. Repayment terms range between one to ten years.	£18	2013-21	£13.3
Wales Life Sciences Investment Fund**	Equity investments in Life Science companies.	£50	2013-18	£48.1
Wales Property Fund*	Loans between £150,000 and £4 million for SMEs. Repayment terms are typically 24 months or less.	£10	2013-17	£32.2
Wales Capital Growth*	Loans between £50,000 and £2 million for SMEs. Repayment periods between 12 and 18 months.	£25	2014-21	£33.2
Wales Technology Seed Fund	Early stage equity investments between £50,000 and £150,000. Tech businesses at proof of concept.	£6	2014-19	£5.7
Wales Technology Ventures Investment Interim	Loans and equity investments between £50,000 and £2 million for technology rich SMEs.	£9.5	2015-20	£8.2
Wales Management Succession Fund	Loans and equity for Management Buyouts, Buy-ins, Ownership Transfers for SMEs. Terms range from 1 to 7 years.	£25	2016-23	£3.7
Wales Business Fund	**£50,000 and £2 million. Loans, mezzanine finance, and equity investments for SMEs. Terms range from 1 to 7 years.**	**£170.9**	**2016-23**	**£49.6**

Wales Flexible Investment Fund	Loans, mezzanine finance, and equity investments between £25,000 and £5 million. For SMEs with the flexibility to provide 10 year terms.	£100	2017-25	£5.8
Property II*	Loans between £150,000 and £4 million for SMEs. Repayment terms are typically 24 months or less.	£30	2017-32	£1.6
Local Energy Fund	Natural Resources	£4.9	2016-	£2.6
Wales Angel Co- Investment Fund	Equity or convertible loan notes between £25,000 and £250,000 in SMEs receiving investment from a business Angel syndicate.	£8	2018-22	
Wales Technology Seed Fund II	Early stage equity investments between £50,000 and £150,000. Tech businesses at proof of concept.	£20	2018-25	
Stalled Sites	Loans up to 48 months between £25,000 and £4 million.	£40	2018-35	
Help to Buy Wales	Shared equity loans to individual buyers of new builds of up to £60,000	£454	2014-20	£253.7
DBW TOTAL		**£983.3**		**£496.4**

*Fund recycle returns for reinvestment

** Wales Life Science Investment Fund is externally managed by Arthurian Life Sciences.

Table 3.3 Summary of Policy Changes and Continued Relevance & Consistency

Policy Initiative	Relevant Policy Changes	Continued relevance & Consistency of the WBF
UK National Industrial Strategy White Paper	UK wide roll out of British Business Bank regional managers	Confirms that access to finance is still recognised by policy makers as a challenge SMEs face across the UK
	Various British Business Bank supply side interventions announced to improve access to finance for businesses, particularly for high growth, knowledge intensive and innovative businesses	Venture capital (equity) finance seen as a priority by UK government for high growth, innovative businesses. This is consistent with the investment focus of the WBF (equity investment under the R&I SO).
Wales Prosperity for All: Economic Action Plan	New Economic Contract between government and businesses. Requires business to demonstrate certain commitments before receiving government support.	The WBFs KPIs are consistent with the requirements in the economic contract.
	Priority sectors targeted for support now defined as thematic sectors and foundation sectors.	The WBF does not have specific sector targets - it was intentionally designed to be flexible in order to respond to demand and maintain investment rates. Therefore the WBF is consistent with the sectors identified in this Economic Action Plan.
	More emphasis placed on spatial planning with regards to economic development in Wales, with a commitment to a regionally focussed model of economic development.	The WBFs spatial approach to investment is based on ERDF programme areas. The DBW has therefore put in place regional investment infrastructure. This approach is confirmed by the emphasis placed on spatial planning in the Economic Action Plan.

Brexit	UK Government to guarantee EU funding for structural investment fund projects	Provides reassurance that funding for the WBF will still be available to be drawn down in-line with delivery profile. Based on national policies, access to SME finance is likely to remain a key priority for government regardless of the eventual relationship between the UK and EU.

4. Demand and Supply of SME Finance

4.1 To understand whether the finance gaps and associated market failures have changed since the original ex-ante assessment, we need to build a picture of the appetite for finance among SMEs in Wales and their ability to access the external finance they need. The industrial structure of Wales and performance against a range of economic indicators can help to inform the nature and type of finance businesses may need. We have also drawn on a range of public data sources, including survey evidence, to build up a picture of both the demand and supply of finance and how this has changed compared to the original ex-ante assessment.

4.2 We supplemented our research with evidence from consultations with representative organisations and public sector bodies (see Appendix A for consultation list) to provide a richer view of changes in the demand and supply for finance in Wales.

Economic Performance

Growing SME Business Base

4.3 Wales is a £59.6bn economy, home to 3.1 million residents[6] and 209k[7] businesses (99.9% are SMEs) providing in the region of 1.3 million jobs[8]. The Business base has grown by around 17% between 2013 (when the original ex ante assessment was carried out) and 2017 (+15,000 businesses), driven primarily by growth in microbusinesses which is consistent with the GB trend.

4.4 The business base has been growing at a relatively faster rate in East Wales compared to West Wales and the Valleys (19% business growth in East Wales, compared to 16% in West Wales and the Valleys in this same period). In both East Wales and West Wales and the Valleys, this growth has been driven by an increasing stock of microbusinesses (the number of microbusinesses increased by 20% in East Wales and 16% in West Wales and the Valleys since 2013).

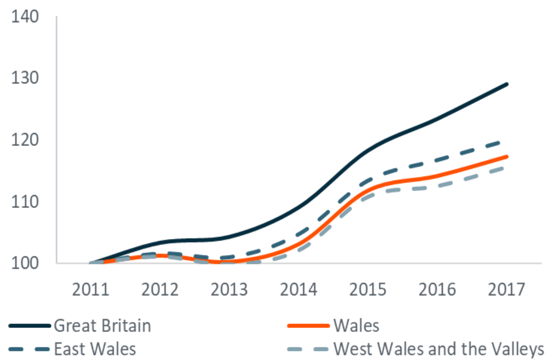
[6] ONS, Mid-Year Population Estimates, 2017

[7] BEIS Business Population Estimates, 2017

[8] ONS, Business Register and Employment Survey, 2017

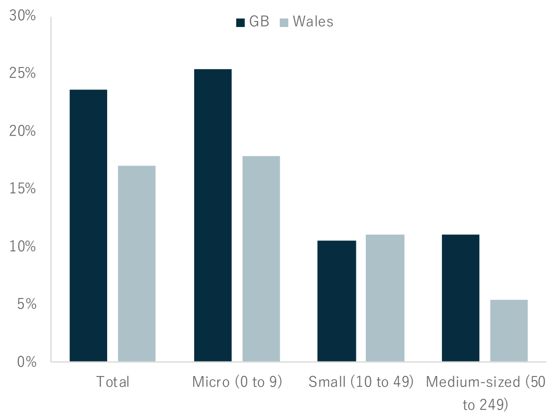
4.5 As shown in Figure 4.1 below, whilst growth in the business base in Wales still lags the GB growth rate, it has accelerated notably over the past four years, especially in comparison to stagnant business base levels in the period preceding the original ex-ante assessment (2011-2013).

Figure 4.1 Business Growth Index (2011=100)



Source: ONS UK Business Counts, 2011-17

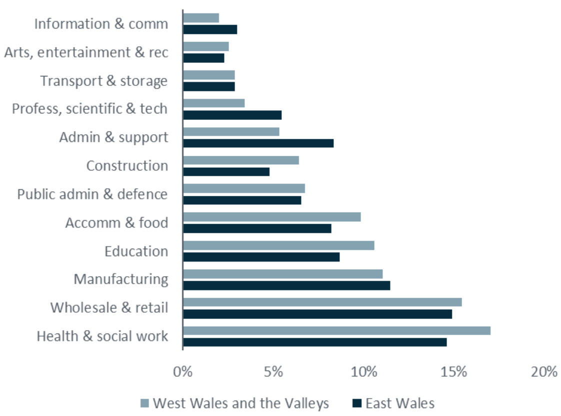
Figure 4.2 SME Growth by Size, 2013-17



Source: ONS UK Business Counts, 2013-17

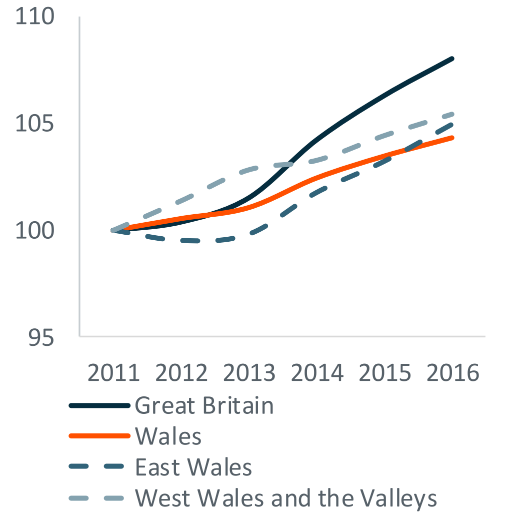
4.6 Employment in Wales has also risen at slower rate than nationally, although similarly to business growth it has accelerated over the past four years. Overall employment has risen by 5% since 2013 (figure 4.4), driven by growth in the information and communication, services and construction sectors. The three most dominant sectors in the Welsh economy in terms of their employment are health and social work, wholesale and retail trade, and manufacturing (figure 4.5). However, this varies by sub-region. In West Wales and the Valleys, there is a higher proportion of employment in health and social work (which tends to be more public-sector employment and therefore lower propensity to access external finance). In East Wales, there is a larger proportion of employment in higher value sectors, such as professional scientific and technical activities, administration and support services,

Figure 4.3 % of Employment by Sector, 2016



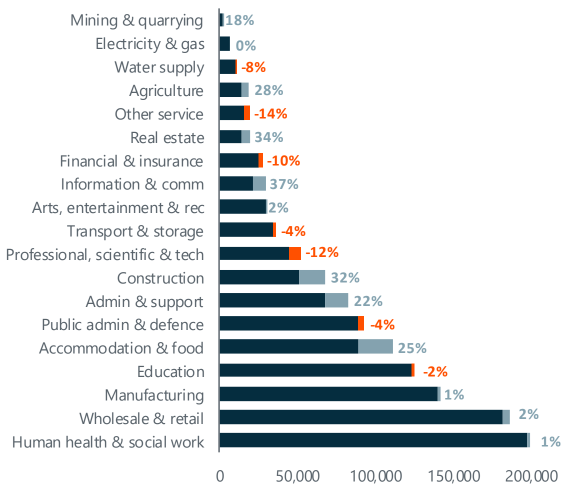
Source: ONS Business Register and Employment Count, 2016 and information and communication which tend to have higher demand for external finance.

Figure 4.4 Employment Index (2011-16)



Source: BRES

Figure 4.5 Employment Count (2016) and % change since (2013-16)

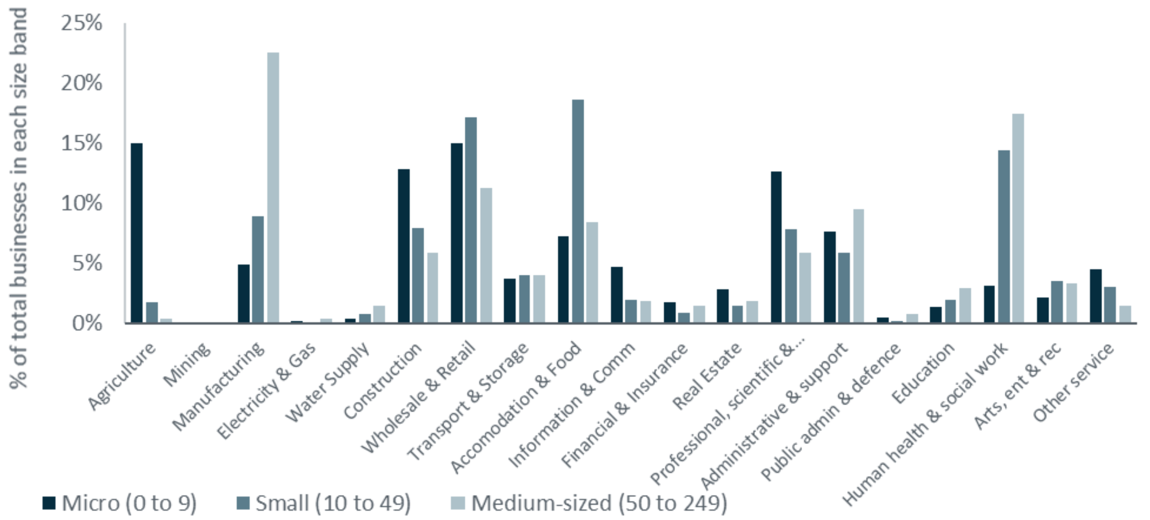


Source: BRES

Similar composition of businesses

4.7 The trend in the size and sectors of businesses in Wales is largely the same as the 2012 data presented in the ex-ante assessment. There continues to be a disproportionate number of microbusinesses in lower value-added sectors, such as agriculture, wholesale and retail. A large proportion of professional firms serving local markets (such as solicitors and accountants), as well as construction firms, are also microbusinesses; typically, such firms make use of overdrafts and credit cards to finance early stages of their activity.

Figure 4.6 Businesses in Wales by Size and Sector



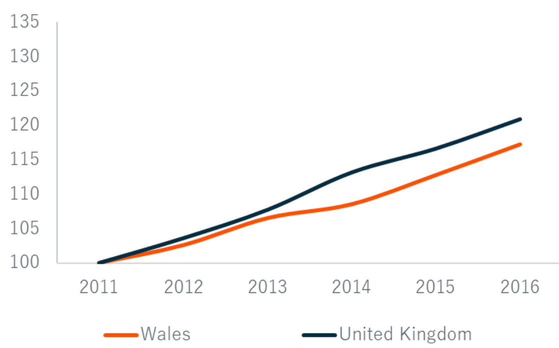
Source: ONS UK Business Count, 2017

Sluggish productivity compared to UK

4.8 The most recent figures indicate that GVA in Wales totals £59.6bn, representing around 3.5% of the total GVA in the UK. Since 2013, GVA has risen by 17% in Wales, lower than UK GVA growth (21% in this same period).

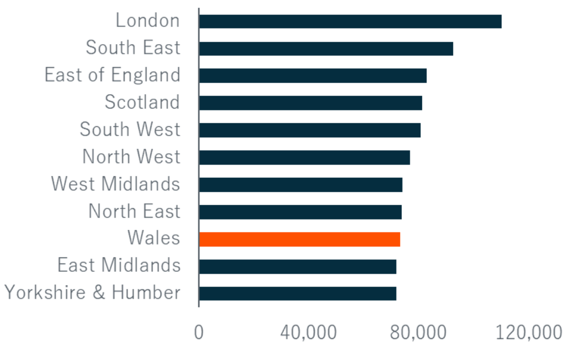
4.9 GVA per Full Time Equivalent job (FTE), a measure of productivity, has increased by 12.5% in Wales since 2009, however the gap between GVA per FTE for Great Britain and Wales has widened during this period, from £10k to £12k. Wales remains one of the lowest ranked regions in the UK in terms of GVA per FTE (Figure 4.8).

Figure 4.7 GVA Growth Index (2011=100)



Source: ONS Regional gross value added (balanced), 2011-2016

Figure 4.8 GVA per FTE employees, 2016



Source: ONS Regional gross value added (balanced) and Business Resister and Employment Survey, 2016

SME Finance Market Assessment

Demand for External Finance

Increasing start-up rate

4.10 The latest Business Population Estimates indicate that there are approximately 209,000 SMEs in Wales, of which around 199,000 are microbusinesses (95%)[9]. The number of microbusinesses in Wales has risen by 8% since 2012, however this growth is relatively low compared to the 19% increase in microbusinesses in the UK during this period.

4.11 The ex-ante assessment observed a steady decline in business births of 35% between 2004 and 2010 (4,000 fewer businesses), and that in 2011, numbers began recovering with a 9.5% increase (+720 start-ups). This recovery has continued, with business births rising by 61% (+4,610 start-ups) since 2010.

Table 4.1 Business Start Ups

	2010	2016	Change in Business Starts		Business Starts per 10,000 WAP (2016)	
			Abs Change	%Change	Number	UK=100
Wales	7,500	12,000	4,500	61%	39	62
UK	235,000	415,000	180,000	76%	63	100

Source: ONS Mid-Year Estimates and Business Demography; note: figures may not sum exactly due to rounding

4.12 Should the current trend continue in the growth of the business base, particularly among microbusinesses, there will likely be a growing demand for smaller amounts of finance and early stage finance.

4.13 However, survey evidence suggests that microbusinesses encountered greater challenges than larger SMEs in gaining finance. In 2016, 73% of microbusinesses were able to obtain finance, compared to 75% of all SMEs. The proportion of both microbusinesses and business of all sizes that answered 'don't know/still pending/refused' was much larger in 2016 than previous year, therefore it is difficult to draw firm conclusions.

[9] BIS Population Estimates 2017. Note that this dataset includes those businesses that are registered for VAT or PAYE, and also includes an estimate of the number of unregistered businesses.

Table 4.2 Percentage of Microbusinesses in Wales Obtaining Finance

	2012		2014		2016	
	All	Micro	All	Micro	All	Micro
Obtained any finance	75%	73%	75%	72%	75%	73%
Did not obtain any finance	21%	23%	21%	24%	13%	15%
Don't know/ Still pending/ Refused	4%	3%	3%	3%	12%	12%

Small Business Surveys, 2012-2016

Increase in overall SME stock, but falling use of external finance

4.14 There are approximately 9,500 non-micro SMEs in Wales (i.e. businesses that employ between 10 and 250 people) according to the latest Business Population Estimates. The number of non-micro SMEs in Wales increased by 16% since 2012, only marginally lower than the 16.5% growth in non-micro SMEs in the UK overall during this period.

4.15 While there has been an increase in the stock of SMEs, the proportion of those seeking external finance has fallen. The proportion of medium-sized businesses obtaining finance decreased by 5-percentage points between 2012 and 2016, as seen in Table 4.3. According to both the BEIS Small Business Surveys and the SME Finance Monitor, at a regional and national level, the percentage of SMEs using external finance at both geographical levels has fallen, while the percentage of permanent non-borrowers (PNBs) has risen. Consultations with financial stakeholders suggested various reasons for this increase in PNBS, including SMEs constrained by the availability and lack of understanding of external finance, or SMEs not borrowing as they assume their applications would be rejected. However, there is no robust published evidence for this and so it is difficult to draw firm conclusions. This trend of increased PNBs across the UK is currently the subject of research being undertaken by BEIS.

Table 4.3 Percentage of SMEs in Wales Obtaining Finance						
	2012		2014		2016	
	Small	Medium	Small	Medium	Small	Medium
Obtained any finance	76%	89%	85%	87%	80%	84%
Did not obtain any finance	16%	8%	13%	7%	10%	6%
Don't know/ Still pending/ Refused	7%	3%	3%	6%	10%	10%

Source: BEIS Small Business Surveys, 2012-2016

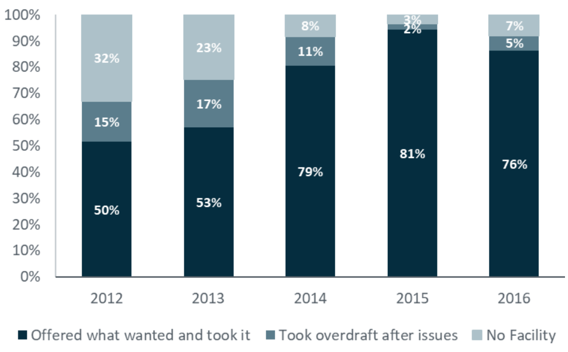
4.16 Data from the latest SME Finance Monitor also provides an indication of the use of external finance by Welsh SMEs. This data shows that in 2012, 44% of SMEs as a whole in Wales were using external finance. The proportion then fell (to 38% for 2015), as it did for SMEs overall in UK (44% to 37%), before increasing in 2016 (to 41%). This data also indicates that the number of permanent non-borrowers has been increasing in Wales over the last 5 years (from 33% in 2012 to 45% in 2016). Consultations with the financial community and representative businesses suggest that these trends to some extent reflect the banks sticking to their tight lending policies following the financial crisis. However, the growth in stock of microbusinesses, which find it more difficult to secure external funding, could also provide an explanation.

Increase in proportion of successful finance applications

4.17 The latest BDRC SME Finance Monitor annual report found that SMEs in Wales were more likely to be using any of the "core" finance products (including loans overdrafts and credit cards) than across the UK (35% of SMEs surveyed in Wales used core products and 17% used other forms of finance, compared to 30% and 16% respectively in the UK).

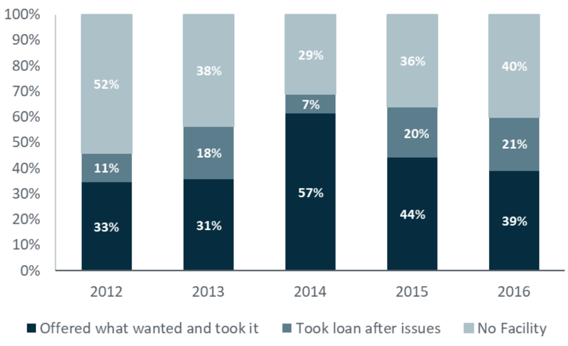
4.18 The most recent BDRC SME Finance Monitor figures show that 76% of SMEs surveyed in Wales that applied for overdrafts were offered what they wanted and took it. The survey found that, after accounting for business demographics, SMEs in Wales were more likely to have applied for a new overdraft than in other regions of the UK. The success rate of loan applications appears to be more volatile and has been decreasing since 2014.

Figure 4.9 Outcome of overdraft applications in Wales



Source: BDRC SME Finance Monitor Annual Reports

Figure 4.10 Outcome of loan applications in Wales



Source: BDRC SME Finance Monitor Annual Reports

4.19 The falling use of external finance, combined with the high application success rates, suggests that only those SMEs who are confident of successful applications are applying for external finance, and that other SMEs are being discouraged from applying. This trend is also occurring nationally and BEIS has recently commissioned research into these issues.

Growing stock of SMEs suitable for equity finance

4.20 Innovative businesses tend to experience higher growth and therefore have greater demand for external finance. The nature of innovative activity places greater emphasis on the need for equity finance rather than debt finance.

Figure 4.11 Higher Education and Business R&D Expenditure Index, 2001-16

Source: ONS Higher education and business expenditure on R&D

4.21 The scale of investment in R&D provides an indication of innovation activity and the scale of early stage ventures. In Wales, there was an estimated £700 million in higher education and business R&D expenditure in 2016. Wales has experienced higher than average growth in this spending over the recent period of around £180 million since 2011 (albeit from a low base), due to increased business expenditure on R&D. This increase in business expenditure of R&D could be an indicator of increased demand for early stage equity finance. Comparatively, government expenditure on R&D in Wales has fallen from

£31m in 2011 to £15m (a 51% decrease, compared to an 8% decline across the UK as a whole).

4.22 The UK Innovation Survey shows that the proportion of innovation active businesses in Wales increased from 41% in 2011 to 51% in 2015. The most recent survey also indicates that there are a higher proportion of product or process innovators in Wales (28%) than the UK (24%). Businesses engaging in innovative activity, such as product development, do not tend to have revenues and therefore cashflow to service capital repayments.

Table 4.4 BIS UK Innovation Survey

	Innovation Active		Product or Process Innovator		Wider Innovator	
	Wales	UK	Wales	UK	Wales	UK
2011	41%	37%	23%	22%	33%	31%
2013	47%	44%	20%	21%	39%	37%
2015	51%	53%	28%	24%	41%	42%

Source: BIS UK Innovation Surveys 2011-15

4.23 The Global Entrepreneurship Monitor (GEM) UK reports indicates that there have been rising entrepreneurial activity rates in the UK in recent years, however the total entrepreneurial activity rate[10] has decreased in Wales, from 8.1% in 2011 to 7.6% in 2016 (compared to an increase from 7.6% to 8.8% in the UK as a whole). This appears to be due to a decrease in the nascent entrepreneurial activity rate in Wales.

4.24 The number of spinouts and start-ups from universities also provides an indication of entrepreneurial and start up activity in Wales. Since the year 2000 there have been 100 spinouts and start-ups from universities in Wales (of which 70% are from Cardiff University and Swansea University), although Wales ranks below the UK average when compared to the working age population.

4.25 This growth in innovation activity is backed up by anecdotal evidence from consultations. In East Wales in particular, there has been growth in the number of incubator and accelerator spaces which are targeted towards start-ups and innovative businesses.

[10] The total entrepreneurial activity rate measures the proportion of the working age population that is in the process of setting up a business (i.e. has been paying wages for 3 months or less) or involved in a business which has been operational for less than 42 months (3.5 years).

Theoretical unmet demand

4.26 There are practical challenges to quantifying the scale and type of unmet demand for external finance. These challenges include:

- The inability to directly and reliably observe unmet demand, and in particular the part that is due to market failure. Only a proportion of the unmet demand for external finance will be for those SMEs with good business propositions.
- The limitations of the published data available on the demand and supply of external finance at a regional and sub-regional level. Much of the evidence is based on survey data, which has limitations with regards to sample sizes and the extent to which it represents the business base.
- The dynamic nature of finance markets and the business base. The growth in the business base and the changing sectoral mix (bearing in mind the focus of growing priority sectors) means it is difficult to predict the nature and scale of unmet demand.

4.27 Applying the results of the 2016 UK level BEIS SBS to current Wales's business base provides an indication of the number of SMEs in different size bands that may be struggling to obtain the finance they are looking for. Assuming the experience of Welsh SMEs is similar to those in the UK as a whole:

- Around 6,900 SMEs (13%) in Wales were looking for external finance in 2017, the vast majority of which were microbusinesses. This is lower than in 2012 when nearly double this amount were seeking external finance.
- Around 1,000 of these SMEs were unable to obtain finance, compared to 2,600 in 2012.
- Around 800 SMEs had a need for finance but did not apply, higher than the estimate in 2012 (450). This is consistent with the survey data presented above - fewer SMEs in Wales are seeking external finance (as shown by the increasing number of PNBs), and those applying are more successful.

Table 4.5 Illustrative Analysis of SMEs' Experience of Accessing Finance in Wales using Survey Data

	Total	Looking for Finance	Unable to obtain any finance	Discourage from applying because thought would be rejected
2012				
Micros	44,050	9,700	2,250	300
Small	7,050	2,250	350	150
Medium	1,150	400	50	-
All SMEs	52,200	12,300	2,600	450
2016				
Micros	44,650	5,350	800	650
Small	8,200	1,300	150	150
Medium	1,250	250	-	-
All SMEs	54,100	6,900	950	800

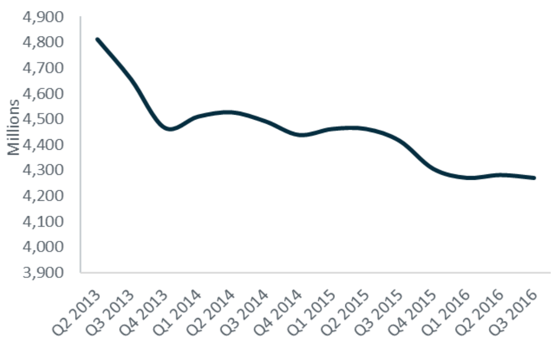
Source: Regeneris Consulting Calculations, using data from the BEIS Small Business Survey 2016, and 2017 Business Population Estimate

Supply

Debt Finance

4.28 The British Business Association (BBA) Postcode lending data provides an overview of trends in loans and overdrafts to SMEs from high street lenders[11]. The most recent figures indicate that the value of SME lending stood at £4.3bn in Wales in Q3 2016.[12] Figure 4.12 shows that there has been a downward trend in the level of lending since 2013.

Figure 4.12 Value of Wales Quarterly High Street Bank Lending to SMEs 2013-2016



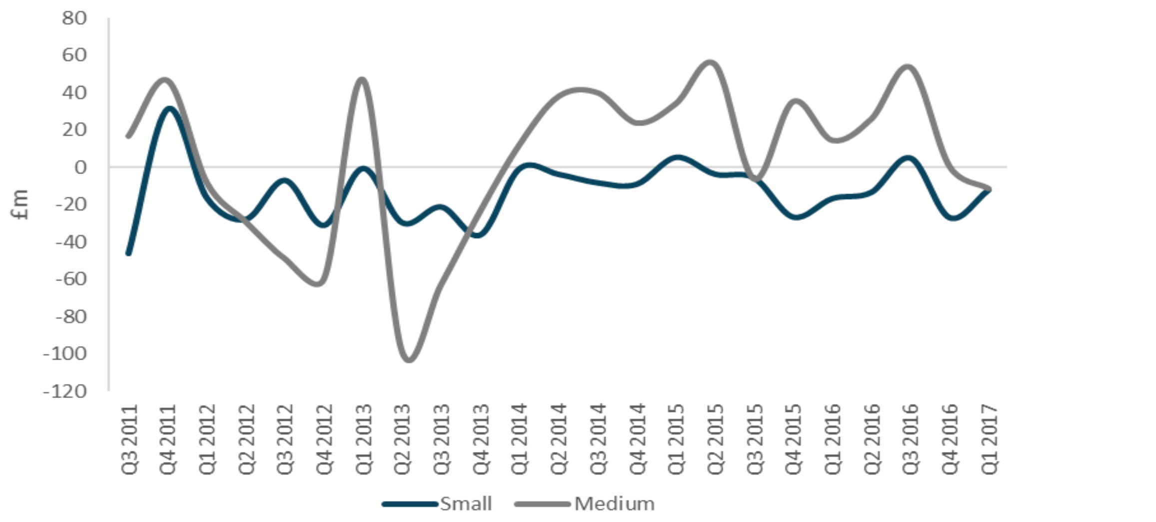
Source: BBA Postcode lending data

4.29 Net lending from high street banks has mostly been negative for small businesses since the ex-ante assessment, which we would probably expect given the lending policies of high street banks following the recession. For medium size businesses, net lending is much more volatile on a quarterly basis, which is more shaped by demand factors Since Q4 2016, net lending to SMEs has been negative in Wales (ie SMEs are receiving fewer new loans from banks than they are repaying) suggesting banks have continued with their tight credit policies.

[11] 7 financial institutions provide data on quarterly lending to the BBA. The BBA aggregate totals of SME loans and overdrafts compiled in this exercise represent about 60% of the total national market of all lending to SMEs by banks and building societies

[12] BBA lending data provides information at the postcode level on the value of SME lending outstanding. We have analysed this for all postcodes in Wales to come up with Wales lending figures.

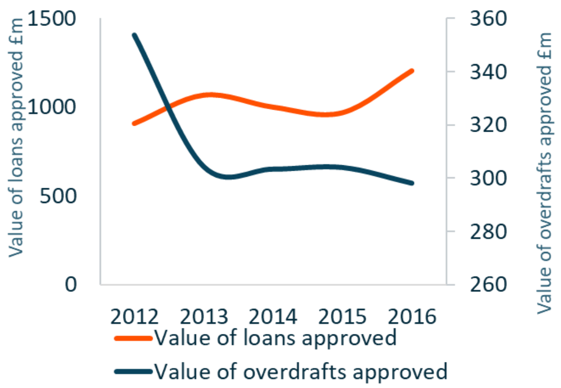
Figure 4.13 Net Lending from High Street Banks to SMEs in Wales, 2011-2016



Source: BBA Lending Data 2011-16; Note: BBA lending data covers 7 high street banks

4.30 BBA lending data indicates that there has been an increase in loan balances and a reduction in the value of overdrafts approved in Wales. When considered against the demand side data from SME Finance Monitor on decreasing use of loans, this suggests that banks are issuing a smaller number of larger sized loans. Comparatively, there has been increasing use of overdrafts and declining value of overdrafts approved. Anecdotal evidence form consultees suggests that the overdrafts are being used for working capital, rather than for expansion/growth.

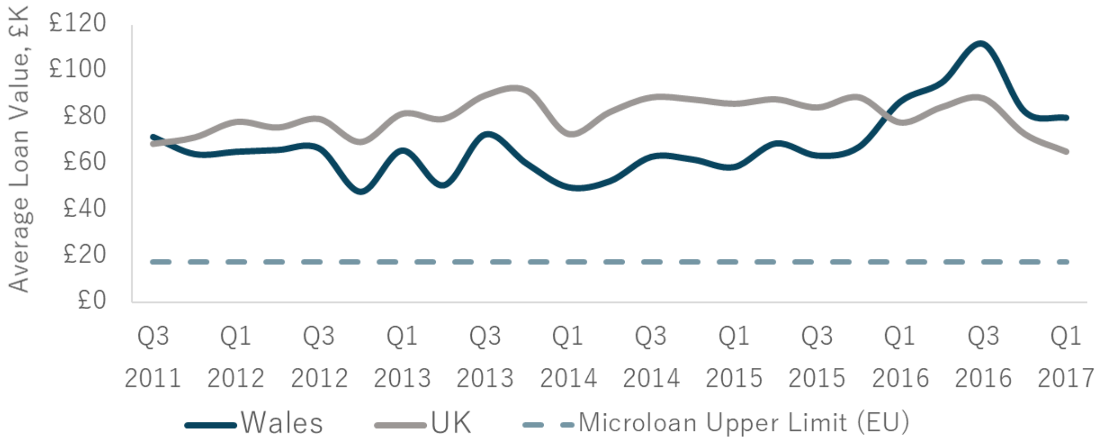
Figure 4.14 Value of High Street Bank Loans and Overdrafts Approved in Wales 2012-2016



Source: BBA Lending Data 2011-16; Note: BBA lending data covers 7 high street banks

4.31 In relation to finance for microbusinesses, the average value of new bank loans approved to smaller businesses has increased by 12% since Q3 2011, while falling by 5% in the UK during the same period. The average value of loans approved to Welsh small businesses stands at around £80,000, well above the EU microloan upper limit and the amount typically sought by microbusinesses.

Figure 4.15 Average Value of High Street Bank Loans Approved to Small Businesses in Wales, 2011-2017



Source: BBA Lending Data; Note: BBA data uses non-exact differentiation between small and medium-sized businesses (the notional difference is based on turnover – up to £1m/£2m for small businesses and up to £25m for medium-sized businesses, but operationally, banks use additional characteristics to position SMEs in the small or medium-sized business product range).

4.32 There are other types of debt finance facilities that are not included in the BBA postcode lending data, and data does not exist on the level of supply, such as asset finance facilities, trade finance and invoice discounting. Anecdotal evidence indicates a mixed picture regarding the use of these finance types.

Growing alternative finance provision

4.33 Since the ex-ante assessment, alternative finance has occupied a growing space in the market but remains relatively small compared to overall value of lending in Wales. There is also low penetration of alternative finance relative to other regions of the UK. Wales ranked second least active UK region by total transactional volume of alternative finance, in both funding received and provided (NESTA UK alternative finance report, 2016).

4.34 There is limited data available on alternative finance provision, however reports tend to indicate that peer to peer lending platforms have not been very active in Wales:

- A Bank of England report on peer to peer lending[13] (2016) indicates relatively low levels of lending and borrowing in Wales compared to other UK regions. Wales lent

[13] Atz, U., and Bholat, D (2016). Bank of England, Staff Working Paper No. 598, Peer to Peer Lending in the United Kingdom.

£12.8m and borrowed £22.4m between Oct 2010 and May 2013 (however, the data doesn't distinguish between consumer and business lending).

- The latest UK Small Business Survey (2016) reports that just 2% of SME employers surveyed in Wales are currently using a loan from a peer to peer platform.
- Wales is underrepresented on Funding Circle, one of the largest peer to peer lending platforms, with a lower share of UK Funding Circle loans than share of UK business population (CEBR Evidence from Funding Circle report, 2016[14]).

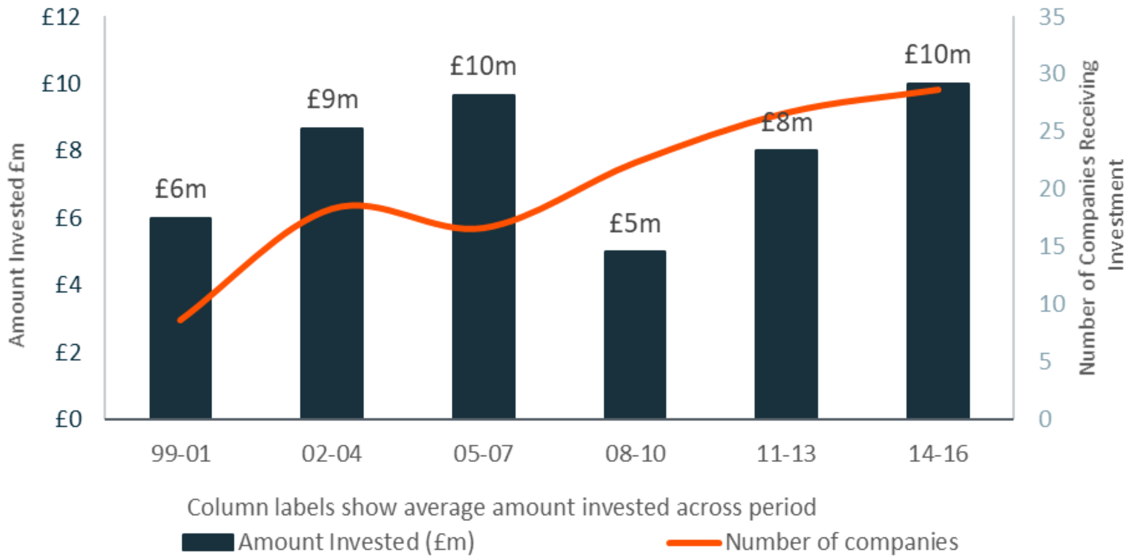
4.35 Anecdotal evidence from consultations also indicates that while the number of alternative finance platforms has increased significantly over recent years, businesses in Wales have tended to not routinely use them as a source of finance and consider the risk in using such platforms to be more substantial than traditional sources of finance. Consultations indicated that there is still a lack of awareness and understanding of alternative finance among businesses in Wales.

Increase in equity lending, but DBW is main provider

4.36 The level of early stage equity investment in Wales has risen since 2011, which is the reverse of the trend experienced across the UK (with the amount invested rising by 13% since 2011 in Wales, while falling by 29% in the UK during the same period). Data from the BVCA suggests that the value of early stage equity investment in Wales has averaged £9.2m annually over the last 5 years. Note that this data includes any publicly backed interventions, and so will include investments by Finance Wales and the Development Bank of Wales (which invested around £13.5m via the Technology Ventures Investments (TVI) sub fund of the Wales JEREMIE Fund over 7 years).

[14] CEBR (2016). Small Business, Big Impact. The changing face of business finance; Evidence from Funding Circle.

Figure 4.16 Early Stage Equity Investment in Wales (3 Year Averages)

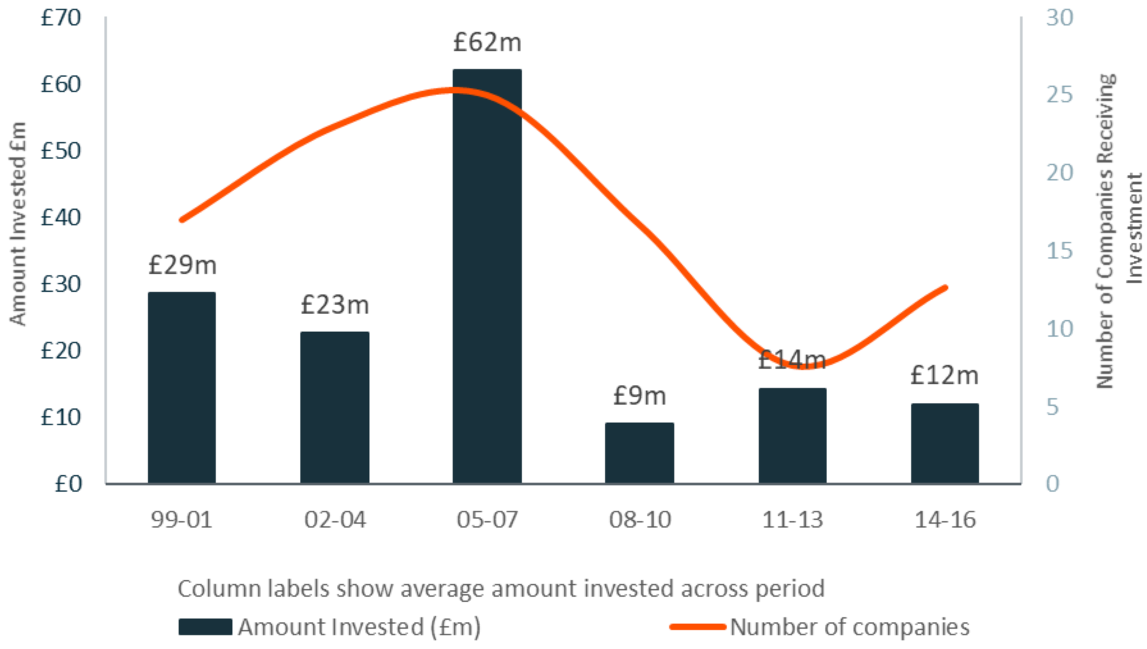


Source: BVCA Private Equity and Venture Capital Reports on Investment Activity

Note: BVCA data can be volatile year on year, therefore we have presented three year averages to smooth out fluctuations.

4.37 In terms of expansion equity, there has been a shift to more frequent, but smaller scale, deals since 2011. The average deal size in 2014-16 was £947k, compared to £1.9m in 2011-13. BVCA data indicates that the average annual amount of expansion equity invested over the last 5 years in Wales is £13.8m.

Figure 4.17 Expansion Equity Investment in Wales

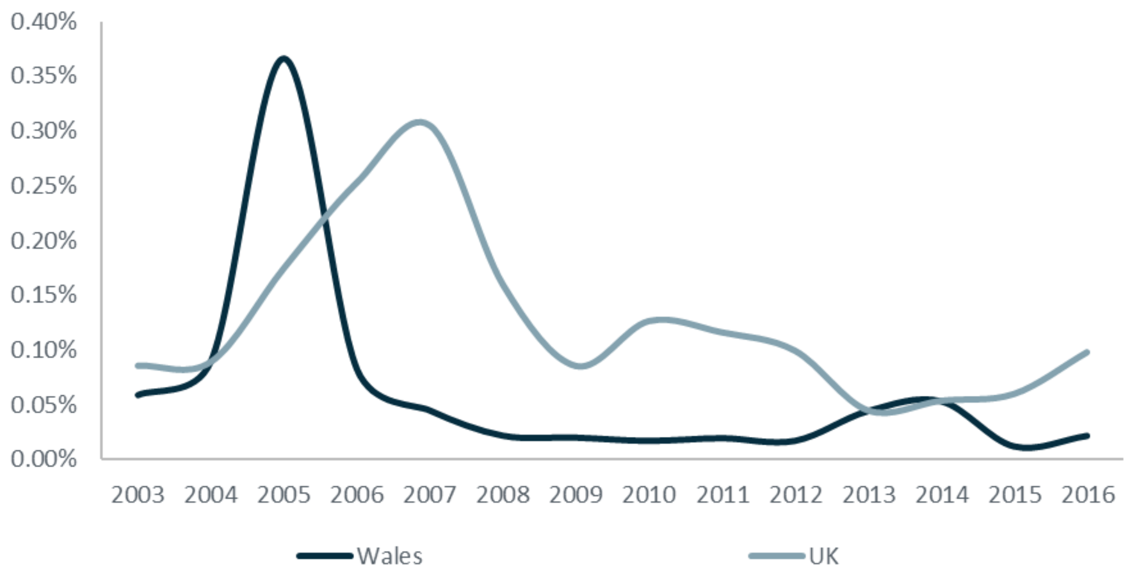


Source: BVCA Private Equity and Venture Capital Reports on Investment Activity

Note: BVCA data can be volatile year on year, therefore we have presented three year averages to smooth out fluctuations.

4.38 BVCA data indicates that there has been a low take up of expansion equity finance in Wales. Expansion equity investment in Wales is lower as a proportion of GVA compared to the UK, and that this gap has been increasing since 2014. This is supported by the latest UK Small Business Survey, which reports that only 2% of SMEs in Wales indicated that they were currently using equity finance.

Figure 4.18 Expansion Equity Invested as a % of GVA, 2003 to 2016



Source: BVCA Private Equity and Venture Capital Reports on Investment Activity

4.39 The British Business Bank's 2017 Equity Tracker states that Wales was one of only three regions that experienced an increase in the number of equity deals in 2016 (Northern Ireland and the East of England also experienced an increase, while the number of equity deals declined in the rest of the UK). The report indicates that Wales accounted for 3% of the total number of UK high growth businesses and accounted for 3% of the total number of UK equity deals in 2016, but only 1% of the total value of UK equity investments. It also states that 40% of equity deals in Wales in 2016 involved Government funds[15] and that the presence of private sector equity investors is limited in Wales. This is consistent with evidence from consultees, which highlight that the DBW has been the main provider of equity finance for SMEs over the past few years.

4.40 The Business Growth Fund, funded by five of the UK's main banking groups and is entirely independent of the government, was established in 2011 to focus on the gap in equity growth capital to SMEs. It is Britain's largest investor of equity in established and growing SMEs (typically making initial investments of £1m-£10m), with £2.5bn of capital available. Take-up in Wales has remained low since its inception, with currently only 4 Welsh SMEs listed in the Business Growth Fund portfolio.

[15] Refers to deals made using funds operated by the devolved administrations, JEREMIE backed funds and other local government funds, in addition to deals including the British Business Bank's Angel CoFund (excluding private sector funds supported by the British Business Bank).

Public Sector Finance Provision

4.41 The UK Government has been active in trying to stimulate the flow of finance to SMEs in recent years, however UK equity policy initiatives have struggled to gain traction in Wales. The main initiatives implemented since the original ex ante assessment include:

- HMRC offers tax reliefs to investors through a number of venture capital schemes. Collectively, tax reliefs are the biggest intervention in UK equity by market value. There are currently four venture capital schemes including Venture Capital Trusts (VCT), the Enterprise Investment Scheme (EIS), the Seed Enterprise Investment Scheme (SEIS) and the Social Investment Tax Relief (SITR). The most recent data from HMRC indicates that in 2015-16, 60 companies raised £20.5m funds through the EIS in Wales (an average of approximately £22.4m annually between 2012-16), which was relatively lower than most other UK regions (other than the North East of England and Northern Ireland).[16] In 2015-16, a total of 40 companies raised £2.3m in Wales through the SEIS (an average of approximately £2.8m annually between 2012-16), which was relatively lower than all other UK regions. In 2015-16, £430m funds were raised nationally through VCT, however regional data is not available.[17]
- The UK Innovation Investment Fund (UKIIF) provides capital for existing venture capital funds, targeting small businesses with growth potential and new ventures in the digital, life sciences, clean technology and advanced manufacturing sectors. There has been £159m committed into underlying funds, capable of making £2.2 billion of investment capital available to companies. Regional data is not available for this fund.
- The Angel Co-Fund: A £100m fund launched in November 2011 that invests in both early and later stage businesses across the UK. The fund invests £100k-£1m in high potential SMEs and helps to leverage significant co-investment from business angels. The latest monitoring data (October 2017) indicates that the fund has invested and committed £37m across the UK, alongside a further £180m from business angels and other investors and provided support to 79 businesses, of which 2 are in Wales. Data on the amount invested at the regional level is not publicly available.

[16] HMRC, Enterprise Investment Scheme and Seed Enterprise Investment Scheme, October 2016, Statistics on Companies raising funds

[17] Data sourced from HMRC, the amount of funds raised by VCTs in each tax year, rounded to the nearest £5m.

- The Enterprise Capital Fund (ECF) was originally set up in 2005 as a government-backed scheme with the aim of investing up to £2 million in early stage companies. ECFs operate as private companies that back private capital with Government-guaranteed leverage. The limit on the amount that ECFs could invest into any one fund was £25m, which has now been increased to £50m. The ECFs are typically UK-wide Funds, although regional funds have been supported. The most recent performance data indicates that around £1.05bn (including third party) has been committed by the ECF (October 2017).

4.42 There is also publicly backed debt finance provision. This appears to have had more success in penetrating the Welsh SME market compared to the equity initiatives identified above and since the previous ex-ante assessment:

- The Start-up Loans initiative was which set up in 2012 to provide new and early stage businesses access to affordable finance and mentoring support. It has had an impact in Wales and is one of the most well know publicly backed initiatives amongst SMEs and finance providers. According to the latest lending statistics, the average loan size has been £6,480 and the Start Up Loans Company has lent approximately £14m to start-ups in Wales of a total £358m across the UK (4%, indicating an overrepresentation when compared to the Wales' 2.9% share of start-up businesses[18]).
- The Funding for Lending scheme was launched in 2012 by the Bank of England and the Treasury to support increased lending to businesses and individuals (data is not split between lending to businesses and lending to individuals, so it is not possible to examine the amount of money provided for businesses).
- The Enterprise Finance Guarantee has had relatively low take up in the region. According to the latest data provided by the British Business Bank, the total amount of loans drawn in Wales totals £116.3m between January 2009 and September 2017, equating to an average loan of approximately £107K. In terms of the ratio of number of loans per 10,000 businesses, Wales ranks 8th of 12 regions.

[18] ONS Business Demography, proportion of business births in Wales of UK total, 2016

5. Implications for the Finance Gap

5.1 This section considers the above analysis of demand and supply of SME finance in Wales, and the performance to date of the WBF to assess what this may mean for the provision of finance and subsequent need for additional funding.

5.2 In summary, the assessment has found that adding another £10m to the overall size of the WBF is justified. The implications of this for the annual investment rates for the different finance types is that they would still be within the ranges of the upper limits set out in the previous market assessment (noting that there are some issues with regards to how mezzanine finance is treated). The key issue is how this additional funding is allocated between debt and equity finance, and between EW and WWV. The findings by the different finance types are presented in Table 5.1, and a summary is as follows:

- There is evidence of strong growing demand for debt finance for established SMEs in Wales since the original ex-ante assessment. This is still not fully being satisfied by other non-public finance sources, such as high street banks and alternative finance.
- The evidence suggests an increase in the allocation for equity finance in EW is justified in demand terms, given the strong demand and continuing presence of market failure. Whilst the evidence also suggests strong demand for debt finance in East Wales (and the associated market failures), equity finance should arguably be prioritised given the stronger market failure case and the higher potential returns from equity investments (subject to the effectiveness of the investments which are made in practice).
- Although DBW is investing considerable effort into market making activity and enhancing its own infrastructure on the ground in WWV, the evidence suggests that it will be challenging to deliver higher amounts of investment in WWV compared to current revised targets (i.e an annual average of around £18m per year compared to £14m per year for the Wales JEREMIE Fund). This is particularly the case for equity investment (£9.6m per annum for the WBF compared to £6.7m for the Wales JEREMIE Fund).
- The proposed ERDF programme modifications indicate a proposed reallocation of funding within WWV to increase the amount of equity finance investment (that is the movement of €20m from Priority 2 Thematic Objective 3 to Thematic Objective

1). This should be carefully considered in light of the evidence presented in this assessment.

Table 5.1 Summary of Market Conditions by Finance Type

	Demand Conditions	Supply Conditions	Finance Gap Implications
Finance for Microbusinesses	• There is evidence of a large stock of microbusinesses that are driving growth in the Welsh SME business base. • There has been a significant increase in the business start-up rate in Wales since the original ex-ante assessment. • Other DBW funds targeted at microbusinesses have experienced strong investment rates, which is illustrative of demand for external finance. **This implies strong level of demand from microbusinesses**	• Given the risks, returns and the costs, this is not a space that high street banks typically operate in without public support/subsidy. This is evidenced by the data on bank lending which shows that the average value of loans made to smaller businesses in Wales has fluctuated between £60,000-£80,000 since the original ex-ante assessment, much higher than the amount typically sought by microbusinesses. • The sub £50k space is largely catered for by publicly back initiative such as the Wales Microbusiness Loan Fund and the Start-up Loan fund, which have had strong investment rates and penetration in the Welsh market. **This implies adequate supply of finance for microbusinesses**	The evidence suggests growing demand for debt finance for microbusinesses. At the microloan level, there appears to be adequate supply through other publicly backed schemes (including other funds that the DBW manage). The WBF does not include the provision of microloans, and so no changes are proposed for this finance type.
Debt for Established SMEs	• There is evidence of a growing SME business base in Wales as the economy continues to grow post-recession, with a slightly higher growth rate in EW compared to WWV. • But there has been an increase across the UK in the proportion of SMEs classified as "permanent non-borrowers". This may not necessary indicate a lack of	• Bank lending data suggests that supply of finance from high street lenders has not had the expected increase post-recession and since the original ex-ante assessment. Anecdotal evidence has also suggested that lending from high street banks has remained subdued in Wales as banks have continued	The evidence suggests there is potentially a case for the increased provision of debt finance for established SMEs in the face of strong demand and the continuation of tight lending practices of high street banks

	appetite for borrowing, but it may be that SMEs are constrained by the availability of finance. • Prominent & growing sectors in Wales including retail, manufacturing, construction and accommodation/food services all have a greater propensity to make use of debt finance when they have funding needs. • These sectors account for half of all investments by value of the WBF so far. Further, 60% of investments by the WBF have been for debt finance, higher than anticipated at this stage. • The Foundation sectors prioritised in the latest Economic Action Plan for Wales all traditionally make use of debt finance. As these sectors grow, so too will the demand for debt finance. **This suggests there is strong and, on balance, growing demand for debt finance in Wales.**	their strict lending policies, particularly in WWV. • Businesses in Wales have been making use of alternative sources of lending, with Funding Circle being reported as the main source of alternative lending. However, it remains small in the context of overall lending in Wales and compared to alternative finance provision in other parts of the UK. • The UK Government has attempted to increase SME lending through various interventions, however these have only had a limited impact in Wales so far. **This suggest there is still significant weakness in the supply of debt finance from the private sector for established SMEs.**	
Early Stage Equity	• Estimating demand for equity investment from SMEs is inherently difficult given that equity investment is only suitable for a relatively small number of SMEs. • Wales performs well on a range of innovation indicators, reinforced by substantial public sector investment into R&I facilities, which suggests there is a growing stock of SMEs suitable for equity finance. • Anecdotal evidence from consultations suggests that whilst equity aversion has historically been present in Wales, this has lessened to some extent over the past	• Data on the supply of early stage equity shows a general increase in supply, although almost all of this is due to the DBW. • Consultations also suggests that there are few other significant players in this area, such as angel investors, other publicly backed initiatives, or alternative finance. • This is backed up by stronger than expected WBF investment rates for equity finance in	The evidence points to a justification for an increase in early stage equity finance in East Wales. There appears to be strong and growing demand for this type of finance in East Wales, although this has not led to a change in the presence of market failure and hence the justification for intervention.

<table>
<tr>
<td></td>
<td rowspan="2">five years, particularly in East Wales. Here, there has been has been growth in the number of incubator and accelerator spaces which is targeted towards start-ups and innovative businesses. This has reportedly increased the appetite for equity finance.
• In EW, employment growth has been driven by professional services and ICT companies, which could indicate stronger demand for equity finance in the future.
• In WWV, employment is dominated by the public sector, manufacturing and construction. These sectors tend to have low propensity for equity finance.
• However, there could be potential amongst university spin outs in WWV (from Swansea in particular) given large public sector investment in R&D, as well as in new technologies such as marine energy. However the scale of this potential demand at this stage is unclear.
• The strategic direction of the Welsh economy suggests that in the coming years there will be a growing need for equity finance given the nature of the sectors which are earmarked for growth - all of the National Thematic Sectors have a strong focus on innovation.

This suggests there is strong and arguably growing demand for early and later stage equity finance in EW.</td>
<td>EW. In WWV, early stage equity investment remains notably lower.

This suggests that the DBW is still the main provider of early stage equity finance.</td>
<td>This market failure is of course also present in WWV. However, the current evidence suggests that it would be challenging to deliver any increase in early stage equity finance above what is already being provided by the WBF. If the WBF were to improve its investment performance in the WWV, this could provide justification for an increase in early stage equity finance, however this would have to be carefully considered in conjunction with the evidence presented in this assessment.</td>
</tr>
<tr>
<td>Expansion Equity</td>
<td>• The supply of expansion equity has fluctuated over the past few years, with a shift to more frequent, smaller deals.
• Survey data indicates that only 2% of SMEs in Wales were using equity finance. Further, the amount of expansion equity invested has fallen relative to the size of the Welsh economy (as a % of GVA) over the past few years.
• As above, anecdotal evidence suggests that there are very few institutions apart from the DBW offering expansion equity investment.</td>
<td>Similarly to early stage equity, the evidence points to a justification in increasing the provision of later stage equity finance in EW. Any increase in later stage equity finance may be challenging to deliver in WWV.</td>
</tr>
</table>

	The evidence suggests demand is far less strong in WWV given the nature and growth of the business base, although this will depend to some extent on the market making activities and local presence of DBW.	Other public sector backed investors have limited penetration in Wales. **This suggests that the DBW is still the main provider of expansion equity finance.**	

PART B

6. Review of Investment Strategy

6.1 This section provides a review of the revised WBF investment strategy. It focuses on the key changes compared to the previous investment strategy reviewed in the original ex-ante assessment. Where no changes have been made, this has been stated. The investment strategy has been developed by the DBW based on discussion with Regeneris. We review:

- The proposed fund size and composition
- Funding sources
- Geographical split
- Sector focus
- Modelling assumptions, including investment & default rates, and outputs
- Value for money
- Governance
- Monitoring and evaluation

6.2 In each instance we review and comment on the changes to the investment strategy in light of the available evidence, with a concluding comment on the robustness of what is proposed.

Proposed Fund Size and Composition

6.3 The WBF will be a £180.9m ERDF backed FI to provide debt, equity and mezzanine finance to SMEs in Wales.

- The revised investment strategy reflects an increase in the ERDF allocation and overall size of the WBF, from £135.9m in the original investment strategy to a current size of £180.9m.
- A revised ERDF contract is already in place that reflects a £35m increase in ERDF, taking the total size of the WBF to £170.8m. This is the current delivery profile that the WBF is delivering towards.

- This revised investment strategy reflects the full increase to £180.9m. It also reflects a reallocation of the sources and profile of the funding (outlined in Section 2 in Part A of the assessment, and below under *Funding Sources*).

6.4 The revised investment strategy for WBF draws upon the range of market assessments that have been produced in order to inform the proposed level and mix of funding, as well as the findings from Part A this updated ex-ante assessment.[19]

6.5 This market evidence, part of which was prepared by Regeneris, is judged to be comprehensive. It recognises the limitations of the available evidence and the challenges of assessing the demand and supply of finance to SMEs and the nature and strength of associated market failures.

6.6 The table below summarises the conclusions of the original ex-ante market assessment on the recommended fund size. The table also sets out the revised allocation for the WBF, split into two sub-funds:

- An equity fund (covering early stage and later stage risk capital)
- A loan fund (covering debt and mezzanine finance)

Table 6.1 Comparison of recommended fund size (£ million)

	Ex-ante evaluation market assessment*		Wales Business Fund	
	Annual	Total 7 years	Annual	Total 7 years
Equity	13-19	91-133	13.2	92.4
-Early Stage	*4-8*	*28-56*	*5.9*	*41.1*
-Later stage	*9-11*	*63-77*	*7.3*	*51.3*
Debt	10-12	70-84	12.6	88.5
Total	**23-31**	**161-217**	**25.8**	**180.9**

*Regeneris Consulting (2013) Stage 2 Market Assessment

[19] Regeneris Consulting (2013), Stage 2 Market Assessment,

Regeneris Consulting (2014) Venture Capital and Loans Market Assessment for SMEs in Wales

Professor Dylan Jones Evans (2013), Access to Finance Review Stage 1 & Stage 2 report

Development Bank for Wales Task and Finish Group (2015), A Feasibility Study in the creation of a Development Bank for Wales

6.7 An important point should be noted when interpreting the figures above. The types of finance have been categorised slightly differently between the market assessment and the WBF. In the market assessments, mezzanine was included as part of later stage equity, whereas in the WBF it is part of the loan sub-fund. In the market assessment, for later stage equity it is not possible to distinguish pure equity from mezzanine.

6.8 The key points from the comparison with the market assessment evidence are as follows.

- The total for debt finance appears slightly higher than the market assessment upper limit. However, the reason for this is that figures for the WBF includes mezzanine investment, whereas the market assessment does not. Taking this into account, if we were to include mezzanine investment into debt for the market assessment figure for comparison purposes, we would expect that the annual investment rate for the WBF would be towards the upper range of the annual investment limit but, still remain within the recommended limit.
    - The annual investment rate of £12.6m for the WBF compares to an achieved annual investment rate of £13.4m in the Wales JEREMIE Fund for debt and mezzanine investment. Whist the Wales JERMIE Fund was operating at a different time, our updated market assessment shows that there has been no real shift in the landscape for SME lending, and that there is still significant weakness in the supply of debt finance from the private sector for established SMEs.
- The total for equity investment, taking into account the point above regarding the treatment of mezzanine, fits within the recommendations from the ex-ante assessment. The split between early stage and later stage is indicative for fund modelling purposes, and there is scope to invest in-line with demand. A similar approach was taken in the Wales JEREMIE Fund, where money was vired between risk capital and early stage products in response to demand trends.
    - The assumed annual investment rate is £13.2m, compared to an achieved annual investment rate in the Wales JEREMIE Fund of £10.9m. However this was achieved over a period where there a significant downturn in business confidence (which had an impact on expansion equity in particular).
- The market assessments included an assessment for microloans. However these are not included in the WBF, as they are being delivered by the Wales Microbusiness Loan Fund.

6.9 The investment period of 7 years reflects DBW's experience of delivering the Wales JEREMIE Fund, where the loans sub-fund was fully invested after 6 years (following a 1 year extension) and the equity sub-fund after 6.5 years following a 1.5 year extension.

6.10 **Taking all of these factors into account, it is Regeneris's view that the size and composition of the Fund in the revised investment strategy fits with the updated market evidence, and has been based on prudent assumptions, drawing on experience from delivering the Wales JEREMIE Fund, on what is deliverable over the investment period**.

Funding Sources

Match Funding at Deal Level

6.11 The WBF is made up of ERDF, deal level match funding, and legacy/FTC funding. The latter of these funding sources lies outside of the ERDF programme period and so has not been reviewed here.

6.12 Deal level match funding requirements have been set based upon the required amount needed to unlock tranches of ERDF funding and to meet priority level intervention rates. The profile of the funding sources means that deal level match funding needs to be sourced early on to enable the drawdown of ERDF.

6.13 The WBF has targeted a total of £139m in deal level match funding to be achieved, implying £1.04 for every £1 of ERDF invested. This ratio applies as the target for both the loan and equity sub-funds, so that £66.6m is targeted for the loan fund and £72.4m is targeted for the equity fund.

Table 6.2 Match Funding Summary (£m, nominal prices)

	Loan	Equity	Total
ERDF	64	69.9	133.9
Deal Level Match	*66.6*	*72.4*	139

Source: Wales Business Fund Investment Strategy Revised (July 2018)

- For the loan fund, the Wales JEREMIE Fund achieved £0.87 in private sector match per £1 invested. This suggests the WBF target will be challenging and fund performance should therefore be carefully monitored in this regard. The performance to date for this is encouraging, with an induced investment ratio of 1.6.

However at this stage this is based on a small number of deals and some particularly high levels of co-investment.

- The equity fund in the Wales JEREMIE Fund was generally able to secure higher levels of deal match funding (£1.79 for every £1 invested) and to date the WBF has managed to secure a high ratio of induced investment of 2.9.

6.14 This amount of deal level match funding, (a £63m increase compared to the original investment strategy), means that we have tested for the potential of the WBF to crowd out private sector investment.

- The updated market assessment (Part A of the assessment) concludes that there has been no significant change in the number of lenders in the market, or willingness to lend at the early stage.
- We have consulted with the DBW investment team as well as private sector finance providers, and have also looked at the network of investors that the DBW have been working with so far in the WBF. Many of these are institutions that are not major players in the market and would be unlikely to invest in Welsh SMEs (or invest the same amount) without co-investment from the WBF.

6.15 On the whole, the deal match targets appear achievable. Performance should be very carefully monitored, particularly for the loan fund, and particularly as the drawdown of ERDF funding is linked to this match funding. For the equity fund, experience from the Wales JEREMIE Fund in securing match for equity deals and the co-investor networks that have been built up, suggest that the target is achievable.

Geographical Split

Investment Rates

6.16 In East Wales, the revised investment strategy for the WBF shows an increase in the fund size compared to both the original investment strategy and current WBF delivery profile. The updated market assessment concluded that there is demand in EW for this increase. The assumed annual investment rate in EW for the WBF is around £7.9m, lower than the £9.2m achieved in the Wales JEREMIE Fund. In addition, in EW the WBF is already well ahead of its profile in terms of investment. This suggests that this increase, and the amount to be invested in EW, is deliverable.

6.17 In WWV, the amount to be invested is higher than the original investment strategy but is the same as the WBFs current delivery profile. In terms of investments, the fund is behind its target.[20] The assumed annual investment rate for the WBF is around £17.9m, compared to £15m achieved in the Wales JEREMIE Fund.

6.18 The overall split in the amount invested in JEREMIE was 62:37 weighted towards WWV. For the WBF this is slightly higher at 69:31.

Funding Sources

6.19 The allocation of ERDF funding for the WBF is driven by the overall programme level allocations for the relevant priorities. As such, these are heavily weighted towards WWV (accounting for 81% of the total ERDF allocation). In order to rebalance out the overall allocation in line with the likely demand for finance, legacy and FTC funding is distributed more towards EW (although it should be noted that legacy/FTC investment lies outside of the ERDF programme period).

Table 6.3 Spatial Funding Split for WBF (£m, nominal prices)

	Loans			Equity			Total		
	ERDF	Legacy/ FTC*	Total	ERDF	Legacy/ FTC*	Total	ERDF	Legacy/ FTC*	Total
WWV	51.1 (80%)	9.5 (39%)	60.6 (68%)	57.4 (82%)	7.5 (33%)	64.9 (70%)	108.5 (81%)	17 (36%)	125.5 (69%)
EW	12.9 (20%)	15 (61%)	27.9 (32%)	12.5 (18%)	15 (67%)	27.5 (30%)	25.4 (19%)	30 (64%)	55.4 (31%)
Total	**64**	**24.5**	**88.5**	**69.9**	**22.5**	**92.4**	**133.9**	**47**	**180.9**

Source: Wales Business Fund Investment Strategy Revised (July 2018)

*Legacy/FTC investment is outside of the ERDF programme period

6.20 This funding spit has implications for the level of deal level match funding:

- In WWV, the target level of match funding is 1:1 (ie £1 for every £1 of ERDF invested). This is lower than the ratio achieved in WWV in the Wales JEREMIE Fund, and lower than the current ratio for the WBF.
- In EW, the ratio of deal level match is higher, at 1:1.25. The Wales JEREMIE Fund achieved a ratio of 1.1:1. The current WBF ratio is higher than this, but it should be noted that this is influenced by a small number of large deals.

[20] The reasons for this are set out in part A of this updated ex-ante assessment.

6.21 **Overall, the spatial split in investment and deal level match funding should be deliverable. The updated assessment is clear that there is sufficient demand in EW to accommodate this increase in fund size. In WWV, the assumed annual investment rates are higher than achieved in JEREMIE and it is currently behind profile. In addition, the projected investment is higher relative to the size of the economy in WWV compared to EW. This will need to be carefully managed and monitored in the delivery of the Fund.**

Sector Focus

6.22 Similar to the original investment strategy, the WBF will be flexible with regards to the sector focus. The Investment Strategy states that *"the Fund is generalist, rather than sector-specific, which will give the Fund flexibility to invest across all eligible sectors. ERDF eligibility criteria will apply. The Fund will support the Economic Action Plan, the Welsh Government's delivery approach to the 2017 Prosperity for all: a national strategy."*

6.23 **This is a sensible approach which ensures that the Fund contributes the Welsh Government's aspirations to develop key sectors, but maintains maximum flexibility in delivery.**

Modelling Assumptions

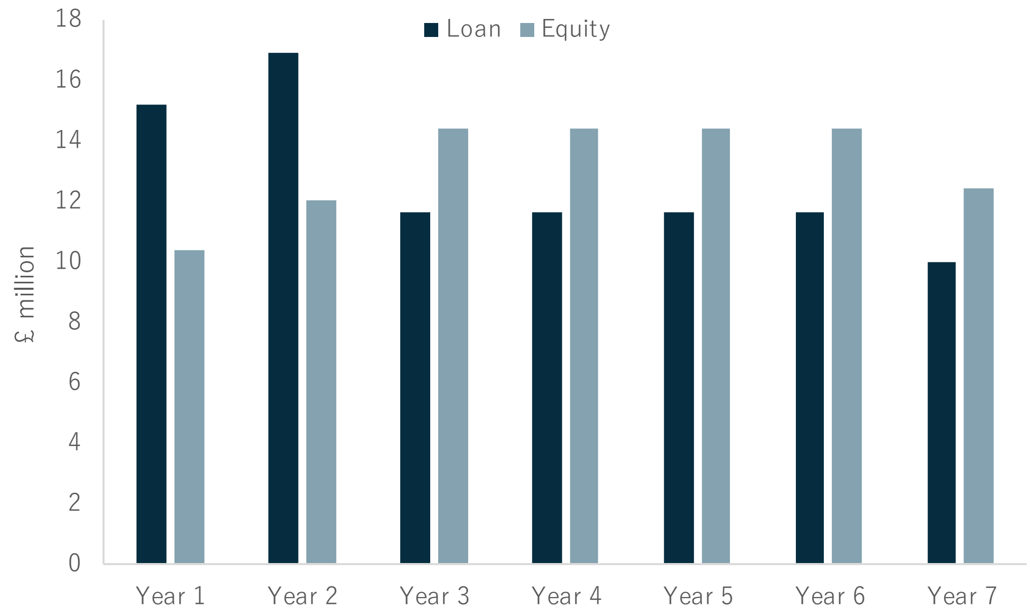
6.24 The WBF is underpinned by a detailed financial model, based on the DBWs considerable experience of delivering financial instruments in Wales. Many of the key assumptions remain the same as in the original investment strategy. Here we review the key changes to the main assumptions.

Investment rate

6.25 Both sub-funds will operate for 7 years. The profiled investment rates are outlined below.

- The equity fund is profiled to invest around £13.2m per annum. This is projected to be fairly constant over the investment period, with a high of £14.4m per annum between years 3-6.
- The loan fund is profiled to invest £12.6m per annum, with particularly high rates of investment in years 1 and 2 (this reflects actual investment achieved). The loan fund is currently ahead of this investment profile.

Figure 6.1 Annual Investment Rates £m



Source: Wales Business Fund Investment Strategy Revised (July 2018)

6.26 These assumptions have been subject to stress testing in the financial model, using a slower investment rate for both the equity and loan fund. In this event the fund will still be fully invested over the investment period, there would be no material impact on outputs or legacy.

Default Rate

6.27 The table below sets out the assumed default rates of each finance type in the WBF, compared to the default rates achieved in the JEREMIE. The overall conclusion is that **the assumed default rates are sensible, and in-line with experience from the Wales JEREMIE Fund, although the assumption for equity defaults appears ambitious.**

Table 6.4 Assumed Default Rate Assumptions

	WBF Assumption	JEREMIE	Comment
Loans	15%	13%	The base assumption of 15% default over the life of the Fund is reasonable given the performance of JEREMIE Loans Fund. It should be borne in mind that the JEREMIE default rate is partly

			influenced by the supply conditions during the period, which saw banks reduce SME lending. Consequently some of the propositions coming to JEREMIE were of a higher quality than originally anticipated, reflected in the lower default rate compared to the business plan (which was formulated before the financial crisis). The update market assessment evidence shows that supply constraints are likely to remain, and hence the assumed default rate looks prudent
Equity	40%	55%	The assumed default rate for the WBF is lower than the current rate for the Wales JEREMIE Fund, which itself is higher than its original business plan assumption (of 34%). The closer relationship between the DBW and Business Wales compared to the time of the Wales JEREMIE Fund could play role here - business propositions can be worked up to a higher standard prior to investment, and during the course of investment to minimise any default, Nevertheless this rate could be challenging to achieve.

6.28 The default rates are also subject to sensitivity testing, examining the impact of a 5 percentage points increase in the default rate across all portfolios. This has the impact of:

- Reducing the legacy returns available from the loan sub-fund by the end of the period from £54.9m to £49.2m (a 10% fall)
- Reducing the legacy returns from the equity fund from £44.5m to £37.4m (a 16% fall)
- Slowing the FTC repayment profile, although the date of full repayment of FTC remains unchanged (due to higher repayments occurring later).

Outputs

6.29 A set of core and value added output indicators have been included in the investment strategy, based on the performance of the Wales JEREMIE Fund. These are set out below.

6.30 **We judge that these outputs are appropriate. As the targets are drawn directly from the experience of delivering JEREMIE in Wales, we judge that this is a sensible approach to estimating outputs for WBF.**

Table 6.5 Summary of Projected Outputs

	Output targets for WBF		
	Loans	Equity	Total
Core Indicators			
No of enterprises supported	308	214	522
Private investment induced (£m)	£66.6	£72.4	£139
Employment increase in supported enterprises	3,025	1,183	4,208
No of enterprises supported to introduce new to the firm products	n/a	47	47
Value Added Indicators			
Jobs safeguarded	6,018	1,464	7,482
No of enterprises cooperating with supported institutions	n/a	26	26
No of enterprises supported to introduce new to the market products	n/a	34	34
No of patents registered for products	n/a	30	30

Source: Wales Business Fund Investment Strategy Revised (July 2018)

Value for Money

6.31 We have used the output targets outlined above to examine the value for money of the WBF. This has been done on an illustrative basis by looking at the gross and net (after legacy returns) cost per job created to ERDF and to the public sector. These unit costs have been compared to those experienced by other ERDF backed Funds, from evaluation evidence. The key points are:

- Based on ERDF investment costs only, the gross cost per gross job created is £31,800. Based on all public sector funding into the WBF (ERDF plus JEREMIE legacy plus FTC), the gross cost per gross job created is £43,000.
- The experience of JEREMIE and other publicly backed FIs suggests that loans appear to be more efficient in creating jobs than equity investments. However it should be noted that jobs created only captures one element of the benefit of equity investments, many of which are innovation intensive and have much higher productivity rates per job. This is one rationale for the added value output indicators for the WBF equity sub-fund. This unit cost is a little above that experienced by some other VCLFs. This may partly reflect the fact that the job creation forecast has been based on the experience of JEREMIE, for several years of which businesses were reluctant to expand.
- The net cost per net additional job created are illustrative, since we do not know the proportion of jobs created that will be net additional. To come up with net additional figures, we have taken evidence from the Final evaluation of the Wales JEREMIE Fund, which indicated that around 86% of gross jobs created were likely to be additional. The net cost calculations use the base forecast on the legacy returns generated by the WBF and is calculated as the gross ERDF investment cost less the projected legacy return to ERDF.
    - On this basis, the net cost to the public sector per net additional job created amounts to £9,500 overall. This represents good value for money and compares favourably to evaluation evidence from elsewhere.

Table 6.6 Value for Money Indicators

	Equity	Loans	Total
Gross cost per job created			
-ERDF	£59,100	£21,200	£31,800
-Public Sector	£78,100	£29,300	£43,000
Net ERDF cost per net additional job created	£26,800	£3,200	£9,500

Source: Regeneris Consulting calculations based on Wales Business Fund Investment Strategy Revised (July 2018)

6.32 **Overall, the proposals for the WBF represent good value for money on the basis of cost per job measures and compare favourably to benchmarks on performance elsewhere**

(both of previous SME FIs in England and Wales and the performance of the English JEREMIE Funds).

Governance

6.33 DBW Investments (14) Ltd is the appointed Holding Fund manager for the WBF (i.e. managing and administering the fund on behalf of Welsh Government), as an Entrusted Entity. This is a sensible approach given their experience, company structure and ownership. Since the original investment strategy, DBW FM Ltd was has been appointed to deliver the sub-funds following a competitive procurement process. The DBW has a successful track record as Holding Fund manager and Fund Managers of the Wales JEREMIE Fund and other Welsh Government funds.

Monitoring and Evaluation

6.34 The DBW has extensive experience in monitoring the delivery of ERDF backed investment funds

- The DBW operates a suite of IT systems to monitor and record fund performance data, which they have used previously for to monitor ERDF backed investment funds.
- Formal quarterly reports are produced, providing the basis for regular review meetings between the DBW, the DBW FM Ltd, and WEFO. Reports are also produced for the Programme Monitoring Committee.
- More detailed Annual Implementation Reports are produced for the European Commission, in a similar vein to the Wales JEREMIE Fund.
- Mid-term and final evaluations of the WBF will be commissioned, with external consultants to be appointed following a formal competitive procurement process.

6.35 We judge that suitable monitoring arrangements and plans for evaluation are in place for the WBF.

Summary of Review

6.36 A summary of the review is provided in table overleaf.

	What is being proposed?	Is the proposal sound, deliverable and evidence-based?
Proposed WBF size and composition	£180.9m pan-Wales Fund for all types of SMES, providing: • £88.5m in loans and mezzanine • £82.4m in equity funding (early stage and later stage risk capital)	The size and composition of the Fund in the revised investment strategy fits with the updated market evidence, and has been based on prudent assumptions, drawing on experience from delivering the Wales JEREMIE Fund, on what is deliverable over the investment period.
Funding Sources		
- Deal Level	£139m in deal level match is required, with £66.6m for loans and £72.4m for equity.	Whilst the deal match targets appear achievable, performance should be very carefully monitored, particularly for the loan fund, and particularly as the drawdown of ERDF funding is linked to this match funding. The investment strategy does state that should insufficient deal level match be secured to trigger ERDF drawdown, elements of FTC can be utilised for investment. For the equity fund, experience from the Wales JEREMIE Fund in securing match for equity deals and the co-investor networks that have been built up, suggest that the target is achievable.
Geographical Split	Split in funding between WWV and EW: • ERDF: WWV - £108.5m, EW - £25.4m • Overall – WWV - £125.5m, EW - £55.4m	The updated assessment is clear that there is sufficient demand in EW to accommodate this increase in fund size, and therefore the overall amount to be invested. In WWV, the assumed annual investment rates are higher than achieved in JEREMIE and it is currently behind profile. In addition, the projected investment is higher relative to the size of the economy in

		WWV compared to EW. This will need to be carefully managed and monitored in the delivery of the Fund.
Sector Focus	Similar to the original investment strategy, the WBF will be flexible with regards to the sector focus.	This is a sensible approach which ensures that the Fund contributes the Welsh Government's aspirations to develop key sectors, but maintains maximum flexibility in delivery.
Modelling Assumptions		
- Investment Rate	The model assumes the following investment rates: • Loans: £12.6m per annum, with a high of £15.2m and £16.9m in years 1 and 2. • Equity: £13.2m per annum, rising to £14.4m between years 3-6	The investment rates appear deliverable and have been subject to stress testing, which shows no material impact on outputs or legacy.
- Default Rate	The financial model assumes the following default rates: • Loans: 15% • Equity: 40%	These assumptions compare to the following default rates for the Wales JEREMIE Fund • Loans: 13% • Mezzanine: 25% • Equity: 55% The assumed default rates are therefore sensible, although the assumption for equity defaults appears ambitious.
- Outputs	A range of outputs have been forecast, including a set of core and added value indicators.	These outputs are appropriate. Since the targets are drawn directly from the experience of delivering JEREMIE in Wales, we judge that this is a sensible approach to estimating outputs for WBF.
Value for Money	On the basis of jobs created, the WBF is projected to have the following unit costs:	The proposals for the WBF represent good value for money on the basis of cost per job measures and compare favourably to

	• Gross ERDF cost per gross job created: £31,800 • Gross public sector cost per gross job created: £43,000 • Net ERDF cost per net additional job created: £9,500	benchmarks on performance elsewhere (both of previous SME FIs in England and Wales and the performance of the English JEREMIE Funds). They are roughly in-line with the benchmarks for the Welsh JERMIE Fund (taking into account the uncertainty regarding the legacy forecast).
Governance	DBW Investments (14) Ltd acting as an entrusted entity to act as the Fund administrator. DBW FM Ltd acting as fund managers for both loan and equity sub-funds.	This approach is consistent with EU guidance and is sensible given DBW experience and status as subsidiary of Welsh Government.
Monitoring and Evaluation	DBW will produce formal quarterly reports, reports for the PMC, and detailed annual reports for the European Commission. External consultants will be appointed following a competitive tender process for mid-term and final evaluations of the Fund.	We judge that suitable monitoring arrangements and plans for evaluation are in place for the WBF.

Appendix A - Consultee List

Table 6.7 Consultee List	
Name	Organisation
Ben Cottam	Federation of Small Businesses
Chris Moon	DBW
David Notley	Impact Innovation
Huw Bryer	Business Wales
Mike Wallwork	WEFO
Rhian Elston	DBW
Rob Hunter	DBW
Robert Lloyd Griffiths	Institute of Directors
Sian Price	DBW
Steve Smith	DBW

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